

# Social Bridges II

## The importance of human capital for growth and social inclusion

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A joint paper by the Swedish Ministry of Finance,  
German Ministry of Finance and HM Treasury

Stockholm, Berlin & London March 2008



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# EXECUTIVE SUMMARY

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## AN INCLUSIVE AND SOCIAL RESPONSE TO GLOBALISATION

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The rapidly changing global economy has presented Europe with a series of new social, economic and demographic challenges, but also unprecedented opportunities, through more and better jobs, continued economic growth and rising levels of prosperity. To maximise the opportunities from globalisation and to ensure that the benefits are shared between all citizens, Europe must combine flexibility and fairness while providing opportunity for all. The adjustment costs associated with globalisation are small compared to the potential gains, but they can be significant for those individuals, sectors or regions adversely affected by structural change, and can emerge as costs such as job losses, welfare dependency and social exclusion. These costs can often be more visible than the greater benefits, and can lead to feelings of insecurity and declining aspirations that can perpetuate across generations and have an effect on social mobility and cohesion. As governments we must act to shape an inclusive globalisation in line with our shared European social values to ensure prosperity and fairness for future generations.

In the first Social Bridges paper, written jointly by the Swedish and United Kingdom finance ministries, we set out a joint vision for a socially inclusive response to globalisation that combines modern economic and social policies to deliver sustainable economic growth and social inclusion. These policies need not be in conflict, as some may suggest, but can be mutually reinforcing providing flexibility and fairness together. Economic policies must entrench macroeconomic stability and embrace open and flexible product markets, capital markets and labour markets. Social policies need to enhance employability, expand opportunity and choice, provide security for the vulnerable and help people to adapt and master change.

### The importance of human capital for growth and social inclusion

In this follow-up paper, written jointly by the finance ministries of Germany, Sweden and the United Kingdom, we build on that approach, but focus specifically on the issue of human capital for promoting employability and social cohesion. The knowledge-based economy favours labour market entrants and workers with higher skills, while technological and structural change may require new and different types of skills, which will need to be updated throughout the lifecycle. Human capital formation is therefore crucial – to promote opportunity and employability of workers, and to increase the innovative capacity of companies and economies. Demographic change makes a culture of lifelong learning even more important. Education alone, however, is not enough. It has to be complemented by policies to remove barriers to labour market participation, and set in the context of well-functioning labour, product and capital markets and macroeconomic stability that together allow for high levels of job creation and international competitiveness.

European Member States share the same fundamental social values, and we can come together to identify common challenges and agree strategic objectives even when the main responsibility to achieve them lies with Member States finding policy responses specific to their traditions and institutions. We have identified some common features of successful policies and drawn on examples of modern policy design and

development from across Europe, so we can begin to learn together and from each other. In order to equip our citizens with the necessary skills to make the most of the opportunities in the global age, public policies need to relate to the new social and economic environment and build better Social Bridges across the lifecycle, by:

- earlier and sustained interventions in pre-school learning, in order to give all children the best possible start in life as well as to support the labour market participation of parents;
- raising standards and achievement in primary and secondary education to ensure all our children have the necessary core skills to enter and progress in the labour market or to build on these skills by attending further or higher education;
- providing greater choice in the education system by offering real alternatives to academic routes through vocational training and apprenticeships ensuring all children can realise their potential;
- improving access to tertiary education and ensuring high quality in order to meet the demands of a knowledge-rich and more competitive global economy;
- embracing a culture of lifelong learning by creating opportunities for adult and in-work education that can help entry and progression in the labour market; and
- reducing barriers to labour market participation especially for those at the margin, including older workers, and by addressing disincentives created by high marginal tax rates.

## The role of public finances

Finance ministers have a key role to play in this debate in both the domestic and European context. The challenge for Member States remains to make more efficient use of public expenditure that allows for sufficient investment in future orientated policies, such as human capital formation, while respecting the Stability and Growth Pact. This requires addressing the need for rigorous policy evaluation and also raises the question of how to better balance expenditure with structural reforms to improve outcomes. It is a priority because of the importance of sustainable public finances in the face of demographic change.

Effective and efficient policies that improve human capital formation and labour market participation can contribute to an improved economic and fiscal position by:

- improving the skills of the workforce contributing to innovation, productivity and competitiveness and attracting foreign direct investment;
- higher employment rates that can raise tax revenues; and
- improving fiscal sustainability over the longer term by reducing social expenditures including on welfare and Back to Work programmes.

# INTRODUCTION

**1.1** Globalisation and structural change are major sources of economic and social opportunity for Europe and its citizens. The potential benefits are huge: new technologies, cheaper imports, larger export markets and dynamic gains through increased competition all offer the prospect of greater rewards, lower prices and rising standards of living. It has been estimated that globalisation could increase permanent annual income in the EU by as much as 8 per cent, equivalent to €800 billion over the next 50 years.<sup>1</sup>

**1.2** To maximise the opportunities from globalisation, and to ensure the benefits are shared between all citizens, Europe must combine flexibility with fairness while providing opportunity for all. Through the Lisbon Strategy, Member States have already committed to ongoing economic and social reforms at the national level designed to deliver greater openness and flexibility, while supporting effective adjustment to global change, widening labour market participation, and increasing social inclusion.

**1.3** The adjustment costs associated with globalisation are small at the aggregate level when compared to the potential gains, but they can be significant for those individuals, sectors and regions adversely affected by structural change. This may help explain why almost half of Europe's citizens feel threatened by globalisation and its impact on companies and jobs.<sup>2</sup> Moreover, these feelings of insecurity are often most pronounced among those individuals from more disadvantaged backgrounds or with low skills, who are less well equipped to deal with structural change. It is therefore essential that Member States develop policies that ease the adjustment process for those people most affected by structural change and promote high levels of labour market participation and social inclusion. This represents a modern and inclusive response to globalisation.

## THE SOCIAL BRIDGES APPROACH: LABOUR MARKET PARTICIPATION AND SOCIAL INCLUSION

**1.4** In the past, policy makers have at times sought to alleviate the effects of structural change through various forms of protection and income support. While this type of insurance plays an important role in safeguarding security and helping to ease transitions, traditional policies often turned out to be less effective and failed to provide the right incentives for people to enter the labour market. Rather than providing the long-term security that was intended, the result was often benefit dependency and increased social exclusion.

**1.5** The Social Bridges approach is a modern policy framework that aims to improve individuals' employability to increase labour market participation and social inclusion. It makes clear that, in order for Europe to meet the increasing competition in the global economy, measures to help individuals to adapt to change have to be combined with well-functioning labour, product and capital markets that facilitate innovation and job creation.

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<sup>1</sup> European Commission, DGECFIN, Globalisation: Trends, issues and macro implications for the EU, July 2006.

<sup>2</sup> European Commission, Flash Eurobarometer: The Future of Europe, May 2006. 47 per cent of those interviewed perceive globalisation to be a threat to employment and companies, as opposed to 37 per cent who see globalisation as an opportunity.

**Box 1.1: Social Bridges – equipping workers to meet the challenges of globalisation**

The term Social Bridges describes a modern policy framework where macro and microeconomic policies combine, allowing individuals, and society as a whole, to benefit from the greater opportunities of globalisation and increasing labour market participation and social inclusion. The responsibilities within such an approach fall to individuals, businesses and government.

This needs to take place in the context of macroeconomic stability, combined with well-functioning and flexible labour, product, and capital markets:

- **labour markets** – should allow for the efficient reallocation of labour into growth sectors, thus aiding individuals to shorten possible unemployment spells and to move between jobs;
- **capital markets** – should enable capital to be deployed efficiently by businesses, entrepreneurs and innovators into growth sectors and products, ensuring individuals have access to the necessary funds to deliver innovations to the market; and
- **product markets** – should enable firms to adapt to changing market conditions, exploit new opportunities and create a dynamic and thriving market that creates new jobs and employment opportunities.

Within this framework, Social Bridges-based policies can provide insurance in the broadest sense for the individual through:

- **efficient and well-designed active labour market policies** that help individuals to find jobs and enter the labour market, and can help promote social inclusion;
- **lifelong learning and skills policies** to improve employability and provide access to retraining and upgrading of skills;
- **policies that make work pay** and increase labour participation; and
- **well designed unemployment insurance programmes** that ease transitions, while providing help for the vulnerable and do not create poverty or dependency traps.

The Social Bridges approach protects individuals' employability, not specific jobs. By equipping people with the necessary skills to manage and adapt to change, governments can provide opportunities for individuals to move from one job to the next, ease transitions from unemployment to employment, and provide employment security over the longer term.

**1.6** This approach was explored in a joint paper published in April 2006 by the Swedish and United Kingdom finance ministries.<sup>3</sup> This follow-up paper, written jointly by the finance ministries of Germany, Sweden and the United Kingdom, builds on the ideas set out in the previous paper, and focuses more specifically on the issue of human capital and the importance of effective social, education and skills policies for promoting employment and social cohesion.

## Human capital – an essential social bridge

**1.7** In today's integrated global economy, Europe is often competing by producing high-tech, high value-added goods and services. This shift towards a more knowledge-based economy is placing greater emphasis on the skills of the workforce. As new jobs

<sup>3</sup> The Swedish Finance Ministry and HM Treasury, Social Bridges – meeting the challenges of globalisation, April 2006.

demand new and often more advanced skills, each generation entering the labour market needs to be better educated and better trained than the previous generation. At the same time, rapid technological and structural change means that people also need to retrain and update their skills throughout their working lives.

**1.8** A comprehensive and inclusive policy approach is required that fosters human capital formation and labour market participation throughout the lifecycle, to ensure that individuals are equipped to work in today's economy and can adapt to work in tomorrow's. This modern policy approach includes not only education, skills and labour market policy, but also family and integration policies. Policies that seek to enhance an individual's human capital – for example through training and education – need to be complemented by policies that remove barriers and disincentives to work, especially for groups and individuals on the margins of the labour market.

## The European dimension

**1.9** European-level discussions can help us address shared concerns in the context of shared European social values that combine flexibility and fairness. The responsibility for structural and social policies lies with national governments. National governments can react to problems quickly and tailor policies to take account of specific national circumstances, such as demographics, and labour market institutions. They can also better represent electoral preferences. But while there are no “one size fits all” solutions, Europe can act as a catalyst for change, identifying opportunities and common challenges, promoting solutions, exchanging best practice and agreeing strategic objectives. As such, efficient co-operation, including exchange of best practices and learning from good examples, between Member States can add significant value.

**1.10** This is the starting point for the current discussion at the EU level on “flexicurity”.<sup>4</sup> Both approaches – Social Bridges and flexicurity – represent modern and inclusive policy responses to globalisation. While flexicurity represents one means to an end which stresses the need for better functioning labour markets and improving employment security for individuals, Social Bridges is a broader concept that covers a wider range of macro and micro policies supporting an individual's development, employability and social inclusion. The two concepts are consistent and complementary approaches.

**1.11** The European Union can help national governments by advancing the debate on skills. Effective education and skills policies, designed and implemented by Member States, are central to meeting the new and emerging challenges in the global economy. An open debate at the European level on skills policy, and how it interacts with employment policy, could help better exploit the synergies and links between skills and employment.

## THE ROLE OF PUBLIC FINANCES

**1.12** Ensuring fiscal sustainability in the face of economic and social challenges is an important factor determining how successfully Member States and the European Union can respond to globalisation. A key concern for EU finance ministers is how to better align structural change and fiscal sustainability in the face of these challenges. Policies that support human capital formation are particularly useful as they can increase

<sup>4</sup> European Commission Communication, Towards common principles of flexicurity, June 2007.

productivity and labour market participation, potentially generating a broader revenue base and reducing social expenditures, creating a more socially cohesive society.

**1.13** However, there is a growing consensus amongst EU finance ministers on the need to focus on the quality of public spending – judging the effectiveness of spending programmes in terms of the results and outcomes they deliver.<sup>5</sup> Higher levels of investment, for example in human capital, do not necessarily guarantee better results and it is therefore important that spending programmes offer good value for money and are compatible with maintaining fiscal discipline. Increasing the efficiency and effectiveness of public spending also helps to fulfil the requirements of the Stability and Growth Pact and is instrumental in promoting the Lisbon structural reform agenda.

**Structure of the paper**

**1.14** This paper sets out the current challenges of globalisation and structural change for economic and fiscal policy in Chapter 2, before addressing the role of human capital policy in both an economic and social context in Chapter 3. In Chapter 4, the paper discusses a lifecycle policy approach to education and labour market, before making some preliminary conclusions in Chapter 5.

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<sup>5</sup> As highlighted by finance ministers during a discussion at the Informal ECOFIN in Berlin on 20-21 April 2007.

# 2

## SOCIO-ECONOMIC TRENDS AND CHALLENGES

**2.1** The European economies face significant economic and social challenges. Globalisation and rapid structural change have increased the need to adjust. Such change has created unprecedented opportunities and huge potential benefits, as well as having a profound impact on the workforce and on skills requirements. This change carries a related risk of economic segmentation and social exclusion. In addition, demographic changes have important repercussions on labour markets and public finances. Taken together, these developments illustrate the importance of policies that look to develop and utilise the human capital of the population.

### Structural change

**2.2** The location and composition of global economic activity has shifted dramatically in recent decades. Global sourcing of goods and services has replaced national sourcing and Europe is increasingly specialising in knowledge rich, high-tech goods and services, affecting the demand for skills in the workforce.<sup>6</sup>

- Today, China and India already account for over 20 per cent of world output and this is expected to rise to 27 per cent by 2015.<sup>7</sup> Developing economies, particular in Asia, are increasingly exporting not only labour-intensive manufacturing goods but also high-tech goods based on technologies developed in advanced economies.
- In the EU services now account for around 70 per cent of value added and employment.<sup>8</sup> This has led to an increasing demand for high skilled labour and resulted in skill shortages in some parts of the EU. For example, in Latvia, Lithuania, the Czech Republic, Poland, Hungary and Romania a lack of higher skills in the available workforce was seen as an important constraint to future firm growth by 35-45 per cent of firms.<sup>9</sup>



<sup>6</sup> See, for instance: The Great Doubling, Richard Freeman, 2005.

<sup>7</sup> European Commission Economic Papers, DGEFIN, Globalisation: Trends, issues and macro implication for the EU, July 2006.

<sup>8</sup> HM Treasury, The Single Market – a vision for the 21<sup>st</sup> Century, 2007.

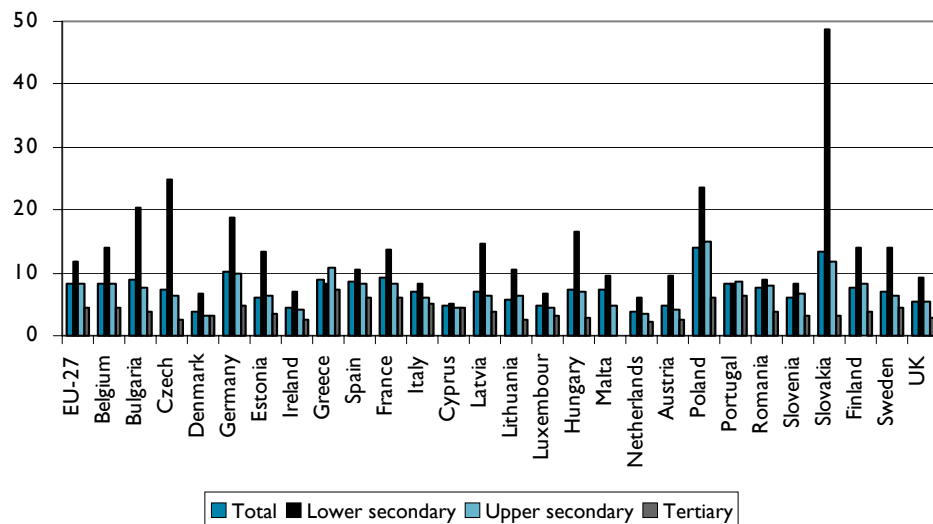
<sup>9</sup> World Bank, EU8+2 Regular Economic Report – part II: Labour markets in the EU8+2, September 2007.

## Labour market segmentation and social exclusion

**2.3** Despite improving labour market performance across the EU in recent years, labour market segmentation and significant social exclusion persists. The level of labour market participation remains low for certain groups in some Member States, such as older workers, women and migrants. Unemployment and the risk of poverty remains too high, particularly for those with no, limited or outdated qualifications and skills. Across Europe:

- around 17 million people remain unemployed, 40 per cent of whom have been unemployed for 12 months or more;
- nearly one in five young people are out of work;<sup>10</sup>
- the average unemployment rate for low skilled workers is around 10 per cent compared to around 7 per cent for those with upper secondary education and 4 per cent for those with tertiary education;<sup>11</sup>
- the employment rate of women, at 57 per cent, remains much lower than for men at 72 per cent, with wide differences across individual Member States;
- the average participation rate for older workers is only 44 per cent;<sup>12</sup> and
- almost 10 per cent of the population live in workless households. The risk of poverty for workless households with dependent children is 68 per cent as opposed to only 5 per cent for households with at least one member in full time employment.<sup>13</sup>

**Chart 2.2: Unemployment rate by level of education 2006**



Source: Eurostat

<sup>10</sup> Eurostat online database, August 2007.

<sup>11</sup> Eurostat online database (data set: Unemployment rates of the population 25-64 by level of education, 2006) and OECD International Migration Outlook, Paris 2007.

<sup>12</sup> Eurostat online database, (data set: Employment of older workers, 2006).

<sup>13</sup> Eurostat pocketbooks: Living conditions in Europe, 2007 edition, table 4.3, page 80.

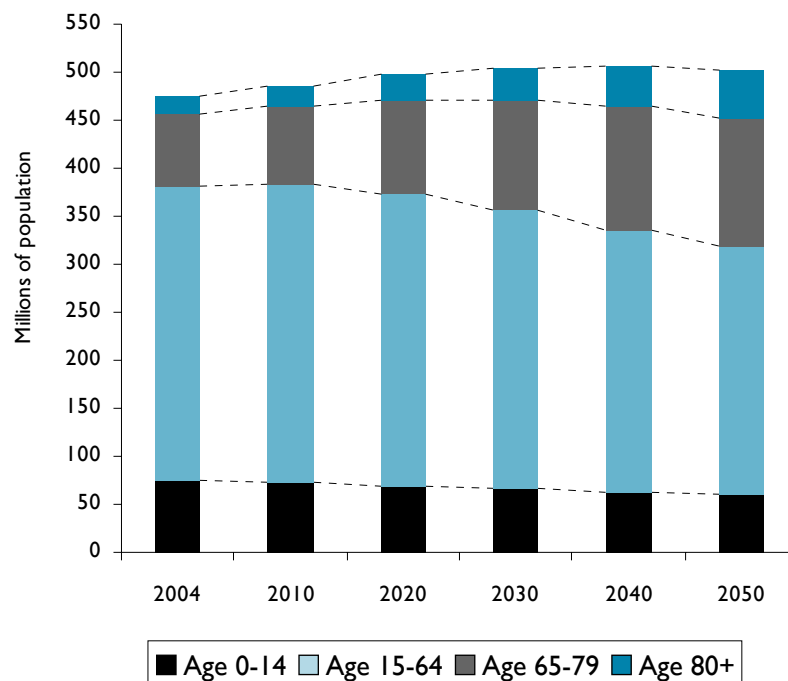
## Pressures from demographic change

**2.4** It is estimated that Europe’s population in 2050 will be slightly smaller and much older. As a result the age dependency ratio is set to rise which is likely to have consequences for economic growth as well as for the sustainability of public finances and social security systems, although the effect will vary between Member States:

- the working age population is expected to fall by 16 per cent, or 48 million, between now and 2050;
- over the same period, the population aged 65 and over is likely to rise sharply, by 58 million, or 77 per cent;
- Europe will go from having four people of working age for every elderly citizen today to a ratio of two to one by 2050;<sup>14</sup> and
- as a result of demographic changes, the public spending rates in the EU15 are projected to increase by 4 percentage points by 2050, mostly because of increasing expenditures on pensions, health services and long-term care.<sup>15</sup>

**2.5** These demographic changes will create a number of challenges. In order to sustain economic growth it will be necessary to increase participation rates and productivity, and extend working lives. Only by utilising the existing human capital of national populations, and by investing in and improving education and skills policies throughout the lifecycle, can Europe meet the challenges of demographic change.

**Chart 2.3: Projections of age distribution 2004 – 2050 (EU25)**



Source: European Commission, *European Economy, Special Report No. 4, 2005*

<sup>14</sup> Economic Policy Committee, European Commission, *The impact of ageing populations on public spending*, 2006.

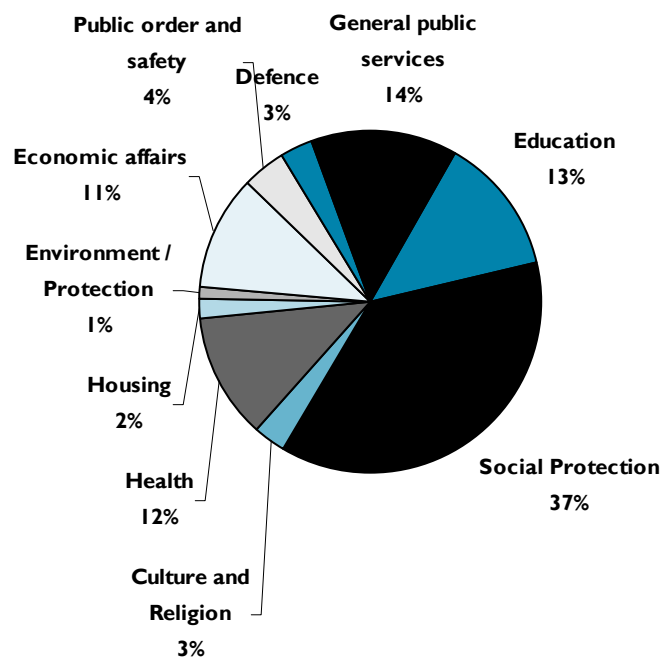
<sup>15</sup> Ibid.

## Sustainability of public finances

**2.6** With high debt ratios in many EU Member States and budgetary pressures resulting from future demographic trends, attaining sustainable public finances will be a significant challenge for European finance ministers.

- The budget deficit for the EU improved in 2007, but the Commission has noted that some Member States have not fully seized the opportunity provided by a favourable economic environment.
- Despite a broadly downward trend, which is partly cyclical in nature, the average government gross debt in the EU is expected to amount to 59.5 per cent in 2007. This development is partly cyclical. There remain sizeable differences across Member States ranging from below 10 per cent in Estonia and Luxembourg to above 100 per cent in Italy by 2008.<sup>16</sup>
- As a percentage of total expenditure across the EU, average expenditure on public sector investment is at 5 per cent, compared to relatively high levels of expenditure accounted for by subsidies, transfers and the servicing of public sector debt that stood at 43 per cent of total expenditure in 2004.<sup>17</sup>

**Chart 2.4: Average public expenditure by function (EU25)**



Source: European Commission, *Effectiveness and Efficiency of Public Spending*, February 2007

<sup>16</sup> Figure for 2006. European Commission, Autumn Economic Forecast, 2007.

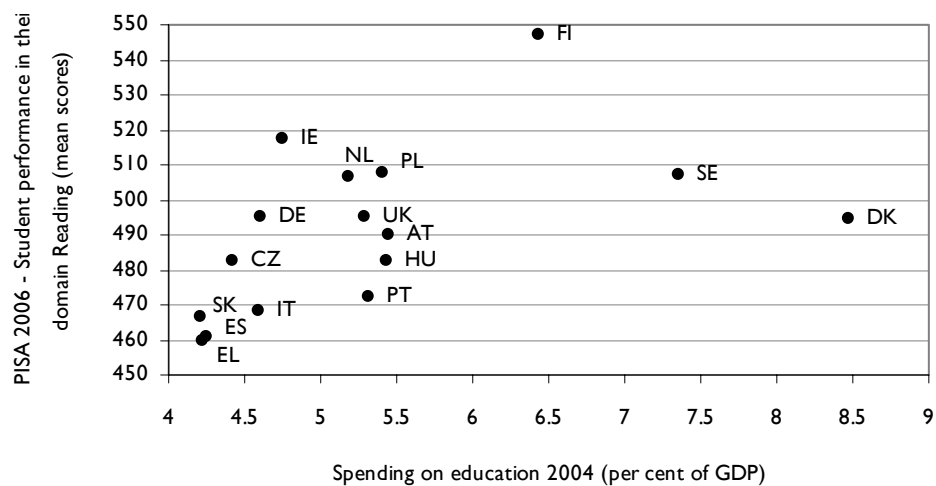
<sup>17</sup> European Commission Services. Countries included are Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Lithuania, the Netherlands, Austria, Portugal, Finland, Sweden and the UK.

- Evaluations demonstrate wide differences in efficiency and effectiveness of public policies in Member States, for example for labour market policy,<sup>18</sup> health care<sup>19</sup> and education.<sup>20</sup>

**2.7** With the need to ensure sound fiscal positions across Europe, the challenge for Member States remains to make more efficient use of public expenditure that allows for sufficient investment in future orientated policies, such as human capital formation, while respecting the Stability and Growth Pact and, for Members of the Eurozone, the additional commitment to aim at reaching their respective Medium Term Objective by 2010 at the latest.

**2.8** In Europe the average level of social policy expenditure accounts for roughly half of total public expenditure, of which around 13 per cent is focussed on education and skills related expenditure. However, while this relatively high level of expenditure in most Member States highlights the importance of education, high spending does not necessarily lead to improved outputs or results. Indeed, while investment can have a positive effect, other factors are also important.

**Chart 2.5: Performance of pupils in relation to expenditure on education**



Source: OECD; Eurostat online

**2.9** In many cases the same results could be achieved at lower levels of spending or better outcomes achieved by improving the quality of provision without raising levels of expenditure. A recent study by the OECD suggests that there is potential for increasing learning outcomes by up to 22 per cent within the current levels of expenditure.<sup>21</sup> This highlights the importance of efficient, equitable and outcome focused policies.

<sup>18</sup> See, most notably, OECD studies and reports. For recent surveys, see Employment Outlook 2005, Chapter 4 and Employment Outlook 2006, Chapters 2–7.

<sup>19</sup> World Health Organisation, The World Health Report 2000: Health Systems – improving performance, Geneva 2000; and Edward Kelley and Jeremy Hurst, Health Care Quality Indicators project: Initial indicators report, OECD Health working papers 22, Paris 2006.

<sup>20</sup> See, for instance, the OECD PISA studies and OECD Education at a Glance, 2005, 2006 and 2007.

<sup>21</sup> OECD, Education at a Glance 2007.



**3.1** The economic and demographic trends set out in Chapter 2 create both opportunities and challenges for Europe’s policymakers. As the economic and social environment changes, government policies need to adapt and modernise to enable prosperity and social justice to advance together. Social Bridges from one job to the next can improve citizens’ security, equipping them to cope better with the impact of global change by enhancing their employability. Measures to maintain and raise individuals’ human capital are a central element of this approach.

### THE IMPORTANCE OF HUMAN CAPITAL FOR GROWTH AND SOCIAL INCLUSION

**3.2** Human capital is a central concept in economics and the social sciences. Broadly speaking, it can be described as the total knowledge and skills individuals possess, which is mainly determined by upbringing, education, training and experience. It includes not only knowledge and skills that are deployed in work to earn income but also social skills. Human capital is a key determinant of productivity, wages and other economic and social outcomes, both at the microeconomic and the macroeconomic level.<sup>22</sup>

**3.3** Human capital in general has a positive effect on well-being, social mobility and levels of social inclusion by increasing a person’s capacity to integrate in society. However, in many European countries we observe trends in society that limit the ability of some individuals to obtain and improve their levels of human capital, which can contribute to increased segmentation and social exclusion. For example, a recent study by the OECD estimates that students are more likely to participate in higher education if their parents completed higher education, although this differs across countries.<sup>23</sup> Empirical evidence also suggests that inequalities in human capital endowment tend to perpetuate across generations in countries where the school system is less open and flexible.<sup>24</sup>

**3.4** Human capital is particularly important in knowledge-based economies. A highly skilled workforce facilitates the dissemination of technological progress. It helps firms to update working practices, technologies and products at the rate demanded by rapidly changing markets, making the economy more flexible and productive in the longer term.<sup>25</sup> Moreover, skills are a main driver of innovation and fundamental to effective leadership and management. Human capital is fundamental in allowing firms and workers at all skill levels to successfully adapt to meet new challenges.

**3.5** During periods of rapid technological and structural change, human capital will usually depreciate more quickly. This means that policies aimed at increasing human capital need to be based on the principles of lifelong learning and continuous ongoing training.

<sup>22</sup> For surveys of the literature of advanced economies, see Angel de la Fuente, Antonio Ciccone, Human Capital in global and knowledge based economy, report for the European Commission, 2002 and Alan B. Kruger, Mikael Lindahl, Education for Growth: Why and for Whom?, Journal of economic literature 39, December 2001, pp 1101-1136.

<sup>23</sup> Students from such a background are more than twice as likely to attend higher education in Austria, France, Germany, Portugal and the UK. Source OECD Education at a Glance 2007 indicator A7.

<sup>24</sup> See again the OECD PISA study 2003 on the US and Benjamin Friedman, ed., Inequality in America: What role for human capital policies, Cambridge, Mass: MIT Press, 2002.

<sup>25</sup> The Leitch Review of Skills, Prosperity for all in the global economy – world class skills, 2006.

**Box 3.1: Human capital**

Economic research shows human capital to be a key determinant of productivity, wages and economic growth:

**At the microeconomic level:**

- there is clear evidence that school attainment is a primary determinant of an individual's future income and labour prospects. An additional year of schooling increases wages at the individual level on average by around 7 per cent across European countries;<sup>26</sup>
- lifetime earnings for graduates are almost 60 per cent higher than for those with only an upper secondary education; and
- firm-level data show that a highly skilled workforce increases a company's productivity, innovation and long-term competitiveness.

**At the macroeconomic level:**

- evidence shows human capital is an important determinant of productivity growth, although uncertainty remains about the size of its effect; and
- a recent study by the Lisbon Council and the OECD estimates that an additional year of education could increase productivity and economic output by between 3 and 6 per cent.

Source: OECD *Education at a Glance 2006*; Fuente and Ciccone cited above p 15; The Lisbon Council, *The Economics of knowledge: Why Education is key for Europe's success*, June 2006

## PUBLIC AND PRIVATE RESPONSIBILITY FOR HUMAN CAPITAL FORMATION

**3.6** Governments provide significant financial support to parents and children, financing compulsory education almost completely, subsidising vocational education and retraining for the unemployed, and funding a large proportion of tertiary education. However, limited fiscal resources make it necessary for Europe to consider the respective contributions of individuals, business and governments in financing education and training, including an assessment on who is best placed to promote human capital.

**3.7** From an economic perspective, there is an argument for governments to direct their assistance towards those areas where society as a whole can benefit most. Fiscal support for pre-school to secondary education is particularly important, because the social returns to education are especially high, particularly for children from disadvantaged social backgrounds. On the other hand, in tertiary education, social returns seem to be closer to private returns as individuals are less likely to be at risk of unemployment or social exclusion. Hence, it could be argued that individuals should assume more responsibility for financing their human capital when the increase in skill level translates into individual economic rewards, for instance in higher wages or career progression.

<sup>26</sup> For a survey of the literature on so-called Mincer wage regressions, see Fuente, Ciccone, cited above, p. 11; for Germany, 6 per cent are estimated, as reported in ZEW news, May 2007. On estimates for total returns of different stages of education, see also OECD, *Education at a Glance 2006*, Indicators A9, pp. 120ff, and OECD, *Human Capital Investment: An International Comparison*, chapter 4, Paris 1998.

**3.8** In most Member States, employers and employees undertake in-work related training because they benefit directly from the returns to that investment, through higher profits and wages. However, for individuals who leave school early and who have low levels of numeracy and literacy, there is a stronger case for public support since benefits to the wider community from further training are likely to exceed the private returns. In the case of retraining of older workers, the respective benefits and costs need to be carefully evaluated.

**3.9** The decision on how to finance the education system depends on economic and also political and social considerations that are unique to each Member State. What is clear, however, is the importance of considering the investment in education and training across an individual's lifetime and also of examining both labour market and education policies, since both impact on an individual's human capital.



# 4

## POLICY AND DELIVERY – AN INTEGRATED APPROACH

**4.1** This chapter follows a lifecycle approach to human capital formation. It looks at economic, education, skills and labour market elements of policy and delivery, drawing on common features of skills policies, with examples of good practice from across Europe. It begins by looking at pre-school education, before exploring the different strands of education policies: vocational and professional training. To complement this approach, this chapter also highlights the synergies between labour market and skills policies, and looks at a set of specific labour market policy issues.

### EARLY YEARS AND PRE-SCHOOL EDUCATION

**4.2** One of the primary responsibilities of all governments is to provide children with the best possible opportunities. A well-developed pre-school system is an important part of any comprehensive strategy for enhancing human capital and tackling disadvantage. Empirical evidence suggests that investment in pre-school education and childcare achieves very high social and private rates of return and is essential for building a child's capacity for future learning.<sup>27</sup> Pre-school investment also offers significant benefits for children from disadvantaged backgrounds, enhances social inclusion and equity, and reduces the likelihood of social expenditure on these individuals in later years.<sup>28</sup>

#### **Box 4.1: National Childcare Investment Programme (NCIP) 2006-2010 in Ireland**

The National Childcare Investment Programme (NICP) is part of the national Childcare Strategy for 2006-2010 launched by the Irish government in 2005 to succeed the Equal Opportunities Childcare Programme (EOCP). The NICP makes large-scale capital grants available to childcare providers both in the private and the community sectors with the aim to create additional childcare places, but also to strengthen broader objectives such as improving the quality of early childhood care, supporting families and breaking the cycle of disadvantage. In July 2007 a new NCIP Community Childcare Subvention Scheme (2008-2010) was launched which is designed to target resources more effectively to disadvantaged parents with children in community childcare services. It is available to community based not-for-profit childcare services to enable them to provide not only quality childcare services, but also to offer reduced fees to disadvantaged parents by means of an effective tiered fee system. Community childcare services will receive subsidies for parents in receipt of social welfare payments or those in education, training or work experience programmes where an underlying entitlement to welfare payment is established, and for persons in receipt of Family Income Supplement.

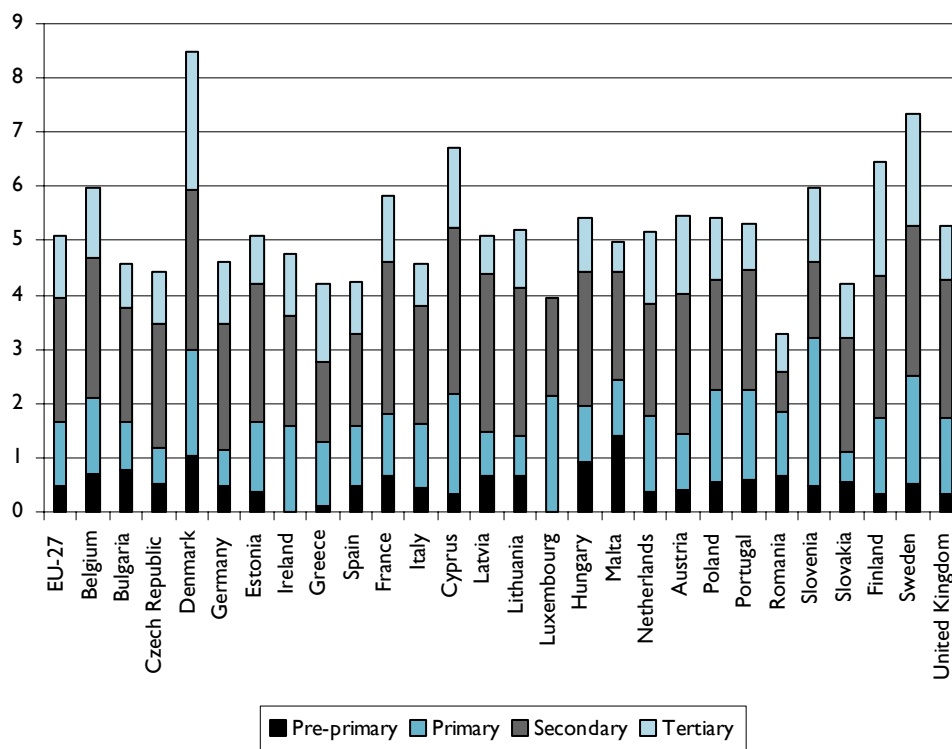
*Source: Ireland: Implementation of the National Reform Programme, 2007*

<sup>27</sup> European Commission, Efficiency and Equity in European Education and training systems, 2006.

<sup>28</sup> Ibid. For example, a study in the US found that for every \$1 spent on pre-school education the general public gained a return to society of as much as \$17.

**4.3** Although public investment in pre-school education remains at relatively low levels in Europe, many countries are now introducing pre-school education: investing in children starting at age three or four, rather than at age five or six. Ireland has recently expanded the National Childcare Investment Programme, which focuses on tackling disadvantage.<sup>29</sup>

**Chart 4.1: Education expenditure by level of education (per cent of GDP), 2004<sup>30</sup>**



Source: Eurostat

**4.4** In addition to improving educational attainment, well designed pre-school policies can also lead to a significant improvement in labour market participation, especially for women, by enabling them to re-enter employment more quickly after having children. High quality and universally accessible childcare facilities give both parents the opportunity to better reconcile work and family life. Increases in the female employment rate in some countries – notably Sweden, Denmark, Finland and the Netherlands – can in part be attributed to an increased availability of childcare facilities.<sup>31</sup> So by enabling women and men to find the right balance between family and working life, more efficient use is made of the skills of the entire population. Access to good quality childcare can also play a critical role in helping families break cycles of deprivation. Extending opportunities within and across generations brings significant long-term social and economic benefits for all.

<sup>29</sup> Department of the Taoiseach, Implementing the National Reform Programme, 2006 and The Lisbon Agenda – The integrated guidelines for growth and jobs, National reform programme Ireland, 2005.

<sup>30</sup> Some caution should be used when interpreting the figures for pre-primary expenditure, as they do not include expenditure on all childcare activities in some countries.

<sup>31</sup> European Commission, Employment in Europe 2006.

**Box 4.2: Universal childcare in Sweden**

Sweden has a long tradition of high quality and affordable childcare mainly financed from general taxation. It is available to all income groups and designed to encourage labour market participation and social inclusion. Responsibility for pre-school provision rests primarily with the municipalities which are obliged by law to provide a place from the age of one and to do so without “unreasonable delay”. A maximum fee equivalent to around €135 per month covers both pre-school and out-of-school childcare for parents with one child. The maximum fee per child then decreases with the number of children attending childcare. A total of 84 per cent of all children aged one to five were enrolled in a preschool or family day-care home in 2006. These family-friendly employment and welfare policies significantly help parents to combine family and paid work. 85 per cent of Swedish mothers of pre-school children participate in the paid labour market.

Sources: Statistics Sweden (SCB) and CEPR DP279 *Day-care Subsidies and Labour Supply in Sweden*

## PRIMARY AND SECONDARY EDUCATION – STRENGTHENING CORE SKILLS

**4.5** A key challenge for governments is to ensure that primary and secondary schools provide all young people with a sound grounding in core skills required in the global economy such as languages, mathematics and science. Failure to prioritise core skills can lead to a deterioration of individual prospects, and on aggregate may also limit the number of students who have the required skills to participate in further and higher levels of learning.<sup>32</sup>

**4.6** The number of children in Europe who leave the education and training system early, with low or no qualifications, is worryingly high by international standards at almost 15 per cent.<sup>33</sup> Greater concentration in high value-added, knowledge-based industries suggests that an individual’s medium and long-term employment prospects will be increasingly dependent on their knowledge and skills. At an aggregate level, this means that ensuring more people achieve at least an upper secondary education is of utmost importance to modern welfare states. This can be an important factor in reducing the numbers of young people not in employment, education or training and is likely to improve their opportunities in the labour market. This is something that has been recognised by the Portuguese authorities in recent reforms of their secondary education system.

<sup>32</sup> Access to tertiary education in Europe generally requires upper secondary or equivalent qualifications.

<sup>33</sup> Figure is based on the number of 18-24 year olds not in education, employment or training with qualifications equivalent to ISCED level 2 (Eurostat Labour Force Survey).

**Box 4.3: Portuguese policies to reduce early school dropouts**

A large share of young people in Portugal leaves school before completing upper secondary education. A new policy aims to reduce school failure and early dropouts by increasing the quality and relevance of education services, without endangering fiscal consolidation. Efficiency gains are being sought by closing very small schools and making better use of teaching staff. New programmes have been launched to improve teachers' training in core topics, modernise the curricula, strengthen vocational and technological streams and make them more attractive, and provide individualised support to low achievers. Companies hiring young people are no longer eligible to a social contribution rebate unless they have completed 12 years at school or are in training.

Source: *OECD Economic Survey of Portugal, 2006*

**4.7** Evidence from the OECD suggests that an individual's socio-economic status can determine the educational aspirations of that individual. Children from disadvantaged backgrounds and ethnic minority groups on average have lower educational expectations compared to national averages in the majority of Member States.<sup>34</sup> Education systems in Europe will thus have to deal more effectively with cultural and socio-economic diversity if they are to equip all pupils with the core skills.

**4.8** The long-term consequences of failing to equip all children with these skills can be significant and costly, potentially restricting social mobility and employability, and therefore have an adverse impact on social cohesion over the longer term. In designing effective education policies, it is worth noting that some countries are already performing well in delivering high-quality education to all students, including those from more disadvantaged groups. For example, Finland and the Netherlands regularly outperform other Member States in comparative studies on equitable education systems.

**4.9** The OECD argues that the design of educational systems can also have an impact on student performance and equity in education. Evidence shows that in general, countries with more selective education systems have a greater variation in educational performance and stronger link with socio-economic background.<sup>35</sup> While most countries set national and regional performance standards for reasons of accountability, the cross-country evidence also suggests that it is important to provide schools with a degree of autonomy especially for budgets and in recruitment. It is also important to accompany greater autonomy with monitoring of standards, ensuring regular assessment and transparency.

**4.10** Another important factor in the success of an education system is the quality of teaching. Along with an individual's background, the quality of teaching is one of the most important factors determining how well students perform.<sup>36</sup> Intensive teacher training programmes and access to training and advice throughout their careers can help teachers to improve and contribute to the success of their students. The Finnish education system provides a very high standard of basic education.

<sup>34</sup> OECD, *Education at a Glance 2007*.

<sup>35</sup> School and system characteristics and student performance in science from PISA 2006.

<sup>36</sup> OECD, *Human Capital: How what you know shapes your life, 2007*.

**Box4.4: Finland – provide high quality basic education**

Finland stands out internationally for having a particularly successful education system, which regularly outperforms other OECD countries in the Programme for International Student Assessment (PISA). The system produces high standard of basic education equitably across the country, while the expenditure levels around the OECD average suggest that the resources are used very efficiently. Finland also has a high-quality system of teacher training. Teaching has a high status, and only 13 per cent of the applicants to teaching degree programmes are accepted, so many top candidates study to become teachers. Other elements that may help explain Finland's success are low social and educational differences among schools and large autonomy given to schools, which are then held accountable for the results. There is also a system of building student engagement with both reading and school more generally.

Source: *OECD Education at a glance 2006 & OECD Education Policy Analysis 2002*

## APPRENTICESHIPS AND VOCATIONAL ROUTES

**4.11** Education and training systems across Europe need to ensure that young people are able to make a smooth transition from education into work. Apprenticeships and other vocational education based programmes can provide additional incentives and opportunities for groups whose options are limited in an academic driven education system. Traditionally vocational training took place within the framework of the existing educational system, whereas apprenticeships were largely the responsibility of the employer. However, today the distinction between the two is becoming increasingly blurred by a complex set of stakeholders including employers, government, trade unions and individuals.

**4.12** The need for a greater variety of skills in the global economy has led to a renewed interest in vocational training and apprenticeships across Europe. This has coincided with an increased awareness of the necessity for the educational system to cater for a variety of educational needs, which goes beyond traditional academic routes, to ensure that societies can fully realise the potential of the future workforce. The balance between academic and vocational education will vary and be based on individual preferences, abilities and talents. The goal of the education system should be to provide a solid foundation of knowledge, from which further skills can be built, enabling individuals and society to adapt to change in the 21<sup>st</sup> Century.<sup>37</sup> There are several reasons for offering greater choice and alternative vocational programmes in the education system, including:

- reducing youth unemployment and social exclusion for particular groups not in employment, education or training;
- facilitating future recruitment into industry and business and providing individuals at risk of exclusion with relevant first hand work experience;
- motivating young people to engage in education after extended periods outside of the labour market; and
- empowering individuals to engage in learning and provide tangible benefits related to learning in the form of employability and higher wages.

<sup>37</sup> A point that was made by Professor Snower (President of the Institute for World Economy, Kiel) during the Informal ECOFIN discussion in Berlin, April 2007.

**4.13** Thus, the existing vocational qualification frameworks should be continuously developed and improved. This also implies the recognition of qualifications in industry and the improvement of vocational training standards.

**Box 4.5: Matching vocational training with market demand in the Netherlands**

To raise overall labour productivity, a good match between vocational training and actual job requirements is needed. Over the past years the Dutch authorities have addressed this challenge by overhauling the vocational education system with a view to making it more demand driven.

The qualification structure for 900 different professional activities is jointly defined by nineteen sector-specific ‘knowledge centres’, which are composed of companies and specialised educational institutions. These centres have set up detailed ‘qualification profiles’, based on knowledge, skills and behaviour, rather than knowledge alone. Competence acquired outside initial vocational education will be recognised more easily than under the old systems. This should increase inter-job mobility. These reforms are likely to preserve the good track record of the Netherlands in terms of high employment and low unemployment rates among young people.

*Source: OECD Economic Survey of the Netherlands, 2004*

**4.14** An effective training system needs to be able to adapt and respond to changes in the demand for skills, therefore it is important that the training offered is driven by demand rather than supply. In addition, the institutional arrangements are crucial. The involvement and support of employers, workers and governments can play a critical role in determining performance and efficiency.<sup>38</sup>

**Box 4.6: The Danish apprenticeship system**

In the Danish system a close relationship between schools and industry increases the possibility of young people finding work after graduation. The Danish apprenticeship system is regulated by legislation. More importantly there is a contractual arrangement between the employer and the apprentice. This arrangement contributes to clear responsibilities and obligations. The apprentice receives a salary agreed by social partners and employers in collective agreements. After an introductory period with theoretical studies, the vocational training starts. A few weeks practicing with the employer is alternated by periods with theoretical studies.

Another prominent feature is the influence of the social partners. They exercise influence through “boards” who have the responsibility for the curricula and surveillance of educational quality. Financing comes from the government (budget allocation), the individual employer (salaries) and a collective fee for all employers regardless of size, which is allocated to a fund administrated by social partners to cover additional costs. Germany, which also has a well developed apprenticeships system, the so-called ‘dual-system’, organises its system along similar lines, but there is no collective fee for employers who do not train apprentices.

*Source: Olofsson and Wadensjö, ESS 2006:4*

**4.15** The design and development of national curricula should support both vocational and academic routes. Institutional arrangements such as good cooperation between the education system and employers can help generate consensual dialogue in order to better align the skills needed by individuals to participate in the labour market, and those needed by employers to be successful in a competitive and open market.

<sup>38</sup> World Employment Report 1998-99.

How this relationship is developed will depend on national circumstances but can be aided by joint responsibility for curriculum development and financing of the vocational education and training system, as in the UK.

**Box 4.7: Equipping teenagers for tomorrow's world – the new UK diploma system**

The diploma is a new employer-led qualification. It combines essential skills and knowledge with practical and applied learning in a work-related subject area. It has a very simple aim – to make learning more relevant to teenagers who are turned off by existing qualifications. The first five diploma subject groups will be information technology; society health and development; engineering; creative and media; and construction and the built environment. These lines will be available for teaching in September 2008. Diplomas will follow in a number of further subjects, and three academic subject based diplomas will be available from 2011, focusing on Science, Languages and Humanities.

*Source: The Department for Education and Skills, 14–19 White Paper, 2005; DCFS press notice 2007*

## TERTIARY EDUCATION – PREPARING FOR A KNOWLEDGE-BASED ECONOMY

**4.16** In the global economy, success often depends on the capacity of an economy to create, harness and apply knowledge, research, and innovation. Universities and tertiary education institutions are often found at the heart of scientific research, technological innovation and teaching and dissemination of knowledge. To retain comparative advantage and competitiveness in the 21<sup>st</sup> Century, Europe must make the successful transition to a knowledge-based economy. A well-functioning and successful tertiary education system is therefore crucial.

**4.17** Highly skilled workers make the economy more flexible and productive in the longer term.<sup>39</sup> In recent years, access to universities and other institutions of higher learning has been substantially widened across the EU. Today, Europe has almost 4000 Higher Education institutions with over 17 million students and some 435,000 researchers.<sup>40</sup> In many Member States more than 40 per cent of young people participate in higher education. However, the increased participation in tertiary education in Europe has not been accompanied by improved access for all students. While the absolute prospects of those from disadvantaged socio-economic backgrounds have improved, the relative prospects have not.<sup>41</sup>

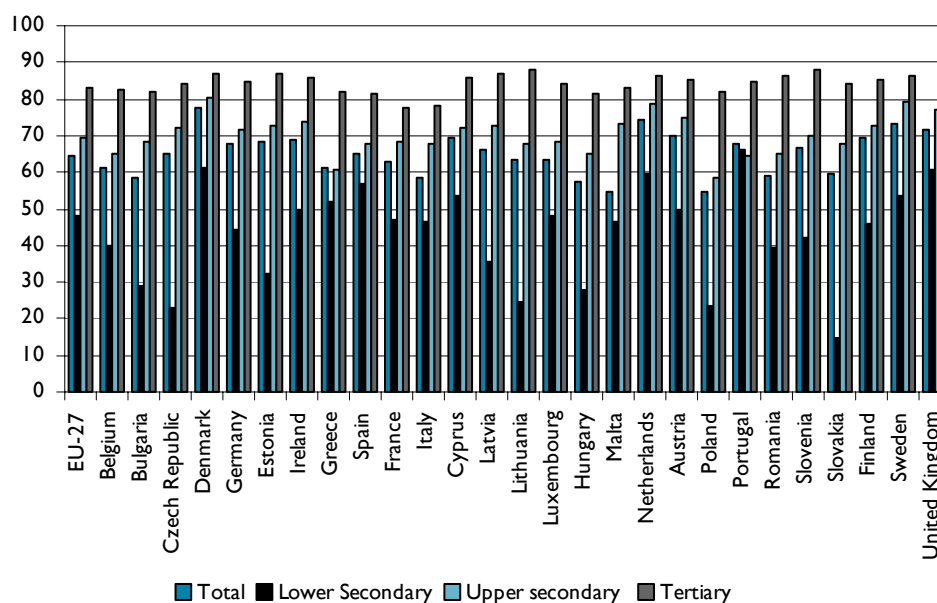
<sup>39</sup> The Leitch Review of Skills, Prosperity for all in the global economy – world class skills, 2006.

<sup>40</sup> European Commission, Delivering on the modernisation agenda for European universities, 2006.

<sup>41</sup> European Commission, Efficiency and Equity in European Education and training systems, 2006.

**Box 4.8: Tuition fees**

Graduates enjoy better employment prospects and higher earnings than those with only an upper secondary qualification. The employment rate for EU graduates is over 80 per cent, while graduate earnings are, on average, almost 60 per cent higher than those with upper secondary education over the lifecycle.

**Chart 4.2: Employment rate by level of education**

Source: Eurostat online

The significant benefits that accrue to individuals with higher qualifications have led some countries in the EU, including the UK and the Netherlands, to introduce tuition fees, so that part of the cost of tertiary education is borne by the individual. In these countries, tuition fees have been introduced or increased without any significant reduction in the numbers of students attending university. Equity has been maintained through the development of loans, grant and scholarships to support those from disadvantaged backgrounds.

However, many EU Member States choose not to introduce tuition fees. This is often related to concerns that asking an individual to meet part of the costs of their education might discourage some people from entering it, also due to a lack of information on the benefits of attending higher education, particularly of those from more disadvantaged backgrounds. In addition, in countries where the tax levels are relatively high, and with a relatively compressed wage structure, the returns to the individual from higher education are lower and the case for tuition fees is weaker.

Source: OECD Education at a Glance 2006; UCAS, April 2007

**4.18** Furthermore, while Europe has a higher number of graduates in mathematics, science and technology (MST) based subjects than the US or Japan,<sup>42</sup> there are increasing concerns that the supply of MST graduates is falling behind market demand. This is compounded by increasing competition in the tertiary education sector from the emerging market economies, which have begun to recognise the importance of MST graduates. Recent reforms in India and China have led to an expansion of people studying MST-based subjects in addition to year-on-year increases in tertiary education participation. This could have serious consequences for European universities and their competitiveness in the future.

**4.19** The challenge for tertiary education institutions in Europe is therefore threefold: Firstly it is necessary to widen access, especially amongst individuals from disadvantaged groups, while trying to increase the uptake of MST-based subjects. Secondly, it is essential to reform Europe's university system to allow for greater autonomy, specialisation and to ensure high standards of teaching. Finally, there is also a question of funding and how to finance tertiary education and where to concentrate government funding. This is of immediate concern to many Member States as the number of students in tertiary education is steadily rising while the level of funding has remained relatively static in most Member States.

**4.20** Many Member States now recognise the importance of widening access to tertiary education. There are several factors that influence participation in tertiary education including a good preparatory education. What is more, evidence shows that countries with the most equitable secondary education systems, such as Spain, Ireland and Finland, also provided more equitable access to higher education. The quality and equity of the secondary education system will have implications for access to post-secondary education, for example in accessing tertiary education, which underlines the importance of a lifecycle approach to human capital and skills formation. In some Member States participation could be increased by providing more flexible access to universities, moving towards a broader recognition of prior experience and informal learning. This could increase mobility from vocational intuitions into academic-based tertiary education.

**4.21** Another reason behind lower participation rates in higher education amongst disadvantaged groups could be attributed to the uncertainties associated with the benefits of tertiary education. Many potential students do not recognise the considerable benefits gained by completing tertiary education. Improving access to information for a wide range of stakeholders, particularly disadvantaged groups, on the benefits of higher education may be one way of raising participation rates. Using a comprehensive system of loans, scholarships or grants to support these groups might be other necessary measures.

## The Bologna process and university reform

**4.22** On average, undergraduate courses in countries across Europe have been three years longer than in other main advanced economies. This was a cause for concern and led to the establishment of the Bologna process. As a result, many Member States are reforming the structure of their higher education programmes to shorten average study durations and improve course completion rates. The aim of the Bologna process was to create a higher education area by making academic standards more comparable and compatible to facilitate inter-university mobility. Many Member States are already

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<sup>42</sup> European Commission, Progress towards the Lisbon objectives, 2006.

making efforts to reform the structure of higher education by splitting up tertiary education programmes into separate cycles, such as bachelor and master degrees. This will increase compatibility, allow diversified qualification patterns, and will contribute to raising the tertiary education completion rates by shortening the average study durations in many Member States.<sup>43</sup> The shorter study times will also create capacity for universities to accept more students over the long run, allow students to better combine studies and working life, and increase labour market participation. Progress has been made but challenges remain. Not all universities are likely to see the benefits immediately.

**4.23** There are considerable differences in the quality of universities and other higher education institutions in Europe that contribute to a large performance gap between EU and US universities according to international rankings. The literature suggests this gap is primarily due to under investment, a lack of autonomy and poor governance in the majority of EU higher education institutions.<sup>44</sup> When looking at the financial investment in universities as a percentage of GDP, Europe lags the US by approximately 2 per cent. When translated into average spending this equates to around €25,000 per student per year.<sup>45</sup>

**4.24** While many commentators may call for an increase in funding, evidence suggests that the quality of expenditure is also as important a consideration. Higher levels of spending are unlikely to make a telling contribution without completing the necessary governance and autonomy reforms. Increasing the financial, recruitment and managerial autonomy of European higher education institutions is likely to allow for specialisation and in turn more quality graduates.

## IN WORK AND PROFESSIONAL TRAINING

**4.25** In knowledge-based economies, people must continue to retrain, update and improve their skills and qualifications, and make use of the widest possible range of learning tools. However, training opportunities are often heavily weighted towards individuals with advanced or higher qualification levels.

**4.26** Older workers and those with low or no qualifications are less likely to receive professional training, despite often being in most need. This implies that public policies towards training primarily need to focus on the low skilled, the older workers and on economically disadvantaged regions.<sup>46</sup>

**4.27** The question for policy makers is how to create the right incentives to ensure that access and take up of training is shared more equally throughout the workforce. The policy options include measures to make the training market more efficient, increasing the incentives for companies and workers to invest in training, and encouraging social partners to invest in the training needs of their members. Although there is considerable uncertainty on the level and mix of training that would be economically optimal, there has been considerable progress in identifying effective policy strategies for raising the overall level of work-based training, such as:

<sup>43</sup> A recent study by the OECD found that longer tertiary study programmes are likely to experience higher drop out rates than those that are shorter in duration.

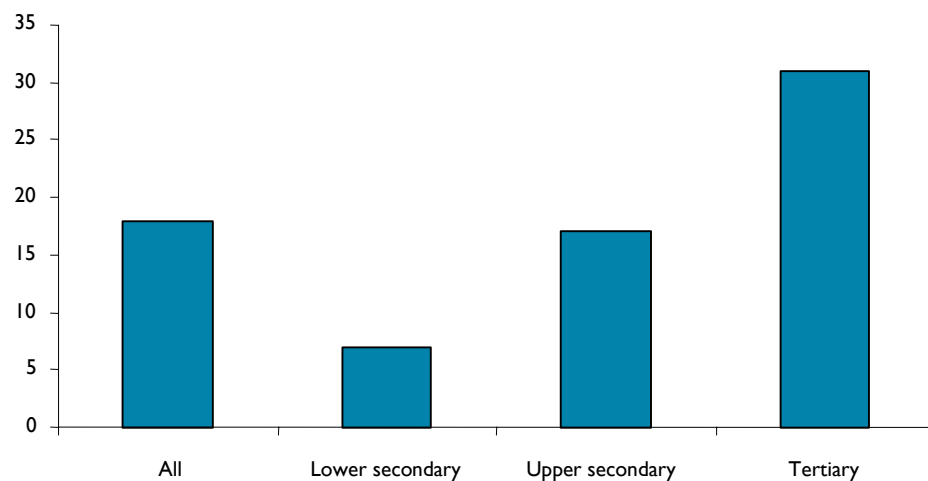
<sup>44</sup> For instance, See Bruegel Policy Brief: Why Reform Europe's Universities, September 2007, and the Centre for European Reform pamphlet, The Future of European Universities – Renaissance or decay?, Richard Lambert and Nick Butler, May 2006.

<sup>45</sup> Ibid.

<sup>46</sup> European Commission, Progress towards the Lisbon objectives in education and training, 2006.

- a mixed and demand-driven training strategy that responds to the changing training needs of the economy and can better facilitate matching of skills to labour market needs;
- improving the functioning of training markets with developed contract forms such as payback clauses and credit based learning;
- supporting innovative forms of self-organised learning including home-based multimedia learning, online workshops and online learning and tuition; and
- government matched funding for training in the workplace including targeted subsidies aimed at specific groups including the low skilled, as is the case in England with the so called Train to Gain programme.

**Chart 4.3: Participation rate of working age adults in training by existing education level, 2006**



Source: OECD, *Education at a Glance 2007*

## COMPLEMENTARY LABOUR MARKET POLICIES

**4.28** Well-functioning labour markets are essential in delivering economic growth, combating social exclusion and alleviating poverty and welfare dependency. Therefore, it is vital to make better use of existing skills in the labour force and to make employment more inclusive.

**4.29** Since the end of the 1980s, most Member States have introduced substantial reforms to improve labour market flexibility. However, much still remains to be done across the EU. Existing skills remain under utilised because of barriers to labour market entry. Too often people on the margin of the labour market are caught in unemployment or inactivity traps. Therefore labour market policies have to address these barriers and traps, e.g. by improving job opportunities as well as incentives for job search and skills updating. Labour market flexibility – in particular – is essential to provide people with the right incentives to invest in their human capital and to provide the relevant returns on that investment in learning through increased labour market opportunity, including both entry and progression in the labour market. Reforms that

increase the labour supply and reduce unemployment are also vital in order to secure long term financing of the welfare state, including education and skill policies within a lifecycle approach.

**4.30** In Europe, policy priorities have shifted away from solely lowering unemployment to raising employment and participation rates in general. Many Member States have adopted tailored policies, which target marginalised or disadvantaged groups. Efficient and well-designed active labour market policies to reduce inactivity and increase inclusion are a key part of this, including measures aimed at disadvantaged groups furthest from the labour market. This section focuses on making work pay and improving the opportunities for disadvantaged groups.

## MAKING WORK PAY

**4.31** The tax and benefit system plays an important role in making employment more inclusive. The wage level and the tax-benefit system, which together impact on the marginal effective tax rate, are important incentives for an individual's decision to work. This is also consistent with the policy lessons from the reassessment of the OECD Jobs Strategy. Marginal effective tax rates (METRs) provide a way to assess whether work actually pays and hence plays a key part in determining the likelihood and pace that an individual will enter or re-enter the labour market. The system must be designed in a way that enhances security in times of change without contributing to the exclusion problem and creating pockets of welfare dependency.

**4.32** Dealing with the problem of high METRs is not straightforward, there are difficult trade-offs which have to be faced. For example, financial incentives to work could be improved by lowering welfare benefits, but that can raise equity issues. Social safety nets, such as unemployment insurance, help safeguard security and ease the transition from one job to the other – but the design of such policies should not hinder re-entry into the labour market. Unemployment insurance should be designed so that work always pays better than prolonged periods of unemployment, reducing bottlenecks in the labour market. Well-designed employment policies also offer people a route out of social exclusion, financial independence and a reduction in social and health problems.

**4.33** There is a widespread consensus among EU Member States that policies in the field of tax and benefit systems are key ingredients to mobilising more people into employment and to meeting the Lisbon goals. The majority of Member States have identified reforms in these areas as being key to sustainable economic growth and social cohesion. Many recent tax reforms have focused on reducing the disincentive effect. These reforms are promising, although they remain only one element of a set of comprehensive measures needed to raise labour participation. Other elements include stimulating the demand side, through policies that allow for high levels of job creation, make it easier to hire employees, better matching of labour supply with labour market demand and policies that promote and facilitate entrepreneurship, especially in new growth sectors. As expressed, by Fitoussi et al. in “A Manifesto on Unemployment in the European Union”:

“The underlying idea is that it is much easier to encourage people to look for jobs if there are jobs to be found and it is much easier to encourage firms to offer more jobs if there are people looking for jobs.”

## MEASURES AIMED AT SPECIFIC GROUPS

**4.34** As a result of Europe's poor labour market performance towards the end of the 1990s and the early part of this decade, Member States embarked on a series of modern social and labour market reforms. Europe's poor labour market performance is often more pronounced in particular groups in society. These differ across Member States, but often include the low skilled, lone parents, the disabled, young people, migrants, women and older workers. This can lead to social exclusion.

**4.35** For many the first obstacle is entering the labour market. This can be partly as a result of hiring costs being high. In order to counteract this, there are a number of possible actions that can improve the labour market position of these groups and allow them to enter and progress in employment. Examples of measures that have been tried are lowering social security contributions and subsidising employment for shorter periods for targeted groups. Well-designed measures aimed at specific groups can also play a key part: tailored and intensive personal support in the form of job search activities and training advice can be particularly successful in helping disadvantaged groups access opportunities in the labour market.

**4.36** Another measure to increase labour participation, and to further improve utilisation of the skills and the potential in the economy, is by enhancing the gender equality in everyday life. A well-developed childcare infrastructure has made it possible to increase female labour participation. Other policies that have been used include reduced tax on household services. In addition, efforts to stimulate women's entrepreneurship could strengthen participation and broaden the labour market for women.

**4.37** In addition, active participation of older people in society and the labour market is vital, not least considering the demographic trends. The high risk facing middle-aged workers, who in most Member States face a low chance to re-enter the labour market if they become unemployed before the regular retirement age, is a particular challenge. These individuals face an increased risk of social exclusion while their accumulated human capital and their life-long experience remain unused.

**4.38** Most Member States need to take action to improve the participation of older workers in the labour market. There are still examples from across Europe of using early retirement to reduce unemployment among older workers. These policies are reinforced by recruitment and training policies that disadvantage older workers. Several policies have proved to be successful in improving the general prospects of older workers, including:

- increasing the human capital of older workers through better incentives for training;
- offering greater flexibility in the workplace including the ability to alter working patterns;
- designing the pensions system to act as a disincentive to early retirement and ensure individuals are not penalised for changes in working patterns;
- basing the wage structure less on seniority and more on productivity, thereby removing incentives of firms to lay off older workers;

- reviewing assessment procedures for disability benefits and allowing for more timely rehabilitation in order to return to work sooner; and
- using active labour market policies including intensive job search advice via public employment services.

**4.39** These measures become particularly important if the statutory retirement age or the state pension age respectively is adjusted to increasing health and life expectancy, as has been the case in some Member States. These measures, aimed at increasing labour market opportunity and flexibility, will form part of Europe’s response to the economic, social and fiscal challenges associated with aging populations and rapid global economic change. Most importantly, continuous training and life-long learning are needed to help older workers to adapt to structural change.

## EVALUATING POLICY – A MODERN TOOL IN POLICY DESIGN

**4.40** The analysis in this paper suggests that European economies should emphasise expenditure that promotes productivity, innovation and human capital. Investing in modern policies alone is not enough, and policymakers will also have to strive for efficiency and effectiveness of public programmes and expenditure.

**4.41** In this modern policy framework, evaluation is an essential tool. Evaluations are in-depth assessments based on state-of-the-art methods and robust data. Systematic and independent evaluations should inform the decision-making processes, encouraging ongoing organisational learning while also making policies more accountable to the general public.

**4.42** A comprehensive evaluation culture encourages an innovative environment for policy formation and adaptation. The challenge is to establish a continuous learning and monitoring process from input to output. One example of such a process is the evaluation of labour market reform in Germany.

### Box 4.9: Evaluation of labour market policy in Germany

Comprehensive labour market reforms have been implemented in Germany since 2002. For the first time, labour market reforms were linked, from the outset, to a comprehensive and systematic evaluation. The aim was to know as early as possible whether the enacted reforms were effective, and whether public funds were efficiently used. The evaluations were intended to inform on the causes of the observed labour market effects and on unintended negative effects, thereby delivering a scientific foundation for *ex post* corrective measures. More than 20 renowned research institutes participated in the evaluations, supported by an improved general provision of data and specifically designed new data. The evaluations focused on microeconomic as well as macroeconomic effects of the new instruments and labour market laws. The government presented the final report to parliament in December 2006. Results of these evaluations have already led to adjustments in the instruments of active labour market policy and provide a scientifically funded basis for further labour market reforms.

*Source: German Ministry of Labour and Social Affairs, Wirkung der Umsetzung der Vorschläge der Kommission Moderne Dienstleistungen am Arbeitsmarkt, December 2006*

**5.1** EU Member States are well positioned to meet economic, social and demographic challenges and make the successful transition to competitive and knowledge-based economies, while ensuring a high level of labour market participation and social inclusion. But we should not become complacent. We must continue to pursue growth and stability oriented macroeconomic policies, openness and opportunity for all. This calls for policies which promote well-functioning and flexible product, labour and capital markets to ensure that businesses and individuals are able to take advantage of new opportunities; and which promote fairness by enhancing employability, expanding opportunity and choice, providing security for the vulnerable, and helping people to adapt to structural and technological change. This is at the heart of the Social Bridges approach to reduce inactivity and increase social inclusion.

**5.2** In the past, economic and social policies have tried to alleviate the repercussions of structural change through various forms of protection and income support. While this type of insurance plays an important role in safeguarding security and helping to ease transitions, this can create the wrong incentives, and strain public budgets without providing any long-term security for individuals. The Social Bridges approach aims to improve the design of policies to create an inclusive response to globalisation. It is only through modern social and labour market policies, geared towards promoting opportunity and employability, and through the provision of skills and labour market flexibility, that Governments can help individuals to adapt to change, and safeguard sustainable public finances and Europe's position in the global economy.

**5.3** This paper has shown the importance of human capital to achieving sustainable growth and social inclusion as one pillar of the Social Bridges model. Modern human capital policies require better-integrated education and labour market policies. It does not advocate any particular combination, as there is no “one size fits all” approach, but we have identified some common features of successful policies, throughout the lifecycle.

**5.4** The evidence, as presented in this paper, argues that educational interventions in the early and pre-school years have the highest social returns and provide a strong foundation to continue learning in the future. During primary and secondary education the focus is on helping individuals acquire the core competences and skills to prepare people for further study or the world of work. Tertiary education is integral to economic growth and the knowledge based economy, but more needs to be done to widen access and participation, taking into account financing and equity considerations, as well as raising standards in teaching and achievement.

**5.5** In-work training and adult learning needs to better reflect labour market demand and truly foster a culture of lifelong learning for employers and employees. Similarly, these policies must be complemented by a modern and well designed tax and benefit system providing incentives for people by making work pay while simultaneously removing barriers to the unemployed on the margins of the labour market, allowing them to enter and progress in work.

**5.6** A key challenge for finance ministers in the field of human capital formation is to promote structural reforms and inclusive labour markets while at the same time safeguarding the sustainability and quality of public finances. This requires addressing

the appropriate mix of public and private contributions to education, as well as regular policy evaluation, to make adequate policy adjustments, including, where appropriate, the termination of policies that are not delivering efficient outcomes. Effective and efficient policy development using a Social Bridges approach may in the long term deliver sustainable levels of public spending and generate increased revenues – creating positive outcomes in several areas, including:

- a better skilled workforce, which can increase innovation, productivity, and competitiveness, and lead to higher wages and tax revenues;
- a higher employment rate of disadvantaged labour market participants, which can strengthen social inclusion and lower public spending on unemployment and social benefits; and
- a higher effective retirement age and less time spent in unemployment, which can improve the financial basis of the pension system and make it less dependent on government investment.

**5.7** Making Europe competitive and increasing social inclusion will require contributions from across a wide range of policy areas and institutions. European governments, citizens, social partners and industries all have a common interest in this. Governments can contribute by helping to equip their citizens to deal with change, not by protecting specific jobs. Skills and education plays a key role in this. Only by creating an inclusive globalisation can we all benefit from it.



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