Investments in human capital should be at the heart of Europe's Covid-19 recovery strategy

When the state spends money on roads and railways, we call it 'investment'. When the state spends on nurseries, school meals, or health care, we call it social, educational, and health expenditure. Yet as **Jakub Sawulski** *and* **Wojtek Paczos** *argue, the latter form of spending may yield a higher rate of return in the long-term.*

The Covid-19 pandemic has triggered a shift in the approach of policymakers to fiscal policy. In contrast to the financial crisis that began in 2008, the state is expected to be very active and contribute high levels of spending to stimulate national economies as we emerge from the pandemic. Many of the projects that have been discussed so far have focused on investing in infrastructure and other drivers of economic development.

But an extensive and growing literature shows that when it comes to public spending, the highest rates of return are not necessarily achieved from those expenses that are considered to be investments in the traditional sense. Indeed, the most profitable state investments also include expenditure on early childhood care, education, and preventive healthcare – that is, spending that can build human capital.

Recent research by Nathaniel Hendren and Ben Sprung-Keyser indicates that rates of return on public expenditure are strongly correlated with the age of beneficiaries. The highest estimated returns were found for measures targeting children. This is consistent with previous research demonstrating that expenditure on preschool programmes and education are extremely profitable. The basic mechanism is simple: higher competences acquired in school result in higher economic growth and higher wages in the future, and consequently also higher tax revenues.

But there are also more sophisticated effects, especially when the intervention covers children from low-income families. Children that are provided with a good education from an early age tend to commit fewer crimes and are less likely to receive social transfers in the future. Thus they 'repay' the investment with a high return.

Healthcare is another area of effective public investment according to previous research. A recent review of 52 studies that estimate returns on public health interventions in advanced economies found that, in most cases, the average benefit of health interventions was several times the initial cost. Better health means higher productivity, more economic activity, and reduced public transfers, for example in relation to sick leave or early retirement.

The public and private sectors are not rivals

Investment, in simple terms, is a use of resources to obtain future economic benefits. All of the types of public expenditure considered above meet this definition. Yet, they are not recognised as such in official statistics. The formal definition of public investment covers only expenditure on physical capital – something we can see and touch. Thinking about investment in these narrow terms and not in the wider sense may distort our image of the public sector and can create flawed incentives for public policy when investment expenditure is used to evaluate government activities.

The consequences may include excessive concentration on the expansion and modernisation of physical capital at the expense of spending on areas related to the development of human capital. Moreover, the technology driven economy is all about non-material assets such as software, which is the product of pure brain power. This is also a reason why the World Bank recently started ranking countries based on their approach to human capital rather than their model for doing business.

We take this wider approach and look at the data on public and private expenditure in the 27 states of the European Union (plus the United Kingdom). For the sake of simplification, we assume that public investment in human capital includes educational and health expenditures. We take a conservative approach and exclude hospital services, assuming they are closer to the function of 'saving' human health than 'building' human capital through health. Thus, the measure we obtain is a lower bound estimate of the rate of investment in human capital.

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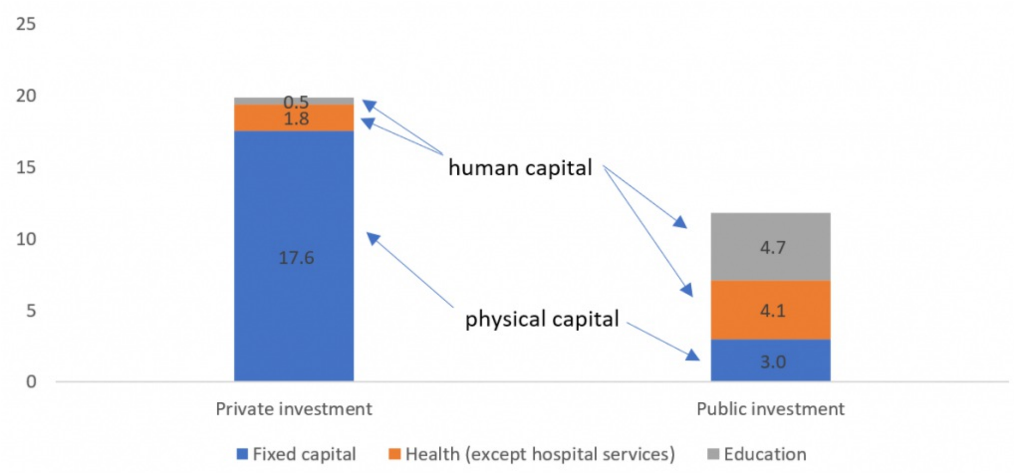
The main message from our data is that the public sector holds the leading role in building human capital in the economy. On average, public investment in human capital is three times higher than public investment in physical capital. It is also four times higher than human capital investment in the private sector, as shown in the figure below.

Figure 1: Private vs public investment in the EU as a percentage of GDP (2009-19 average)



Source: **Compiled by the authors using Eurostat data.**

There is one more important conclusion from this data: the public and private sector are not rivals. While the public sector is more responsible for investment in human capital, the private sector uses this capital to create value added and strengthens it by developing physical capital. Each of these elements is necessary for the success of the economy.

Changing the definition of public investment

The current definition of investment should be expanded by including investment in human capital. Reaching this point will be a long journey. It will require a renewed debate which can hopefully result in a unified approach to what constitutes investment in human capital. This debate will also need to be followed by fundamental, but necessary changes in national statistics and the system of national accounts.

The argument we have presented here is a first step toward stimulating this debate. Our hope is that international development agencies will subsequently use this approach more often. We believe that a proper quantitative understanding of the role of the public sector in the economy is essential for the development of our societies in the 21st century. Development is no longer simply about physical infrastructure – intangible non-material goods are just as important as railways and roads.

Note: This article gives the views of the authors, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: Alexis Brown on Unsplash

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