



The Social Dimension of Economic and Monetary Union

Towards Convergence and Resilience

European Political
Strategy Centre

The social dimension of Economic and Monetary Union (EMU) has too often been neglected, due to the implicit assumption that making EMU more “social” would somehow hamper the economic performance of the euro area. Nothing could be further from the truth. Not coincidentally, the recent financial crisis proved that countries with more dynamic and inclusive labour markets – as well as a better skilled labour force and interventionist social systems – are more resilient: they better withstand shocks and recover more quickly.

The social costs inflicted by the crisis continue to weigh heavily on the euro area’s performance and internal cohesion (see Box on page 4). They also reveal a dramatic divergence between Member States – be it in unemployment rates, which vary from 4.7% in Germany to 23% in Spain, or the share of low-skilled in the workforce, which ranges from 15.1% in Estonia to 56.3% in Portugal. Such divergence is not sustainable in the context of a common currency union and therefore must be urgently addressed.

“Social” with a Purpose: Activation, Protection, Resilience

In advanced economies, which base their prosperity on productivity growth and innovative prowess, social and economic performance are two sides of the same coin. Modern social policy must be both about enabling people to make the most out of their talent as well as ensuring equity in opportunity.

Dynamic and Inclusive Labour Markets are Key for Convergence

High-performing, inclusive labour markets need to be at the heart of the social dimension of EMU. Thus, in line with the logic of ‘flexicurity’, the key to ultimate success is finding the right balance between protection and flexibility. Incentive structures for individuals, firms and countries need to be rethought in order to better link social and economic outcomes.

Skills Acquisition: Best Protection from Poverty

Human capital is one of Europe’s undisputed strengths, but emerging economies are quickly catching up, threatening to erode our basis of competitive advantage and source of high living standards. That is why Europe needs to prioritise skills acquisition and retention, for instance by developing a strong skills agenda that sees human capital enhancement as an investment rather than an expenditure.

Building Resilience for the Next Crisis

Framework conditions for reforms will not get better than they are now: low oil prices, quantitative easing and a low exchange rate invite policy makers to use the current ‘breathing space’ to reform and modernise. Only effective social security systems can successfully master the challenge of overcoming mass unemployment and growing social exclusion, with the ultimate goal of recovering from the crisis and boosting social resilience before the next asymmetric shocks hit.

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Upward convergence must be seen as the unifying common goal and *leitmotif* of Economic and Monetary Union. European citizens should no longer equate it with declining living standards and lower disposable incomes, especially since many of these phenomena are driven largely by Member State decisions, such as achieving the necessary budget consolidation through tax hikes for wage earners (Graph 4, p. 7) or failing to equip citizens with the skills needed to sustain their living standards in an ever more competitive and innovative global economy. The Economic and Monetary Union needs to embrace a logic of upward convergence and embed the social component at the very core of its policy inception and design.

Social Dimension of EMU: Activate and Protect

Economic and Monetary Union is, in and of itself, a social project. Its prime objective is to create conditions for stronger growth, more and better jobs and higher living standards. There is no doubt that by virtue of sharing a common currency, EMU members are tied by a stronger social bond. And the performance of the euro area depends in no small measure on the effectiveness of its members' social systems. Indeed, social imbalances pose a political and economic threat to the sustainability of the euro area, similar in magnitude – even if different in character – to economic and financial risks.

Against this backdrop, it is necessary to shore up the social dimension of EMU via the measures outlined below.

Activate and Protect to Build Greater Resilience

Modern social policy is about activation and helping each and every citizen use their potential to the fullest. That requires personal attention and tailor-made services, especially for those at highest risk of poverty, social exclusion and long-term unemployment. A one-size-fits-all approach to social policy is doomed to fail as individuals with the most profound challenges are difficult to reach with standardised approaches. This requires a thorough examination of social protection systems, with a view to measuring and tracking impact and performance. Are social protection systems merely administrating the poor and unemployed or are they actively helping a disadvantaged person find new opportunities and escape marginalisation? In the short-run, this will require investments in – and close monitoring of – social protection systems. But in the long-run, the extra cash will pay off as nothing is more costly than a growing number of permanently disenfranchised citizens.

The flipside of activation must be protection, ensuring a “living income” and robust social welfare systems which are effective in the fight against poverty and social exclusion. Protection also means examining the distributive impact of reforms by consistently addressing

basic trends in inequality, exclusion and other measures of *outsiderness* while ensuring intra-generational solidarity – an increasingly salient issue given the ageing of European society. The bottom line, however, should be **resilience** and “**protection with a purpose**”, that is ensuring everyone's participation on a fair level playing field in society and across Member States in the context of a European single market.

Social and Labour Market Benchmarks On Par With Economic Ones

A number of social and labour market benchmarks should be introduced or strengthened. Their purpose should not only be to depict the current social situation in the euro area but also to accompany necessary policy interventions with analyses and comparative insights, as well as systematic measures of progress.

The labour market benchmarks should be built around a **revamped flexicurity agenda** that combines labour market flexibility with a high level of security and quality of social support systems, articulated into:

- **key parameters of the labour market**, including employment and unemployment rates with generational and gender breakdown; coverage, duration and generosity of unemployment benefits; the extent of exclusion and poverty rates;
- **level of skills acquisition** with particular focus on basic and vocational education and ICT skills, linked to employability;
- **duration and intensity of training and retraining**, with a firm focus on outcomes, particularly successful (re-)entry into the labour market. Too many training systems do not equip graduates with competencies and skills that are relevant in today's labour market, leading to misallocation of funds, not to mention frustration and loss of morale among job seekers and trainees;
- **quality of public administration**, which also accounts for effectiveness of public employment services and investment (in skills, job creation, etc.). Already included in the European Semester, this benchmark warrants greater attention as inefficient public administrations not only greatly contributed to aggravating the crisis in many countries but also often failed to respond successfully to the social fallout.

Benchmarks should also be developed beyond the labour market to cover essential social dimensions, such as the idea of a “social protection floor”. It will be fundamental for policymakers to place social benchmarks in a coherent framework, such as the European Semester, and look at them not in isolation but holistic policy concepts, such as upward convergence or social resilience. At the same time, the European level should spell out overall policy objectives rather than over-prescribing the minutia of every reform.

Social Priorities in the European Semester

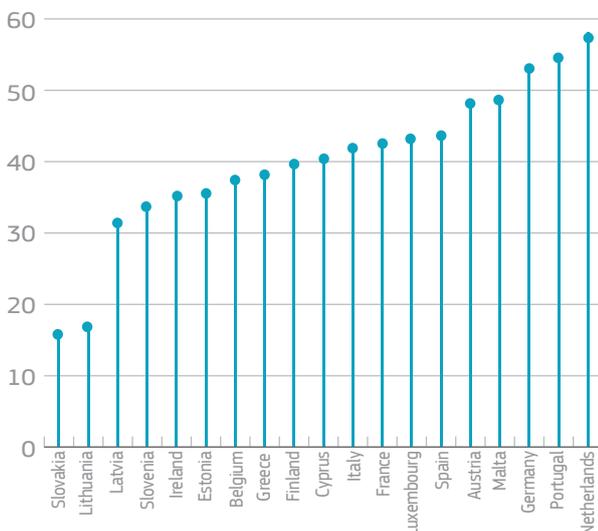
Social policy priorities are already part of the European Semester, but they tend to be of a more generic nature in comparison to fiscal policy recommendations, which have specific numerical targets.

The crisis pressured Member States to pursue budget consolidation, which often led to indiscriminate cuts in social welfare systems as well as inordinate tax hikes on the working population. Both had negative social and, ultimately, economic repercussions: those on the fringes of society were further marginalised while the ones in employment found themselves with less spending power and growing anxieties about their future. Neither was conducive to overcoming the crisis or spearheading a recovery.

Going forward – and in view of possible future crisis – EMU needs to augment the use of social indicators to better assess economic impact, both in the short- and long-term. The interplay between social and economic indicators can

Graph 1: Low Skilled Employment in Euro Area Countries

In percentage of total low skilled



Source: World Indicators of Skills for Employment Database, OECD.

also serve as a tool to discourage countries from enacting indiscriminate cuts because it is the easiest way to bring budgets in line in the short-run, without understanding the scarring implications over time.

In general, **the European Semester must ensure that policies are ranked with respect to their effects on short and long-term growth, employment and income distribution, social impact and fiscal sustainability.** For instance, how socially just is a pension system that is not sustainable over time? Or how precisely does a country get more competitive by cutting access to health care for the most vulnerable? Evidence shows that fiscal consolidation instruments can have vastly different impact on equity and growth - such is the case of cuts in education, healthcare and family policy. Thus, the OECD suggests to rank instruments, taking into account their long-term effects.

Driving Convergence and Performance in Euro Area Labour Markets

Social convergence in the euro area has broken down; it needs to be restored. The seeds of high unemployment in many euro area countries long precede the crisis. What has been particularly challenging in the context of a currency union was the combination of unreformed labour markets in the absence of a flexible exchange rate, a condition which clearly exacerbated an already worrisome situation.

In this context, **not having a converging labour market is counterproductive and downright threatening for the sustainability of the common currency area.** The euro area suffers from often contradictory trends in the national labour markets (Graph 2, p. 6). The result is that levels of unemployment and labour market participation continue to vary widely, posing a challenge to solidarity within the euro area where countries with reformed and better performing labour markets thrive while those that stick to the status quo lag behind. What is more, the effects of unemployment also manifest themselves in social and economic exclusion, poverty and inequality. There are three effective ways to address this challenge, which would immediately go to the heart of some of the long-standing issues plaguing labour market performance.

From Duality to Flexicurity

Sustainable job creation is the prime task of well-functioning labour markets. That is why the sense of direction of most labour market reforms is clear: maintain a sufficient level of protection to ensure

investment in skills and avoid falling into the poverty trap, while reducing rigidities which lead to disincentives for job creation and uptake. Even though uniformity of approaches across the euro area is not desirable, efforts should be made to align reforms more closely and reach a higher level of convergence. A way forward could be the re-introduction of the flexicurity agenda, which in the past facilitated a constructive dialogue around combining labour market flexibility with protection and rights for workers.

In the absence of a unique European model for labour market reforms, Member States have tended to focus primarily on flexibility at the margins of the labour market, which in turn has led to a gaping duality in labour markets across EMU countries. This pits mostly older insiders with permanent contracts that enjoy maximum protection against a growing number of younger outsiders confronted with short-term contracts and precarious working conditions. Although the duality generates societal tensions (Graph 3, p. 6), it should not be forgotten, however, that short-term

Social Conditions in Euro Area: A Wake-Up Call

While social conditions were already challenging before the economic crisis hit in 2008/2009, **the situation has much deteriorated since**. For example, the proportion of young people not in education, employment or training (NEET) reached 13% in 2011 against 11% in 2008: according to Eurofound estimates, the annual cost of NEETs in terms of loss of human capital is about 1.2% of EU GDP (€153 billion). **Long-term unemployment (i.e. individuals unemployed for 12 months or more) has increased in most Member States** in recent years, doubling between 2008 and 2013 at EU level. The problem, however, is particularly acute in some countries, notably Spain and Greece. In recent months, very long-term unemployment (for 24 months or more) has continued to increase, while overall unemployment has only modestly declined. Men, youth and low-skilled workers are more vulnerable to long-term unemployment, as well as those employed in declining occupations and sectors, whose skills often need upgrading. Thus, despite it being an EU-wide problem, not all unemployment is created equal: the severity of its effects varies across countries and groups.

The effects of unemployment have also manifested symptoms that extend beyond the purely economic diagnosis of the phenomenon. **One in five long-term unemployed EU citizens has never worked, three quarters of them being below 35 years of age.** This creates a strong risk of marginalisation, exacerbated by the low demographic growth of the continent, which is pushing more and more European societies from ageing to aged (i.e. more than 14% of the population aged above 65 years).ⁱ

Poverty and social exclusion among those of working age (18-64 years) have increased significantly in two thirds of Member States as a combined result of rising levels of unemployment and in-work poverty. The likelihood of entering into and exiting from poverty varies greatly across Member States. In some countries a significant proportion of the population is trapped in persistent poverty, while in others they succeed in escaping poverty but often only temporarily. Available data show that social mobility varies significantly across EU countries. For example, the UK is highly unequal but also mobile, while in Germany there is mobility but only within the original socio-economic group, making it hard to move from a lower to a higher category.

According to Eurobarometer, **high unemployment and general economic conditions are, by far, the most important concerns of Europeans.** In Autumn 2014, 46% of Europeans (49% of those living in the euro area) thought that the worst part of the crisis in terms of job losses was “still to come”, leading to risk-averse behaviour and subdued spending and investment. These are not unjustified concerns. Take Spain, where, from 2007 to 2011, the poorest 10% lost 13% of income annually vis-à-vis the richest 10% whose income only dropped by 1.5%.ⁱⁱ What is more, higher inequality is toxic not just for income and growth, but it shortens poorer children’s prospects of staying in education, curtailing their future opportunities.ⁱⁱⁱ Worryingly, across OECD countries – despite some variation – the top 1% of households has gotten richer (in terms of real income) while the bottom 40% has become poorer, exacerbating the inequality gap.^{iv}

i. “What’s Next in Ageing Europe: Ageing with Growth in Central Europe and the Baltics,” World Bank (2015) <http://www.worldbank.org/content/dam/Worldbank/Publications/ECA/aging%20europe.pdf6>

ii. *In it Together: Why Less Inequality Benefits All* (2015), OECD.

iii. *Ibid.*

iv. *Ibid.*

contracts often create additional employment. In Germany, for instance, a significant number of low-wage “mini-jobs” have been taken up as second jobs, without squeezing the low-wage part of the labour force¹. A unilateral move to prohibit temporary contracts, as it is sometimes suggested, would certainly have a negative impact on employment.

A better way to resolve this situation is the introduction of a **new, single employment contract** – one of the key ideas underpinning, for instance, Italy’s recent “Jobs Act”. In such a contract, a lower level of protection is compensated by offering training rights and other forms of active policies, as well as protection from poverty. The introduction of severance payments which increase with seniority should accompany the single labour contracts. However, in order not to reduce incentives for professional mobility, such payments should increase with seniority in the career, not in the current place of employment.

Reduce the Tax Wedge: Boosting Incentives for Employers and Spending Power for Workers

During the crisis, the urgent need to reduce fiscal deficits often led to stop-gap actions which carried significant social costs. While budget consolidation is often

associated with cuts, in reality many countries raised taxes to meet budget targets. As a result, household disposable income spiralled down as taxes increased, even after GDP growth picked up (Graph 4, p. 7). Now that the recovery is solidifying, euro area countries must seize the opportunity to **reform tax and expenditure policies in ways that enhance employment creation and increase household spending power**.

Another area that demands stronger action is Europe’s exceptionally high tax burden. OECD data indicates that **the 15 advanced economies with the largest tax wedge are all in Europe, with 12 of them in the euro area** (Graph 5, p. 7). It is difficult to see how the euro area will make a serious improvement in labour market performance without finally addressing this issue. A 2013 study, for example, estimated that a shift from taxation of wages to taxation of financial wealth and transfer would raise the long-term employment by between 1.8% and 4.7%.²

Moreover, **a reduction in the tax wedge may also imply a direct increase in net salaries for employees**, which would send an important signal, given that households shouldered the bulk of tax increases imposed since the crisis started. In Greece, net real income dropped by 8% for the average household between 2007 and 2011, largely due to fiscal pressure.³

Social Dimension of EMU: Quick-Wins and Low-Hanging Fruit

The following areas – of which some already exist and other are under consideration – would immediately have an impact:

Flexicurity

Until the economic crisis hit, there was a vibrant exchange on flexicurity at the European level, a type of labour market reform which combines flexibility with high levels of social protection. Inspired by the success of Danish labour market reforms in the 1990s, the concept of flexicurity is still valid and could be re-introduced in European policy making.

Tax Wedge

The Eurogroup has identified the tax wedge as a key stumbling block for job creation and uptake. These efforts should be recognised and supported at the highest political level. A coordinated approach should be embraced: not only would this send an important signal to investors, but it would also maximise the tangible benefits for citizens in terms of higher disposable income and spending power.

Labour Mobility

Labour mobility is an essential but often overlooked element of well-functioning currency unions. It helps to match demand and supply in labour markets and it is an area where Europe needs to improve exponentially. Portability of social rights and mutual recognition of qualifications should be high on Europe’s to-do list.

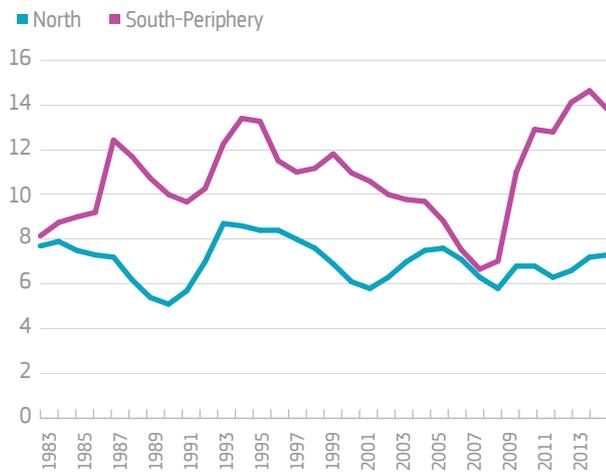
European Semester Reforms

The European Semester needs to include better and more precise social benchmarks, accounting for social conditions while linking them closely to short- and medium-term economic performance. At the same time, the already existing focus on quality of public administrations in European Semester framework needs to be strengthened and augmented. Many social objectives cannot be achieved with underperforming or underfunded public administrations, which need to modernise their services into more targeted, strategic, cost-effective actions.

On the other hand, the Czech Republic in 2008 provided an example of tax reform which, among other things, introduced a flat rate system with a rate of 15% levied on direct labour costs (down from a progressive system with an upper rate of 41.3%). This was accompanied by the creation of tax credits (including a family tax credit) and a 2.5% reduction in social security contributions. As a result, wages and salaries in the Czech Republic grew above the EU and euro area averages between 2008 and 2012. Additionally, in the EU there is a significant

Graph 2: Unemployment Rates in Euro Area Countries

% of the labour force

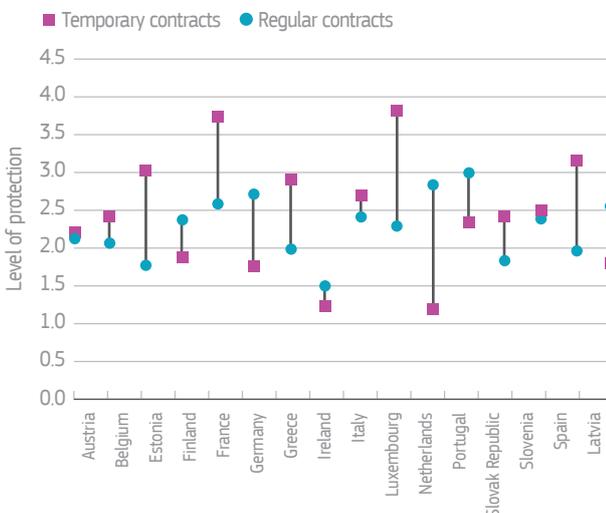


Note: North: Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands. South-Periphery: Spain, Italy, Greece, Malta, Cyprus, Portugal, Latvia, Lithuania, Estonia, Slovakia, Slovenia

Source: Unemployment Rates Database, Eurostat

Graph 3: Employment Protection Legislation Index in Euro Area Countries 2013

Level of protection 0 = Unprotected, 6 = Protected



Sources: Strictness of Employment Protection – Temporary and Regular Contracts Databases, OECD.

negative relationship between the tax wedge and total employment creation, which is especially strong for higher EU tax wedge countries.⁴

If such a cut in the tax wedge was coordinated at European level, it would send a powerful signal that the euro area is prepared to address the tax burden on labour and bold enough to do so collectively.

Fostering Mobility to Better Match Demand and Supply

Enhancing mobility of the European workforce is an important way to stimulate job creation, steer productivity and absorb asymmetric market shocks as workers move from regions of high pressure in the labour markets to those with greater opportunities and higher demand for skills. Such labour mobility is historically closely linked with the success of currency unions and therefore warrants policy attention.

There has been growing labour mobility in the EU in the last ten years, as a consequence of the 2004-2007 accessions of Central and Eastern European members as well as social imbalances created in the euro area. Around 7 million EU citizens – or 3.3% of the EU's total labour force – worked and lived in a different member state in 2013⁵, with migrants being on average much younger and more highly educated.

Given the importance of the issue, a new Mobility Package should focus on both opportunity and security:

- **by removing barriers to mobility**, such as limitations in the portability of pension contributions and some other social entitlements, and speeding up the mutual recognition of qualifications.
- **by improving the cross-border functioning of the labour market**, by establishing European antennas in Member States' labour offices and allowing for broader access to information about job opportunities across the EU. A key vehicle to facilitate this exchange is EURES, the European job mobility portal.

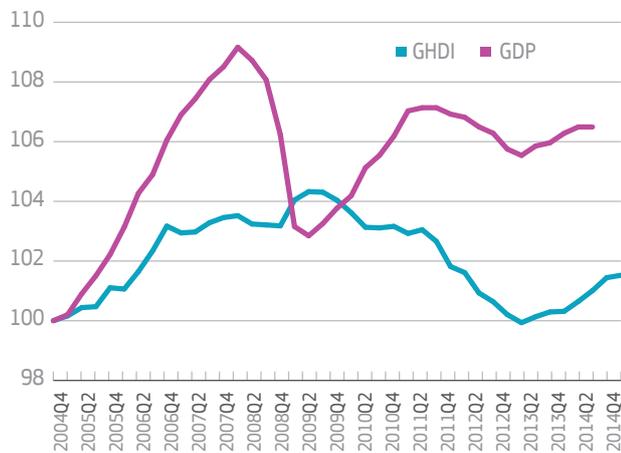
A Mobility Package would help relaunch the case for labour mobility in the EU and catalyse all existing provisions in the area into a clearer and more transparent common policy framework, identifiable by citizens as a positive European achievement. Promoting mobility should go hand in hand with establishing a level playing field, fighting potential abuses and social dumping.

A 21st Century Skills and Human Capital Agenda

In a rapidly changing global economy, which puts a premium on skills and competencies, social policy has not been able to halt the growing ranks of unemployed and disenfranchised. What are the chances of a country with a workforce in which 45% are classified as low-skilled – such as Portugal – to uphold its standard of living over time? And how can one boost employment

Graph 4: Gross Household Disposable Income and GDP in Euro Area

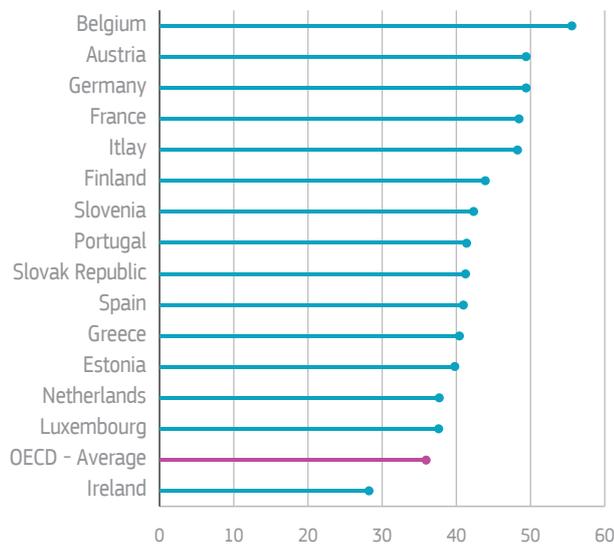
Index 2004Q4 = 100



Source: Key Indicators and GDP and Main Components Databases.

Graph 5: Tax Wedge in Euro Area Countries, 2014

% of labour cost



Source: Taxing Wages 2015, OECD

rates for the low-skilled with social policy alone when less than 40% are active in the labour market, as is the case in several euro area countries, including Finland, Greece, Belgium, Estonia, Ireland, Slovenia, Latvia, Lithuania and the Slovak Republic?

A much closer policy link between skills and human capital and economic and social outcomes is needed. There are no quick fixes or shortcuts to overcome Europe’s skills challenge in the short-term. But what can – and must – be done urgently is to put human capital at the heart of social and economic policy. Europe will not be able to retain its status as an advanced economy unless its skills base moves up the value and innovation chain. **A new approach is needed which prioritises social investment and aims to ensure that human capital is put to an optimal use.**

Vastly Changing Demand for Skills Tests the Limits of Social and Economic Policy

The challenges facing Europe are formidable and will test the limits of what social policy can achieve in the absence of a serious skills and human capital agenda: almost half of all existing job categories are at risk of being automated in the next two decades – especially in the manufacturing sector – making certain skills obsolete and some types of workers unemployable.⁶ In addition, more European societies are becoming “aged”, whereas training opportunities are decreasing exponentially for older workers. Yet, we are increasingly relying on workers staying in the labour force longer. Unless Europe succeeds in activating and up-skilling its human capital base, a larger proportion of the workforce will be idle and largely unprepared for the future job market, which in turn increases the burden on pension, insurance and healthcare systems.

The European Union must therefore be at the forefront of efforts to prioritise and boost human capital. While these are often seen as marginal policy issues, in reality they are integral to the long-term success of Europe at large and the euro area in particular. For instance, **gains from improving educational standards have been shown to lead to average increases in GDP of 4.5% to 16.8%**, depending on the country⁷. However, the basic literacy and numeracy skills currently taught in European schools will only fill 11% of jobs in 2025. A targeted investment in human capital, which addresses the skills shortage while anticipating future developments in the job market, is particularly urgent for low-skilled workers who were strongly affected by the crisis and need to be retrained to become employable.

Additional education and training, however, do not suffice if they are not consistently adjusted to the genuine and fast-changing needs of the economy and society. Research shows that the skills most in demand in advanced economies are “non-routine and interpersonal” while many of our citizens are trained in more traditional “routine and manual” skills (Graph 6, p.8). Indeed, the employment share of non-routine jobs, such as design-related occupations, grew from 28% to 38% between 1995 and 2010, whereas traditional routine jobs fell from 53% to 41%.⁸ Thus, not only will such a skills divide determine the concentration and distribution of job creation, but it may also widen wage inequality.

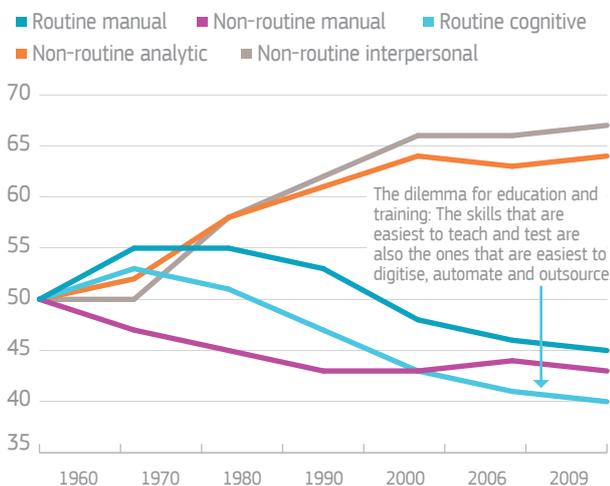
The toxic combination of high unemployment and severe skills shortage requires instruments that equip people – especially the young – with skills that anticipate the demands of a rapidly evolving labour market, particularly in the digital realm. Today, some 47% of European workers have insufficient digital skills – and 23% lack them completely – meaning that Europe is faced with 1 million unfilled vacancies in ICT jobs by 2020.⁹ Using European instruments, such as the Youth Guarantee, to link a generation of digital natives with genuine demands in the job market would likely yield more success in landing real and good jobs than is currently the case.

Reflecting Social Investment in National Accounts

Funds aimed at increasing and enhancing human capital should be properly reflected in the System of National Accounts as investments rather than current expenditures – as they are under existing

Graph 6: Trends in Routine and Non-Routine Tasks in Occupations, United States

Mean task input in percentile



Source: [OECD Skills Outlook 2013](#), OECD

rules. This would incentivise national governments to engage in a social investment agenda. A similar debate took place more than 10 years ago about expenditures on research and development (R&D), at the time recorded as a cost and not as an investment. As a result of an OECD initiative, the System of National Accounts was modified and all EU Member States revised their figures in 2014 to include R&D in investments and, therefore, in GDP.

Within the framework of a European skills agenda **national accounts should come to record in a comparable way public and private expenditures aimed at improving human capital in Member States**, eventually differentiating them by objective (basic education, digital skills, etc). Estimates of the stock of human capital could already be produced using existing methodologies.

Conclusions

In modern, advanced economies, social and economic goals are two sides of the same coin. It is time for Economic and Monetary Union to embrace this logic and put human capital investment, social benchmarks, well-functioning labour markets and mobility at the heart of its focus. This is the only way to rekindle the upward convergence which inspired European integration in the past, and must now guide its future.

Notes

1. Another institutional feature relevant for the positive performance of the German labour market was its *Kurzarbeit* (literally, “short work”) framework. Under *Kurzarbeit*, the German government compensates between 60% and 67% of an employee’s lost net wage, in case the employer needs to cut wage costs and working hours during an economic downturn. The employee’s contributions toward pensions and health care plans are also met by the German Federal Employment Agency. OECD data suggests that over 200,000 jobs up to 2009 may have been saved as a result of *Kurzarbeit*. But this has come at a high cost: between 2009 and 2010, the German Federal Employment Agency paid €4.7 billion in *Kurzarbeit* benefits. During the euro area sovereign debt crisis, *Kurzarbeit* was extended from 6 to 24 months, while its application process was simplified, facilitating its usage by companies
2. Varga, Janos; Roeger, Werner and in’t Veld, Jan, “Growth Effects of Structural Reforms in Southern Europe: The Case of Greece, Italy, Spain and Portugal”, *European Economy, Economic Papers* 511, December 2013.
3. Ibid.
4. See Dolenc, P. and Laporšek, S. (2010), “Tax wedge on labour and its effect on employment growth in the European Union”, *Prague Economic Papers*, 4 (2010): 344–358.
5. Eurostat, “Labour market and Labour force survey”, 2013.
6. Bowles, Jeremy, “The Computerisation of European Jobs”, Bruegel, 2014.
7. Hanushek, Eric A. and Woessmann, Ludger, “The Economic Benefit of Educational Reform in the European Union”, *CESifo Economic Studies*, vol. 58, 1/2012.
8. OECD Skills Outlook, 2013.
9. European Commission, “Digital Agenda Scoreboard 2014 – Digital Inclusion and Skills”, 2013.