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Four Points about Financing Social Policies and Public Investment

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* The views expressed in this paper are those of the authors and do not necessarily represent those of the United Nations.

1. Some services, including public services, are investments

Certain expenditures of time, money, and economic resources should be considered investments, although most macroeconomic measurements treat them as a type of consumption. These include investments in human development, such as health and educational services. They also include non-market, unpaid care services, often provided within the household. Why should these services be classified as investment? Physical investments in capital goods, such as machines, computers, equipment, roads, power infrastructure, etc., increase the productivity and productive capacity of the economy. An investment made now yields returns, in terms of greater productivity, in the future. Along similar lines, public investments in infrastructure have the ability to enhance the productivity of businesses and households.

Like public and private investments in physical capital, investments in human beings help sustain and improve their future productivity. The major difference is that these human investments are less tangible, and often involve services rather than goods.

Economics has a long history of focusing primarily on material production. Much economic theory sees the driving force of economic growth to be the accumulation of physical, productive goods. Because services are intangible, they have received less attention. Services are ephemeral. They only last for a specific duration and they cannot be accumulated the same way that physical products can. Because of this, economic theory often assumes that the provision of services cannot constitute investments.

This is a mistake. Although services themselves are intangible and fleeting, the effects of consuming services can be long lasting and affect future productivity. A training program that builds productive skills only last a set amount of time. The services themselves are perishable. But the skills acquired through the training program have a much longer lifespan.

Most traditional definitions of human capital adopt narrow definitions that only include activities that take place within the market economy or in the public sector. Only those activities that would be included in the traditional definition and measurement of GDP are considered to contribute to human capital formation. But many contributions that are made to health and education take place outside of the market economy and involve unpaid care work. What we miss when we focus only on formal health and educational services measured in the system of national accounts are all of the human investments associated with non-market production.

One important area of human investment in which non-market production plays a substantial role is early childhood development. Numerous research studies show that investments in early childhood development affect cognitive development, educational achievement later in life and health outcomes. All of these outcomes have important consequences for overall economic performance. Unpaid care work is central to investment in early childhood development, although its contribution and the importance of gender roles are not always recognized. Direct interactions between children and caregivers—including speech, gestures, facial expressions, physical contact and body movements—provide the stimulation necessary for children’s cognitive development. This kind of direct care represents a critical component of non-market human investments that have implications for the long-run health of an economy.

Because of the unequal burden of unpaid care work, this raises a challenge for designing policies that support positive outcomes for children as well as for gender equality. Care work is necessary to the investment in human beings required to maintain the productive capacity of the economy. However, the current distribution of this work between women and men is highly unequal and it entrenches women's unequal position in the economy. In order to incorporate unpaid care work into the formulation of macroeconomic policies in ways that actually reduce gender inequalities, policies need to be designed in such a way as to reduce and redistribute the burden of this work.

2. Public investment spending does not crowd out private spending.

One of the issues that has to be confronted in any discussion of how to finance social policies and infrastructure investment is: to what extent do increases in public spending cause a reduction in private investment? At one extreme is the pure crowding out position that contends that any increase in public spending triggers a one-for-one reduction in private investment. Imagine that an economy is fully utilizing its resources and that productive capacity is fixed. Under these conditions, the size of the economic "pie," to be divided up between businesses, households, and government, does not change. If this is the case, any increase in the portion of the economic pie dedicated to public expenditures must come at the expense of a reduction in expenditures elsewhere in the economy. According to the crowding out theory, this usually occurs through price changes. For instance, higher government spending would push up interest rates and discourage private investment. When this happens, public spending crowds-out private investment.

Even if the economy were operating at or near full-employment, the crowding-out argument will not always hold. If public spending raises the productivity of private investments, then the size of the economic pie will no longer be fixed. Specifically, when public investments raise the return on private capital, such spending will not crowd-out private activities, but may instead encourage private growth and investment. Enhanced productivity makes it possible for the economy to accommodate more public spending without compromising private investment. If the productivity of private capital increases, returns to capital would also rise in the form of greater profitability, potentially encouraging additional investment. Public spending on infrastructure assets, such as roads, transportation systems, water and sanitation, and electricity, and on human investments linked to social policies has the potential to boost the performance of the private business sector.

Public infrastructure not only increases the productivity of capital invested in private businesses, it can also raise the productivity of economic activities within households. This has important implications for gender equality. Non-market household production is critical for sustaining families and maintaining the quality of their lives. Such production includes direct care of other people, preparing meals, household maintenance, and fetching water and fuel. Women's unpaid labor produces the majority of these non-market services and goods. Therefore, public investments that raise the productivity of this labor have the potential to contribute to greater gender equality by reducing the time burden of unpaid work. Research studies have demonstrated this link between physical infrastructure investments and women's unpaid care burden. For instance, providing water taps in communities drastically reduces the time women spend carrying water.

Public investments also impact on women's access to labor markets and their earnings from remunerative employment. For instance, safe, reliable transportation infrastructure can improve women's participation in labor markets. Electrification has the potential to raise the productivity of women's informal self-employment, including income-earning activities performed within the home such as tailoring or preparing food for sale. Women's improved access to income has other knock on effects. It can result in more resources being invested in children's human development. This is due to women's propensity to spend a larger share of their income than men do on children. These linkages imply that physical infrastructure investments to reduce women's care burden and improve their well-being have long-term economic benefits. Under these conditions, the standard crowding-out arguments do not hold.

3. Human investment generate private and future returns

Intangible investments in human capacities generate future returns – just like investments in physical capital. One category of intangible investments that economists have long recognized is education. Investments in skills, knowledge and know-how, grouped under the heading “human capital,” have been seen as complementary to investments in physical capital. The accumulation of knowledge and skills enhances people's productive contribution. At the individual level, greater productivity justifies paying more highly educated people additional money for their labor. At the macroeconomic level, investments that raise formal educational attainment or build new skills support economic growth. It helps to consider the example of education within a broader discussion of financing these kinds of human investments.

The idea that education represents a type of investment has generated a great deal of literature that attempts to understand the returns to this investment. Investment in physical capital raises future productivity and, as a result, generates returns on that investment in the form of more production and additional earnings. Along the same lines, investments in education should generate similar returns if such investments enhance future productivity. The evidence seems to suggest that this is the case. A review of over 1,100 studies across a range of countries (139 in total) found that the global average of the returns to an extra year of schooling were approximately 9 percent. In other words, having one more year of schooling would raise future earnings by 9 percent (Psacharopoulos and Patrinos, 2018). As long as the cost of that extra year of education is less than the total present value of the increase in earnings, investing in more education makes economic sense, that is, if we restrict our valuation of education to its effects on a person's earning power.

Most estimates of the returns to education only look at private returns. Private returns represent the money value of higher individual earnings associated with additional education. But education also generates social returns. We all benefit, to some degree, by being part of a more educated community. Working alongside someone with special skills could have knock on effects, as other, less-skilled employees pick up knowledge from their colleagues. Innovations arising out of more educational investments can benefit everyone. Social returns are not adequately captured by the standard measures of returns to education. Currently, our understanding of these social returns is limited. There have been some efforts to measure at least some aspects of the social returns to education and this research tends to show that social returns exceed private returns.

Although private decisions whether to invest in human capacities will be based on the private returns to education, health, or other intangible investments, government decisions should take into account the social returns. If social returns are greater than private returns, net positive externalities exist. This suggests that private human investments will fall short of the socially desirable level of investment. Under these circumstances, there is a role for the public sector in support investments in human capabilities that generate social benefits beyond the private returns. The economic logic of implementing public policy to increase investment when the social returns exceed private returns is impeccable, yet, from a practical standpoint, it is often difficult to estimate with any precision the social benefits associated with human investments.

4. Public investments, broadly defined, can be self-financing

If the goal is to increase public investment, tangible and intangible, to support the long-run health of the economy while reducing gender inequalities, the question arises of how to pay for such investment. One obvious answer is to finance the additional public expenditures by mobilizing tax revenues. Increasing total tax revenues, in the short run, involves a transfer of resources from the private sector (households and businesses) to the public sector. If this were the only effect of such spending, we would expect private expenditures to fall – less household consumption, lower levels of business investment, or a combination of the two. But such investments raise productivity and lead to higher aggregate incomes. The increase in incomes could entirely offset the initial transfer of resources to the private sector. In other words, crowding out does not occur and the investment are effectively self-financing.

Even if private returns, measured with respect to the growth of future incomes, are not high enough to provide full monetary compensation to households and business for the taxes required for an increase in public investment, such an increase may still be justified. This would be the case if the social returns to investment were sufficiently high to provide other benefits, possibly non-monetary, that households and businesses value.

Another possible way to finance more public investment is through government borrowing. Borrowing creates a claim on future budgets, since debt has to be serviced and repaid. In deciding whether public debt should be used to finance investment expenditures, broadly defined, it is critical to consider whether the debt-financed resources are being allocated in a way that raises future productivity. As discussed at length, borrowing to finance public investments can crowd-in private investment, leading to higher rates of growth. Faster growth generates additional economic resources that support higher tax revenues and allow governments to re-pay the debt. For these reasons, debt-financed fiscal expansions are more likely to be sustainable when the additional spending is concentrated in productivity-enhancing areas. As long as the returns to public investment, as measured by their contribution to future revenue growth, are greater than prevailing interest rates, debt-financed public investment will be fiscally sustainable – i.e. the growth in revenues would cover debt servicing costs and allow repayment of the debt over time.

Whether financed through transfers from the private sector (i.e. taxes) or through debt, public investments have the potential to be self-financing without reducing, over time, average private consumption or investment expenditures. This is a significant departure from the standard crowding-out story. It also underscores the importance of redefining critical macroeconomic variables – specifically what counts as investment.