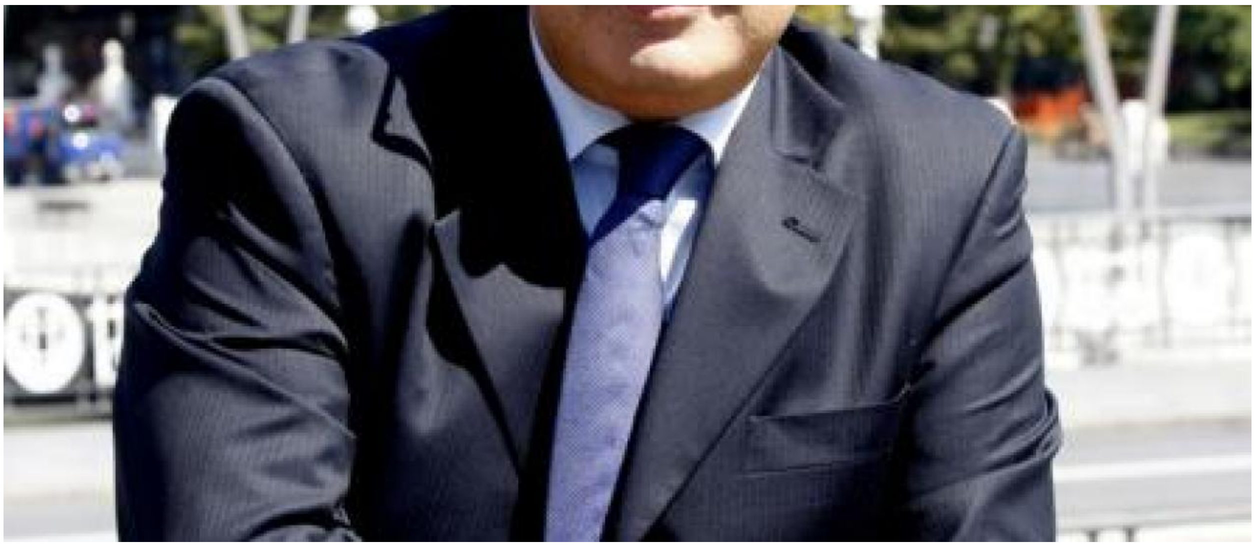
What next after human capital, infrastructure, and good gove



By Sami Mahroum

It takes more than human capital, infrastructure and good governance to foster economic growth and development, writes Sami Mahroum from INSEAD's campus in Abu Dhabi.

Over the past two decades, a thin consensus has been emerging on what countries should do to foster economic development and growth. The consensus revolves around a three pillar formula representing the lowest common denominator among development economists.

The first pillar is about the importance of developing a country's human capital. Human capital fuels economic growth and contributes significantly to higher labour productivity. Human capital is also crucial for innovation and the absorption of ideas and techniques from around the world. No country can expect to grow fast and continue growing and competing internationally without an accompanying commitment from its government to investing in human capital. It is not surprising then to learn that the world invests about

4.6 per cent of its GDP on education. Countries like South Korea, Ireland and Singapore are said to owe their fast-tracking to advanced nation status to their high levels of investment in education and human capital.

The second pillar is physical infrastructure. It is an important enabler of economic activity and a prerequisite for inward investment, trade and productive activities. Over the last five decades, governments across the world have invested in building traditional infrastructure, such as transport networks, sewage systems, and power grids. The trend continues and a recent OECD report expects global investments in infrastructure over the next 20 years to grow to around US$ 70 trillion. Lately, governments have also rushed to invest in new infrastructure such as superhighway broadband networks and 3G mobile telecommunication systems, which by 2008 amounted to around 5.6 per cent of the world’s GDP.

The third pillar is the hardest of them all: good governance. These range from having efficient and transparent public sector institutions, to having strong laws on intellectual property rights (IPR), a fair competition law and an independent judicial system.

There is no doubt that this three pillars formula will help many countries mobilise their resources more efficiently. But a number of problems arise when one begins to use these as textbook prescriptions for economic development.

Where the three pillars fall short

Let’s start with investments in infrastructure. While infrastructure is seen by development economists as a key enabler of economic growth, policymakers view it more as a driver of short-term economic growth and invest in it accordingly. Very recently, both new and traditional infrastructure have benefitted from new waves of investments as governments attempted to spend their way out of the global recession. But these investments are often geared towards short-term economic growth, rather than long-term economic growth. In some cases, it is not clear whether the expansion an upgrade of infrastructure is actually needed. To give an example, 82 per cent of the US population is concentrated in cities and suburbs; just how much impact would upgrading rural America’s access to the internet have on its economic growth? Unless there is clear evidence that more people would move out of the cities to the countryside as a result of the upgrade, the impact of the new investments in broadband infrastructure on the growth of the rural economy will be dismal.

Investment in human capital has followed a similar logic and has come to be equated with more education meaning more higher education. Across much of the world, demand for higher education has soared, universities are overcrowded, staff are overworked, and the quality of graduates is suffering. The situation in the UK today is a witness to such policies. Years of New Labour's policy of getting more people into higher education have produced a glut of graduates in the labour market and strained the capacity of UK universities. In developing countries, the situation is worse. In Jordan, Egypt and across much of the Arab world, university graduates en masse either go unemployed, take under-skilled jobs, or emigrate. In fact, the oversupply of university graduates has crowded out non-university graduates from the labour market and pushed the incomes of the rest to the bottom.

Good governance is important, and developing countries in particular still need to make long strides in this regard. But the lack of it does not explain the double-digit growth of China and Vietnam, or Russia and India; this is unless "good" means something else, perhaps more along the definitions of Harvard University's economist Dani Roderik, or the Financial Times' editor Alain Beattie. Roderik emphasizes the stability and predictability of governance structures in an economy rather than their efficient performance; while Beattie emphasizes the effectiveness of countries' institutions rather than their transparency and correctness.

Firms from the developing world seem to understand good governance much better; Chinese, Indian and Arab telecom companies are very active and successful in regions such as Africa and Central Asia, where good governance is supposedly a rare currency. Investors, it seems, are driven more by opportunity than 'good governance' and 'good governments' seem to know that and take it into consideration while inducing foreign investors to invest in their economies. Unless there is a United Nations embargo on a country, foreign investors tend to move in on the basis of special arrangements and agreements with the government of the host country and without demanding substantial reforms to their governance culture and structure.

While infrastructure, human capital and good governance are very important, the question in the minds of many policymakers from Canada to Singapore today is: what next? Advanced economies that already enjoy high levels of human capital, infrastructure and ‘good governance’ are increasingly finding themselves stagnant. A visiting Finnish delegation to London once put it this way: despite all the hoopla around Finland’s investment in new infrastructure, human capital, and good governance, the country still occupies a mid-table position in the EU’s GDP per capita rankings.

The efficacy gap

A straightforward answer does not exist and each country probably requires its own answer. But one area worth our attention is efficacy. Countries with similar levels of socio-economic development, along with matching physical and social infrastructure, tend to display different levels of economic performance. The productivity gap between the EU and the US is consistently in favour of the latter. Northern Europe has higher productivity levels than continental and Mediterranean Europe. Malaysia and Korea started off with similar levels of human development but with different natural resource endowments (Malaysia was richer). Both invested in infrastructure, human capital, and good institutions, but South Korea still managed to grow much faster.

Efficacy is an important enigma to explore. Why is it that some countries make better use of their human capital, physical and social infrastructure than others? Why would one village benefit in gaining access to broadband connectivity more than other villages, and one country benefit from a range of talents, while others allow talent to leave? This efficacy gap remains largely enigmatic.

Closer to the policy domain, there is a clear need for a better match between investment in physical and social infrastructure and opportunity. The ‘build it and they will come’ approach for investment is a platform for generating inefficiencies in an economy. Infrastructure, education and good governance are enablers and not drivers of economic development, and accordingly, governments should link their investments in infrastructure and human capital to specific growth opportunities and where an expanded and upgraded capacity will make a real difference.

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