

“THE THEORY OF HUMAN CAPITAL STRUCTURE”

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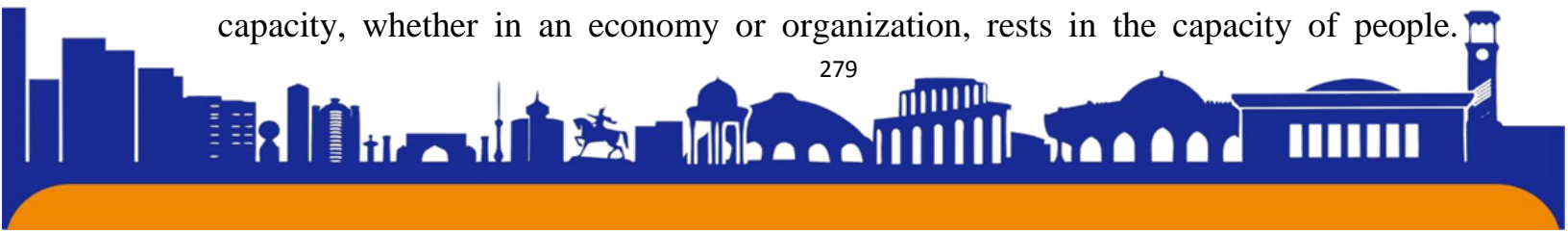
Annotation: Human capital, intangible collective resources possessed by individuals and groups within a given population. These resources include all the knowledge, talents, skills, abilities, experience, intelligence, training, judgment, and wisdom possessed individually and collectively, the cumulative total of which represents a form of wealth available to nations and organizations to accomplish their goals. Human capital is available to generate material wealth for an economy or a private firm. In a public organization, human capital is available as a resource to provide for the public welfare. How human capital is developed and managed may be one of the most important determinants of economic and organizational performance.

Keywords: human capital, investment, economic growth, profitability direct cost, human-resource capital, managing human capital, human capital and performance, state of human capital in the world, economic outcomes

Human-resource capital

The concept of human capital stems from the economic model of human-resource capital, which emphasizes the relationship between improved productivity or performance and the need for continuous and long-term investments in the development of human resources. This model can be applied on a broad scale where investments in human capital are viewed as affecting national and global economic performance or, more narrowly, where investments in people are viewed as crucial to organization performance. That differs from a more traditional and instrumental approach where human resources are primarily seen as a cost to be contained beyond immediate and short-term needs. This short-term view often addresses change or poor performance by seeking government intervention to offset competition and by using cutback methods for keeping wages down, contracting out, and automating jobs.

A human-resource capital model argues that the principal source of productive capacity, whether in an economy or organization, rests in the capacity of people.





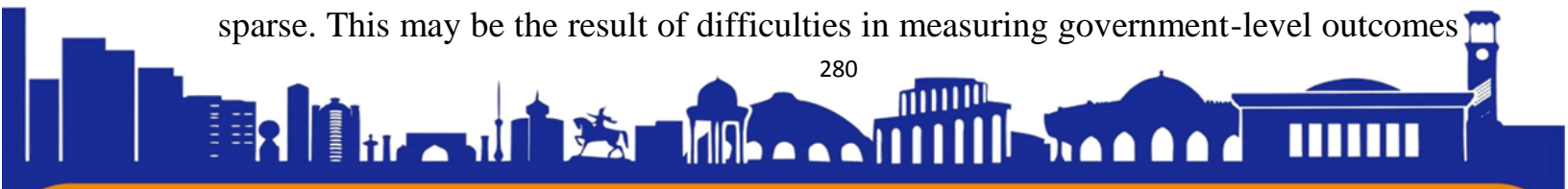
Therefore, strategies need to be developed to capitalize on the potential of this resource by developing learning systems that will cause the capacity of human capital to grow into the future. For a national economy, this may entail reforming educational institutions to ensure the provision of a quality workforce that fits the needs of industry for high economic productivity and the maintenance or improvement of the national quality of life. For an organization, this model suggests that high productivity and performance depend on developing learning systems that reflect the commitment of an organization to its human resources. As a result, ongoing investments in training, skill development, and job enrichment (versus expansion) engender a reciprocal commitment among members to organizational goals and objectives.

Managing human capital

The management of human capital is diffused throughout an organization. All management decisions and actions that affect the nature of the relationship between the organization and its employees are seen as important. As a result, all management actions can positively or negatively affect the potential of human capital to influence organization performance. In this view, although the organization may contribute to the development of human capital, its ownership rests with each individual. Collectively, all the knowledge, skills, and abilities within an organization and available at any given time constitute a human capital pool. Although this talent is available to achieve positive performance, the totality of management practices needs to consistently tap this human capital pool in such ways as to influence individual and group attitudes and behaviour toward the desired organizational goals.

Human capital and performance

Reciprocal commitment in an organization suggests that a relationship exists between certain management practices and performance. At a point where the total effort of human capital coalesces into a critical mass, high organizational performance seems possible. Here, human capital, fully developed and tapped appropriately, can influence organization-level outcomes. Empirical research in the private sector appears to identify specific management practices as universally superior to others in achieving firm-level outcomes such as market share and profitability. This universal perspective has led to benchmarking certain practices as “best” for contributing to high performance. Empirical research in the public sector establishing such a relationship is sparse. This may be the result of difficulties in measuring government-level outcomes



and being able to clearly establish this connection, because outcomes are often influenced by a myriad of variables outside the control of public management. Even so, the same superior management practices thought to favourably influence human capital in private enterprise have been often adopted in public administration reforms.

Practices thought to result in a high-quality, committed, and flexible workforce in private enterprise are also seen as important contributors to productivity and performance in the public sector. High levels of expenditures in training and development, empowering workers with decentralized decision-making authority, and encouraging participation, pay for performance, the use of self-managed work teams, and flexible job designs, among others, are commonly associated with improved performance in public agencies. Theories of motivation support such management practices where the first priority is to ensure that workers have the skills and ability to perform (training and development) and where the second priority is to afford them the opportunity to test their problem-solving skills (decentralized decision authority). The belief is that investing heavily in improving worker skills and abilities leads to a higher-quality workforce. This combined with valued rewards and a role in problem solving can result in greater effort, commitment, and motivation within a workforce that is more flexible and innovative. This combination then, it is thought, results in higher organization performance.

What is the state of human capital in the world today?

Despite unprecedented human development gains over the past 25 years, serious challenges remain, especially for developing countries.

In 2019, more than 1 in 5 young children were stunted due to under-nutrition (with low height for their age—a red flag indicator for the risk of physical and cognitive deficits) (JME 2020). The current global pandemic may lead to even higher numbers of children stunted.

A learning crisis is holding many countries back. Data show that in some countries, children acquire significantly fewer years of learning than in other countries, despite being in school the same length of time. This is exacerbated by the pandemic – with many children out of school and losing out on learning. People in developing countries spend half a trillion dollars annually — over \$80 per person -- out of their own pockets to access health services, and such expenses hit the poor the hardest.

COVID-19 is also causing significant disruptions in essential health services including routine vaccinations and child healthcare.

In the world's poorest countries, four out of five poor people are not covered by a social safety net, leaving them extremely vulnerable to shocks.

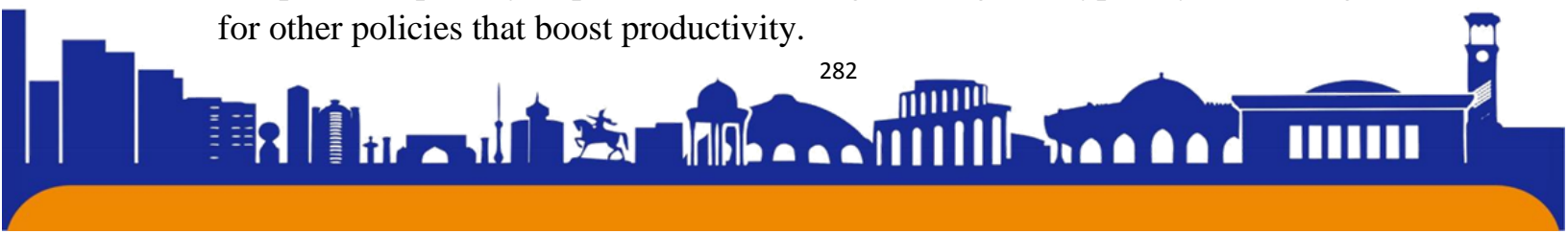
Nearly 300,000 children die every year from diarrhea linked to a lack of access to safe water and sanitation.

The first edition of the Human Capital Index (HCI), published by the World Bank Group in October 2018 and updated in 2020, shows that nearly 60% of children born today will be, at best, only half as productive as they could be with complete education and full health (as defined by the index, see question 5). This reflects a serious human capital crisis, with strong implications for economic growth and the world's collective ability to end extreme poverty by 2030.

Gaps in human capital are at risk of widening amid rapid global changes in technology, demography, fragility, and climate. Conflict events and pandemics can have a devastating effect on human capital through loss of life, livelihood, nutrition, and the interruption of essential health and education services. Such impacts will likely reverberate throughout many individuals' lifespan limiting their productivity. Yet investment in people is often neglected. This is despite many examples of rapid national transformation of human capital—including Singapore, the Republic of Korea, and Ireland—and specific successes in some of the world's poorest countries.

The importance of human capital for economic outcomes

Human capital is widely regarded as a fundamental input in growth theory. Furthermore, recommendations to boost human capital feature prominently among structural policy priorities identified by the OECD for a number of countries. However, the empirical evidence linking human capital with macroeconomic outcomes has been problematic. This chapter first provides an overview of the role of human capital in determining economic outcomes and reviews existing evidence on this topic. It then presents a new measure of human capital based on OECD education data surveys, which better incorporates both quality and quantity dimensions. Drawing on the proposed measure of human capital, this chapter suggests a substantial scope for long-run productivity gains from human capital, with a larger effect from quality as compared to quantity improvements, although the lags are typically much longer than for other policies that boost productivity.





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The fiscal response of OECD governments to the COVID-19 crisis has been swift. Across the OECD, governments have committed billions of dollars to support public health systems, prevent massive business failures and protect households from the impact of the crisis. The additional spending (or forgone revenue) amounts to around 10% of Gross Domestic Product (GDP) on average in OECD countries over 2020-2021, with wide disparities across countries (IMF, 2022[1]). The aid to the health sector represents on average 1.5% of GDP. Public debt ratios in 2023 are projected to exceed 2019 levels considerably (by 15 percentage points in the median OECD economy) (OECD, 2022[2]). They will need to be adjusted over the medium term given future demands on public finances from long-term trends such as ageing populations (Guillemette and Turner, 2021[3]) and climate change. Boosting growth will help reduce the debt-to-GDP ratios. However, more recent developments related to the consequences of Russia's war of aggression against Ukraine are likely to further strain public finances. While stagnating economic growth will lower fiscal revenues, increased expenditures are expected in many OECD countries: rocketing energy costs call for efforts to support households and small businesses, rising interest rates put pressure on public debt, and spending on defence gains new priority in the new geopolitical context (OECD, 2022[4]; NATO, 2022[5]).

Substantial public resources will continue to be needed to support the health sector further, to address the economic consequences of the new geopolitical situation and to accelerate the green and energy transitions in an effort to limit climate change and enhance energy sovereignty. Finance ministries will therefore be faced with complex choices and competing budgetary priorities in seeking to balance short-term and long-term economic, geopolitical, environmental and social goals. In this context, it is useful to undertake a critical assessment of the importance of various pillars of economic growth, and more specifically the importance of education, for economic outcomes.

A new measure of human capital to improve estimates of the macroeconomic outcomes of education

A new stock measure of human capital has been developed recently by exploiting data from the OECD Programme for International Student Assessment (PISA) and the Programme for the International Assessment of Adult Competencies (PIAAC) (Égert, de la Maisonneuve and Turner, 2022[57]). It attempts to overcome inherent problems





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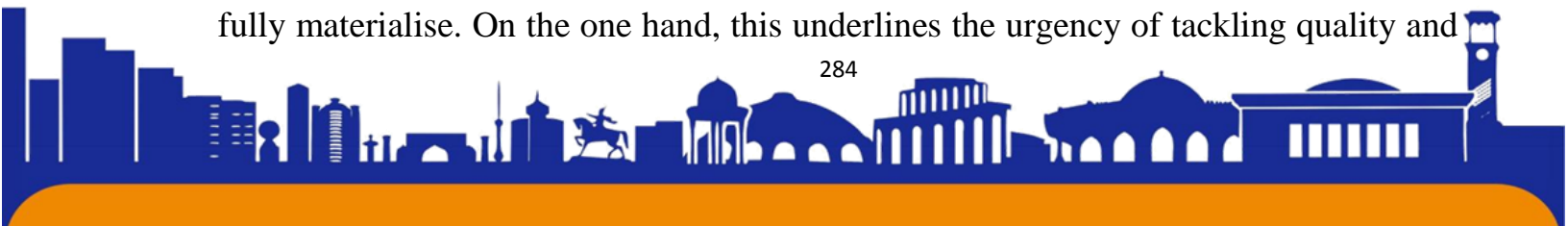
with using either in isolation: PIAAC provides a measure of skills for the entire adult working population, but has no time series and limited country coverage; PISA, especially when combined with similar international test scores, has a much longer time series and country coverage, but only applies to those aged 15. Moreover, conceptually, PISA measures the quality of education in primary or secondary schooling resulting in quality effects transmitted to the stock of working-age population with long lags.

The analysis shows that skills at the age of 15 (measured by student test scores) have a strong empirical relationship with skills (measured by PIAAC) observed later in adulthood of the same cohorts (Figure 1.3). Regression analysis estimates that, depending on the specification, the elasticity of cohort-specific adult skills with respect to student test scores is three to four times higher than the elasticity with respect to mean years of schooling. Exploiting this link, a new stock measure of human capital, covering the working-age population and reflecting both the quality and quantity of education, is calculated as the cohort-weighted average of past student test scores and mean years of schooling of current cohorts.

Conclusion: Overall, this new measure of human capital based on Survey of Adult Skills (PIAAC) and PISA data to account for the quality of human capital in a more fine-grained manner confirms the importance of human capital improvements for multi-factor productivity, and ultimately economic growth. In doing so, this analysis sends a strong message to finance policy makers for continued public investments in education given the magnitude of this impact which is equivalent to improvements in product market regulation in the long run.

This new analysis also provides important messages for education policy makers, insofar as it shows stronger economic effects on multi-factor productivity deriving from quality improvements in human capital relative to gains in educational attainment and mean years of schooling (representing the quantity of human capital). For education authorities, these findings send a strong signal calling for sustained efforts to boost the learning outcomes of all students and to enhance the effectiveness and efficiency of their education systems, in order to realise these potential productivity gains and economic returns.

Lastly, a third important message for both finance and education policy makers relates to the time lags of human capital improvements, which take around 50 years to fully materialise. On the one hand, this underlines the urgency of tackling quality and





equity challenges in education to maximise economic returns. On the other hand, it highlights the critical importance of a long-term commitment and non-partisan process of continued improvement in the education sphere, as its benefits will take far longer than the time horizon of electoral cycles to materialise.

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