

# **‘People are the real wealth of the country’**

## **How rich is Montenegro?**

**National human development report, Concept note, version 2**

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The countries in RBEC region have that experienced a major (often dramatic) change. It entailed also change in human capital, its composition, relative weight of individual components, the mechanisms of building human capital stock and its depletion. The process of human capital formation was evolving responding to a “moving target” – the rapid systemic change of East European societies.

Montenegro is not exception from this trend. On its path to EU accession the issue of human capital will be gaining increasing significance. Politicians (in every country perhaps) tend to repeat that “people are the real wealth” of their countries. What does it exactly mean, how is this wealth being accumulated and utilized is still an open issue with explicit practical and political implications. This is also a valid reason for analyzing the issue of human capital in depth in an NHDR devoted to the topic and estimating the existing human capital stock, its dynamics in the process of transition (patterns of accumulation and depletion), the institutional aspects of the process and the extent to which both the stock and the mechanisms driving its formation are reflecting the country’s long-term vision and priorities.

### ***The ‘path to the current topic’***

A national human development report will address these issues from both historical perspective (the departure point of independent Montenegro in regards human capital, what has the country gained and what has it lost) building a vision for the future (where is the society heading, what is necessary to get there and is the human capital accumulation mechanisms up to the needs in that regard). The report will consider trends in human capital formation and depletion in the country, will analyze the institutional mechanisms involved and will make recommendations on improving the efficiency of human capital formation and utilization.

The topic of human capital has been selected through a long process of consultations. The initial idea was to address the issue of capacity development in national context. Then the discussion evolved in the direction of building a more comprehensive vision of the country (“capacity for what”). All these aspects still remain valid. Bringing in the topic of human capital will add explicit accent on the question “capacity of whom?” Thus it would make the topic more attractive and easily understandable for wide public but would also to include academic expertise on the topic that is crucial for the future of the country. It is expected that this combination of academic rigor and innovativeness will contribute to the ongoing EU integration processes.

This NHDR would for the first time put human capital topic on the agenda and it could hopefully persuade the authorities (both central and local, including multiplicity of actors including business sector) to revise the overall agenda and increase investment (both short and long term) in human capital for sustained economic growth, increased employment and greater social cohesion.

### ***Defining human capital***

Human capital is usually being defined in narrow terms with explicit focus on integration into the labor market, adaptability to economic environment and applicability to employment challenges. This approach paradoxically resonates strongly with Marx’s “ability to work” and is largely being reduced to human resources characteristics (with primary focus on education, professional qualification and health).

From human development perspective however this is not appropriate approach. It is even less appropriate in conditions of changing environment – and thus changing requirements in regards knowledge and skills. In the process of change when new opportunities emerge and old patterns become irrelevant changing the relevance of previously acquired knowledge and skill with some of it becoming outdated and other gaining in significance. In RBEC region these changes are generally associated with the shift from extensive focus on manufacturing to services but on a global scale it is related to the rise in significance of ICT.

This is why the traditional approach to human capital needs to be reconsidered. It will be one of the objectives of the regional report, which will introduce a broader definition of human capital, as the **integrity of knowledge, skills, values and experience of people that make them more productive, both economically and in terms of achieving non-economic fulfillment**. It is definitely broader than “ability to work” and its value is not fixed; it depends (can increase or decrease) depending on the social capital stock and the institutional frameworks involved in human capital formation and utilization. In that sense human capital – just as physical or financial – can be latent and unless unleashed, its value is negligible.

This is the link between the analysis of human capital and its policy implications. A major message of the report can be that having big stock of human capital is not sufficient for a country (society) to prosper in human development terms. Human capital dies away if not put in operation – in other words, if not given the opportunities to materialize its potential. In such cases it usually follows the pattern of financial capital fleeing to environments offering better returns.

## ***Composition of human capital***

Human capital can be increased by investing in education, health care, and job training. This notion is closely related to the concept of sustainability: in conventional economic terms sustainable development might be translated as development that preserves or enhances initial capital endowments – including natural resources and human capital, i.e. the stock of skills and knowledge.

The traditional approach to human capital is 'flat', not dynamic. It is suitable for static environment – which definitely the environment in the region was not twenty years ago (and is not at this moment globally). The traditional elements (knowledge, skills, health) outline the individual's potential; the extent to which it will (or will not) be materialized depend on other characteristics that constitute the second (functional, behavioral) aspect of human capital. These include

- inventiveness, entrepreneurship and risk-taking,
- ability of engage in social and political activity,
- democratic values and ability to internalize alternative arguments,
- ability to constantly gain knowledge and practical skills responding flexibly to changing environment
- ability to apply knowledge
- ability to accommodate to changing environment
- basic moral values and cultural patterns that put other elements in context; proneness to solidarity

Thus the issue (and definition) of human capital goes beyond education and health. The process of both human capital accumulation and depletion has important momentum (it takes time to deplete existing stocks and similarly to accumulate). Its value is highly dependent on the purpose (a kind of "market valuation of human capital through applicability"). Skills that were useful and demanded in one environment can easily become obsolete when the environment changes. The purpose is also historically-determined (the relative value of individual aspects depends on the stage of societal evolution - industrial or post-industrial). In that regard life-long learning and adaptability becomes increasingly important component of human capital formation. But the mechanisms of building human capital are also historically-determined – what works in one system, doesn't work in another.

## ***Estimating the stock of human capital***

Claiming that human capital stock has been depleted (or increased) doesn't say much unless some quantitative estimates are introduced. In that matter a number of open issues remain – how to measure human capital and its components, what are the relative weights of individual components, what kind of data can be used, what methodologies for aggregation to apply.

One example of possible approaches in that matter is the "European Human Capital Index" that looks at the ability of countries to develop and deploy their human capital, defined as the cost of formal and informal education expressed in and multiplied by the number of people living in each country. The approach adopted in this particular case is following the traditional (narrow) interpretation of human capital but still provides interesting inputs because it

addresses the aspects of human capital **stock**, its **utilization** and **productivity**. It assumes that four components of human capital contribute to the wealth of European citizens:

- Human Capital **Endowment**. The cost of all types of education and training in a particular country per person active in the labor force (i.e. employed person).
- Human Capital **Utilization**. How much of a country's human capital stock is actually employed? This indicator measures human capital as a proportion of the overall population.
- Human Capital **Productivity**. The productivity is derived by dividing a country's GDP by all of the human capital deployed in that country.

In addition, the European Human Capital Index introduces "Demography and Employment" aspect looking at existing economic, demographic and migratory trends to estimate the number of people who will be employed in the year 2030 in each country.

Clearly estimating the human capital stock and its utilization through constructing HC Index could be important element of the future report – and in particular, analyzing the correlation between its levels and HDI.

### ***Links to other human-centered concepts***

#### **Human capital and human development**

The link between human capital and human development is 'intermediated' by economic growth with human capital seen as important factor for the latter. The dynamic link between economic growth and human development is well studied. While people are the end of development themselves, higher levels of human development affect the economy by enhancing people's capacities and, consequently, their creativity and productivity. Ample evidence suggests that as people become healthier, better nourished and educated, they contribute more to economic growth through higher labor productivity, improved technology, attracting more foreign capital, and higher exports. On the other hand, better economic growth (fueled by higher human capital) expands possibilities of individuals and governments to invest in human development (although link between economic growth and human development is not automatic). In analyzing these links the 'agency' aspects of human development are usually being left out thus reducing the human development concept to its human capital core.

#### **Human capital and capacity development**

The stock of human capital and the supply of general and technical skills are crucial not just for the economy but for the society in general. This has direct link to capacity development. Human capital formation (accumulation) generally corresponds to "individual capacities development" in capacity development jargon. However, a country's ability to use and utilize people's talent and skilled personnel to good effect depends on the incentives generated by organizations and the overall environment. Capacity development – particularly improving institutional capacity and creating conducive environment – is instrumental in that regard. It entails unleashing, strengthening and maintaining of the ability of people and organizations to define and achieve their objectives (on three levels: individual, organizational and the enabling environment).

The capacity development approach moves beyond the typical focus on training in order to address broader questions of institutional change, leadership, empowerment and public participation. The capacity development approach assesses capacity at three different levels: the enabling environment, the organization and the individual. UNDP brings the human development approach to all its work and put human development as an objective, for defining and achieving of which people and organizations need to develop their capacities.

The work on capacity development also suggests that having knowledge and skills is not sufficient. Even more important are ethics, values and attitudes. A country (society) can relatively easily pick up in terms of knowledge and skill but unless the latter are based on a strong values basis, the improvement in human capital will not lead to achieving higher levels of human development.

## **Social capital and human capital**

People are part of social settings and networks. Thus human capital is intrinsically linked to social capital with both reinforcing each other (and having certain overlap). As a sociological concept, social capital refers to connections within and between social networks. Though there are a variety of related definitions, they tend to share the core idea that social networks have value increasing the chances of human capital to increase productivity (both individual and collective) and reach a better level of individual fulfillment.

## ***Evolution of human capital stock after transition***

The new economic and political systems provided huge opportunities but not all could benefit from them. Globalized economies and freedom of movement largely intensified the brain-drain exactly of those who are more entrepreneurial, inventive and risk-taking. In many countries the corrupt environment has aggravated the process. The picture however is mixed and any generalization is risky.

Before transition socialist governments in the Region – and Montenegro in particular – used to pay particular attention to certain aspects of human capital, primarily in the area of education and health. Universal education and universal coverage with free-of-charge health care services was a rule and achievements in building human capital in these areas were significant—universal literacy, close to universal secondary education, high levels of enrollment in higher education with explicit gender balance (equal for boys and girls), etc. In the area of health the outcomes were not so impressive, with life expectancy in most countries of the region stagnating starting from the late 70s but largely due to the design of the health-care system heavily focused on hospital care and input indicators.

The model of building human capital served well socialist economy, with its central planning, central allocation of resources, centralized formulation of demand for labor force, possibilities of administrative reallocation of labor force, orientation toward big production facilities, etc. This is the reason why other aspects of human capital (like social adaptation, networking skills, entrepreneurship, inventiveness etc.) were falling off the government's radar screens. This is also the reason why they were developing in their own peculiar way constituting an entire parallel reality – parallel to the official political ritual. Having such skills was a necessary precondition to survive on a daily basis the reality of the 'shortage economy' of 'real socialism'.

Transition brought a lot of changes. The economy changed significantly, moving from central planning toward liberal market (though the level of liberalization varied significantly across the region). Along with liberalization, the responsibilities of different actors with a stake and a role in human capital formation have been redefined. The entire region witnessed a pendulum swing from over-centralization and omnipotent state towards withdrawal of the state from as many areas as possible. This withdrawal was matched (or even reinforced and legitimized) by the shrinking opportunities of governments to maintain the level of investment in spheres crucial to human capital formation due to the declining output and fiscal revenues at the first phase of structural reforms. But even if (when) resources were available, the old systems of social services provision were not designed for operation in market conditions and investing more money wouldn't ring about better outcomes. This is why **new mechanisms of human capital formation are required** for the changing economies and societies en large.

Putting the issue of human capital in Montenegro in regional context will be also important element of the process. The former 'socialist bloc' was all but homogeneous with different 'models of socialism' applied. The former Yugoslavia had quite unique experience in that matter and a historical analysis of the patterns of human capital formation (how, what kind of capital) and utilization can have practical relevance in understanding and meeting many of today's challenges.

### ***The policy response of the first years of transition***

The magnitude of the challenge however wasn't immediately clear, both in Montenegro and in the region as a whole. The magnitude of human capital formation momentum is measured in generations and not years. The first transition governments were benefitting from the investments of the late socialism in education, qualification and primary health care that were maturing during the first years of reforms. At the same time reform attempts, say in education and health sector, had been notoriously postponed, usually conducted on a "peace-meal" basis, without comprehensive vision of the post-transition societies. They were often replicating the old pattern and beliefs in a new 'market-based' reality, with ideologically-driven withdrawal of the state from its responsibilities.

Education is clear case in that matter. With centralized demand for labor gone and centralized planned demand for education vanished, market mechanisms of labor reallocation emerged, but the link with education demand was (and remains) weak. Market-driven private educational institutions focus on short-term profitability at the expense of rigorous quality. Usually more flexible than the old state-run establishments, they better able to raise funds (through imposed fees and from donors), better communication strategies and easily drain human resources from the state sector. The virtual explosion of private education facilities (and demand for 'new style' diplomas like MBAs, marketing and lawyers) meets the limited supply qualified faculty staff. The outcome is often corruption, declining quality of education and devaluation of degrees (anecdotal example of hiring ad for "delivery boy, higher education degree in management required" is quite vivid). Lifetime learning, short courses, reprofiling trainings are still very new in the region, although in some countries they were introduced with success.

The overall amount of investments in human capital has also declined in the region, in many countries significantly. With most of the economy privatized (and with most private companies heavily undercapitalized), private investment in professional and vocational education was

minimal, reduced to introductory short-term trainings or limited refreshment courses. But even if the private companies were willing to invest in their staff capacities, there was no provider of such services because the system that was supplying the plants and factories of the former socialist economies with qualified workers was tailored to the needs of those non-existent nowadays plants and factories. The system of professional schools that collapsed in most countries of the region wasn't replaced by a new, designed to the needs of the new economic realities.

The health sector was facing similar challenges. Fiscal deficits affected negatively resource allocation for health care. In countries that maintained the old, hospital care focused system, the scarce resources were being wasted. In countries that embarked on health insurance based systems and privatization of healthy care provision, the reforms were often implemented half-way and national health insurance funds were facing decapitalization. The problems are being aggravated by the demographic trends in most countries of the region where population is ageing (with the exception of Central Asia), old-age dependency ratio is increasing and social insurance contributions are declining (both due to low levels of nominal incomes and to high incidence of informal economy). On top of all that transitional stress negatively affected health, especially of men and especially in Western CIS. In the meantime, countries which maintained investments in human capital in transition period showed better economic performance after transition.

### ***Institutions and human capital***

The countries in our region have peculiar experience in that regard with simultaneous evolutions – of the “purpose” and of the “mechanisms.” Both were matched by the collapse of the old system of political governance and individuals' patterns of socialization and both were not always evolving in the similar direction. Generally speaking, old stocks of human capital (not in terms of age but “relevance for purpose”) have been replaced by new stocks but the process is far from over and is largely chaotic (for evidence - see the history of reforms in social services).

Institutions and their transformation were (and still are) having huge implication for human capital formation and utilization (putting it in operation). It involves both institutions directly involved in human capital formation, those constituting demand for it but also the entire make-up of the governance systems in regards responsibilities for human capital formation. In that sense the families are also considered as crucial institution, which is playing its role largely in ad-hoc basis.

The new institutional approach (Douglass North) is applicable analytical framework in that regard adding institutions as a critical constraint and “directing framework” of human capital formation and utilization. Political process and political culture in the countries of the region are particularly relevant factor in the performance of economies largely materializing this impact through the way human capital is being accumulated and utilized. This is also direct link to capacity development agenda in its institutional capacities and enabling environment.

The institutional aspects however are not limited to the formalized structures (sector-specific state institutions) implementing state priorities. They include local communities, family, religious institutions. All they are part of the interrelated process of human capital

accumulation and utilization, affecting both the purpose and the mechanisms (effectiveness of utilization).

### ***Demographic aspects of human capital***

Similarly to most of the European countries, the demographic trends in Montenegro show increasingly ageing population with inevitable impact on the country's employment, health and social systems. Labour supply will decrease, dependency ratio will increase, and there will be a decreased youth with up to date qualifications in labour supply. Consideration is also economic migration and its effects when anticipating future needs from an employment and wider socio-economic perspective. Furthermore, aspirations for the knowledge based economy together with globalisation trends, require more people with better, more specialised, skills and qualifications but also anticipation of the new knowledge and skill profiles for jobs that even do not exist now.

### ***Human capital and county's policy priorities***

There is important momentum in human capital formation that needs to be taken into consideration. What are we currently preparing for – the challenges of yesterday (what we know) or the challenges of tomorrow (where we would like to be?). Also, human capital formation cannot be chaotic ad hoc process. The state has crucial responsibilities in that matter. A major responsibility in that regard is outlining a vision of the country in which the future human capital will be integrated (and within which it will be utilized or wasted).

Drafting a vision is not in the scope of NHDR's task. In that matter the team will be benefitting from (and contributing to) the ongoing discussion managed by the Academy of Sciences in Montenegro. What is possible – and necessary – however is outlining the general parameters that could provide hints in regards the conditions and the environment in which the future human capital will be 'put in motion'. To large extent this will be resource and energy constrained environment with challenges generally referred to 'green economy and society'. The report will thus make explicit link to 'preparedness for the future green society' from the perspective of human capital.

### ***The future NHDR***

The report will consider the **status** of human capital in Montenegro, the **trends** in its formation/depletion since the beginning of transition, the **institutional mechanisms** involved and will make recommendations on improving the efficiency of human capital formation and utilization. The analysis – and the recommendations in particular – will be constructed against the background of the **vision** of Montenegro in 15-20 years from now.

In order to provide relevant analysis of today's challenges, the NHDR would have to root in a historical perspective. Thus can be done both in a separate **introductory chapter** analyzing the departure point of independent Montenegro in regards human capital or can be mainstreamed in individual chapters as introductory sections.

It is too premature to determine the **structure** of the report. At this point it is more appropriate to talk about substantive blocs that would be necessary to have. These are:

- Definitions of human capital – existing thought on the issue, the specific choice made by the authors team and its justification
- Quantifying human capital – overview and comparative analysis of approaches to measuring human capital; feasibility of sound measurement; necessary data; HC Index and correlations with other HD indicators (both historical trends as well as group-level distributions)
- The starting point – human capital in the first years of transition. Overview of the inherited stock of human capital after the beginning of transition. Sector specific aspects (demographic, education, skills, values).
- Evolution of human capital stock in the course of the two decades. Human capital and the ‘moving target’ of human capital formation (evolving parameters of the ‘demand’ for human capital, both due to the transformation as well as globalization)
- Major sector reforms and their implications for human capital (education, health, labor market). ‘Soft’ aspects of human capital (entrepreneurship, costs of entry/exit into markets, values and attitudes)
- Institutional aspects of human capital formation and depletion; current determinants of human capital formation and depletion. Do the systems and institutions work? If now, where exactly are the deficits?