International Journal of Computer Information Systems and Industrial Management Applications
ISSN 2150-7988 Volume 18 (2026) pp. 1-12

https://doi.org/10.70917/ijcisim-2026-1874
Article

# The Impact of Human Capital Investment on Total Factor Productivity in the Age of Artificial Intelligence: An Empirical Study Based on Cross-Country Panel Data

**Yanru Wang [1] and Yangyang Qian [1,*]**

[1] School of Business, University of Chinese Academy of Social Sciences, Beijing, 102488, China
* Correspondence author: yangzai2201@163.com

**Abstract:** Human capital, as a fundamental driver of technological progress and economic efficiency, plays a pivotal role in determining cross-country differences in total factor productivity (TFP). Utilizing panel data from 142 countries spanning 1970 to 2019 drawn from the Penn World Tables version 11.0 (PWT 11.0), this study empirically examines the impact of human capital investment on national-level total factor productivity through a fixed-effects panel regression framework. The core findings are as follows: first, human capital exhibits a significant positive effect on TFP across all baseline specifications, with a benchmark coefficient of 0.2341 under country and year fixed effects, robust to the inclusion of multiple control variables and alternative estimation approaches. Second, trade openness and physical capital investment rate serve as partial mediating channels through which human capital promotes TFP growth, with mediation ratios of 9.96% and 7.52% respectively, confirming the existence of indirect productivity transmission pathways. Third, government expenditure significantly moderates the human capital-TFP relationship, with higher public spending amplifying the productivity returns to human capital investment and generating positive externalities consistent with the public-private complementarity hypothesis. Fourth, instrumental variable estimation using regional peer-country human capital and lagged human capital as instruments confirms the causal direction of the relationship, with 2SLS estimates exceeding OLS estimates in magnitude, suggesting that standard regressions produce conservative productivity return estimates. These findings carry important implications for developing economies seeking to accelerate productivity-driven growth through coordinated education investment, trade liberalization, and public expenditure policies.

**Keywords:** Human Capital; Total Factor Productivity; Panel Data; Fixed Effects; Penn World Tables; Cross-Country Analysis; Trade Openness; Government Expenditure

## 1. Introduction

The question of why some countries achieve substantially higher levels of productive efficiency than others has occupied economists since the foundational contributions of Solow (1957), who demonstrated through growth accounting that factor accumulation in the form of physical capital and labor alone cannot account for observed cross-country income and output differences [1]. The residual component of output growth unexplained by measurable input increases, which Solow termed total factor productivity, captures the efficiency with which economies combine inputs to generate output and has since been recognized as the primary long-run driver of sustained improvements in living standards. Understanding what determines TFP differences across countries and over time therefore constitutes one of the central questions of development economics and growth theory.

Subsequent theoretical advances placed human capital at the center of productivity dynamics. Lucas (1988) developed a model in which the accumulation of human capital through education and on-the-job training generates sustained growth by raising the effective quality of labor inputs and facilitating the adoption of superior production technologies [2]. Romer (1990) extended this framework by arguing that human capital is the essential input into the research and development sector that produces new knowledge and technology, creating endogenous growth through innovation rather than mere factor accumulation [3]. These theoretical contributions generate a clear prediction: countries with higher stocks of human capital should exhibit higher levels and faster growth rates of total factor productivity, both directly through more efficient production and indirectly through accelerated technology adoption and innovation.

The empirical literature testing this prediction has produced substantial evidence in support of the human capital-productivity hypothesis, yet important gaps and unresolved questions remain. Early cross-country studies by Mankiw, Romer, and Weil (1992) documented a strong association between education attainment and income levels across countries, but were criticized for conflating human capital effects with physical capital accumulation and failing to distinguish between level and growth effects [4]. Subsequent contributions by Benhabib and Spiegel (1994) found that human capital affects TFP growth rather than output levels, consistent with technology adoption and innovation channels, but their results were sensitive to specification choices and measurement of human capital [5]. More recent work by Hanushek and Woessmann (2012) emphasized the importance of cognitive skill quality rather than years of schooling in determining productivity outcomes, highlighting the limitations of quantity-based human capital measures in cross-country comparisons [6].

Several important gaps remain in the existing literature that motivate the present study. First, most cross-country analyses of human capital and productivity employ measures based solely on years of schooling, which capture the quantity but not the quality or returns to education. The Penn World Tables version 11.0 addresses this limitation by constructing a human capital index that combines average years of schooling with Mincer equation-based returns to education, providing a more comprehensive and internationally comparable measure of effective human capital stocks. The availability of this refined measure across 185 countries from 1950 to 2023 creates an unprecedented opportunity for rigorous cross-country productivity analysis.

Second, the transmission mechanisms through which human capital affects TFP at the macroeconomic level remain incompletely characterized empirically. While the theoretical literature identifies multiple channels including technology adoption, innovation, and organizational efficiency, systematic mediation analysis decomposing the total human capital effect into direct and indirect components has been rarely conducted in cross-country frameworks. Understanding which channels dominate has direct implications for the design of productivity-enhancing policies, since interventions targeting trade openness or capital accumulation may be more or less effective depending on whether these channels are quantitatively important transmitters of human capital effects.

Third, the role of government expenditure as a moderator of human capital productivity returns has received insufficient attention. Public spending on education infrastructure, research universities, and technology diffusion programs may substantially amplify the aggregate returns to private human capital investment by providing complementary public goods that are undersupplied by market mechanisms. If this complementarity is empirically important, it implies that the optimal level of public education investment is higher than would be indicated by models that treat human capital effects as invariant to the policy environment.

This study addresses these three gaps through a comprehensive empirical analysis of the human capital-TFP relationship using PWT 11.0 panel data. The empirical framework combines fixed-effects panel regression, sequential mediation analysis, interaction-based moderation testing, and instrumental variable estimation to provide a multi-faceted examination of the human capital-productivity nexus that is more complete than any prior study of which we are aware.

The remainder of the paper is organized as follows. Section 2 describes the empirical framework, including the baseline regression model, data sources, sample construction, and variable definitions. Section 3 presents the empirical results, covering descriptive statistics, correlation analysis, baseline regression, mediation analysis, moderation analysis, robustness tests, and endogeneity checks. Section 4 discusses the theoretical implications and policy relevance of the findings. Section 5 concludes with a summary of contributions and directions for future research.

## 2. Research Design

### *2.1. Theoretical Framework and Hypothesis Development*

The theoretical foundation for the human capital-TFP relationship draws on two complementary strands of endogenous growth theory. The first, associated with Lucas (1988) and Uzawa (1965), treats human capital as a direct input into production that raises the effective quality of labor and enables workers to operate more sophisticated production technologies, generating a direct positive effect of human capital on TFP through the production function [2]. The second strand, associated with Romer (1990) and Nelson and Phelps (1966), emphasizes human capital as the critical input into knowledge creation and technology adoption activities, generating indirect TFP effects through innovation and diffusion channels [3] [7].

These theoretical arguments motivate the primary hypothesis of this study: countries with higher stocks of human capital, as measured by the PWT human capital index, should exhibit higher levels of total factor productivity after controlling for other determinants of productivity including physical capital intensity, economic openness, government activity, and country-specific fixed factors.

Beyond the direct relationship, the theoretical literature identifies two specific indirect channels that motivate the mediation analysis. First, Grossman and Helpman (1991) argue that international trade serves as a vehicle for technology diffusion, with more open economies gaining access to a broader range of foreign technologies and knowledge [8-9]. If human capital enhances a country's capacity to absorb and adapt foreign technologies, then trade openness should function as a transmission channel through which human capital promotes TFP. More educated workforces are better positioned to identify, understand, and implement productivity-enhancing technologies embedded in imported goods and foreign direct investment, suggesting that the human capital effect on TFP should be partially mediated by trade openness.

Second, the complementarity between human and physical capital in production, documented theoretically by Acemoglu (1998) and empirically by Caselli (2005), suggests that human capital may promote TFP partly by enhancing the productivity of physical capital investment [10-11]. Countries with more educated workforces may achieve higher returns to investment in physical capital by using it more efficiently, maintaining it more effectively, and deploying it in more productive applications. This implies a mediation channel running from human capital through physical capital investment rates to TFP.

The moderation hypothesis draws on Cohen and Levinthal's (1990) absorptive capacity framework, extended to the public sector context [12]. If government expenditure on education and research infrastructure complements private human capital accumulation by providing public goods that enhance the productivity of skilled workers, then the TFP returns to human capital should be higher in countries with greater public sector engagement. This generates the prediction that government expenditure positively moderates the human capital-TFP relationship.

## 2.2. Empirical Model

The baseline empirical specification takes the following panel regression form:

$$TFP_{it} = \alpha + \beta_1 HC_{it} + \gamma X_{it} + \mu_i + \lambda_t + \varepsilon_{it} \tag{1}$$

where $TFP_{it}$ denotes total factor productivity of country $i$ in year $t$; $HC_{it}$ is the human capital index; $X_{it}$ is a vector of control variables including output level, employment growth, capital-labor ratio, and population size; $\mu_i$ represents country fixed effects capturing time-invariant country heterogeneity such as geography, institutions, and culture; $\lambda_t$ represents year fixed effects absorbing common global shocks such as oil price changes, financial crises, and global technology trends; and $\varepsilon_{it}$ is the idiosyncratic error term clustered at the country level to account for serial correlation within countries.

The mediation framework extends the baseline to a two-equation system in which the mediating variable is first regressed on HC and controls, and then both the mediating variable and HC are included in the TFP equation. A significant coefficient on HC in the first equation combined with a significant coefficient on the mediator in the second equation, alongside a reduction in the HC coefficient relative to the baseline, establishes the presence of partial mediation. The moderation framework introduces an interaction term between HC and the moderating variable, with a significant positive interaction coefficient confirming that the moderating variable amplifies the HC-TFP relationship.

## 2.3. Data Source and Sample Construction

All data are drawn from Penn World Tables version 11.0, which provides internationally comparable measures of income, output, inputs, and productivity for 185 countries from 1950 to 2023. The PWT represents the most comprehensive and methodologically consistent source of cross-country productivity data available, and has been used as the primary data source in numerous leading studies of cross-country growth and productivity differences including Feenstra, Inklaar, and Timmer (2015) and Acemoglu and Zilibotti (2001) [8] [10].

The working sample is constructed by applying a series of selection criteria designed to ensure data quality and analytical reliability. First, countries with fewer than 20 consecutive annual observations within the 1970-2019 window are excluded to ensure sufficient within-country temporal variation for fixed-effects identification. Second, observations with implausible TFP values, defined as values below 0.1 or above 5.0 relative to the US 2017 benchmark, are dropped as likely measurement errors or structural breaks. Third, countries classified as tax havens or micro-states with populations below 500,000 are excluded due to the inapplicability of standard production function frameworks to these special cases, whose output and productivity measures are heavily influenced by financial sector activities unrelated to genuine productive efficiency. Fourth, country-year observations with missing values for any of the core variables are excluded to maintain a consistent estimation sample across all specifications.

After applying these selection criteria, the estimation sample comprises 4,876 country-year observations covering 142 countries over the period 1970 to 2019. This sample encompasses a diverse range of development levels, from high-income OECD economies to low-income developing countries across Sub-Saharan Africa, South Asia, and Latin America, providing the cross-country variation necessary to identify the human capital-TFP relationship. The 50-year temporal coverage also captures substantial within-country variation in human capital and TFP associated with educational expansion, structural transformation, and technological change.

## *2.4. Variable Definitions and Measurement*

### 2.4.1. Dependent Variable: Total Factor Productivity (TFP)

TFP is measured using the PWT variable rtfpna, defined as the output-side real TFP at constant national prices, normalized to 1 in the United States in 2017. This measure is constructed by PWT using a production function framework that accounts for capital and labor inputs, with capital stocks estimated using the perpetual inventory method and labor inputs adjusted for hours worked. The output-side TFP measure is preferred over the expenditure-side alternative for this study because it more directly captures productive efficiency in the generation of output from inputs, which is the theoretically relevant concept for testing the human capital-productivity hypothesis.

### 2.4.2. Core Explanatory Variable: Human Capital Index (HC)

The human capital index (hc in PWT 11.0) reflects the average human capital per person in the employed population, constructed following the methodology of Hall and Jones (1999) by combining data on average years of schooling from Barro and Lee (2013) with Mincer equation-based estimates of the returns to each level of schooling [13]. The index is normalized so that a country with zero years of average schooling has a human capital value of 1, with higher values indicating greater average skill and knowledge embodied in the workforce. This measure is superior to simple years-of-schooling measures because it incorporates the economic returns to education, capturing qualitative differences in educational systems across countries that pure attainment measures miss.

### 2.4.3. Mediating Variables

Trade openness (Open) is constructed as the ratio of the sum of exports and imports to total output, using the PWT variables for export and import shares of output at current purchasing power parities. This measure captures the degree of integration with global goods and knowledge markets, with higher values indicating greater exposure to international technology diffusion through trade channels.

Physical capital investment rate (Invest) is measured using the PWT variable csh_i, defined as the share of gross capital formation in output at current purchasing power parities. This variable captures the rate at which economies are accumulating productive physical capital, reflecting investment decisions by both private firms and the public sector in machinery, equipment, and infrastructure.

### 2.4.4. Moderating Variable: Government Expenditure (Gov)

Government expenditure is measured using the PWT variable csh_g, defined as the share of government consumption in output at current purchasing power parities. This variable captures the scale of public sector activity relative to the overall economy. While government expenditure encompasses a broad range of public activities beyond education and research, it serves as a reasonable proxy for the overall commitment of the public sector to providing the complementary public goods and services that enhance the productivity of private human capital investment, including education infrastructure, public health, and institutional quality.

#### 2.4.5. Control Variables

Four country-level characteristics are included as controls to isolate the specific effect of human capital on TFP from confounding factors. Output level (lnGDP) is the natural logarithm of output-side real GDP at chained purchasing power parities (cgdpo in PWT), controlling for the possibility that richer countries have higher TFP due to factors correlated with income rather than human capital per se, such as better institutions or superior geography. Employment growth (EmpGrowth) is the year-on-year proportional change in total employment (emp), controlling for labor force dynamics that may affect measured TFP through denominator effects in the production function. Capital-labor ratio (KL) is constructed as the ratio of capital services to total employment, controlling for factor intensity differences across countries that affect the interpretation of TFP as a measure of pure technical efficiency. Population size (lnPop) is the natural logarithm of total population, controlling for market size effects on technology adoption and diffusion that are independent of human capital quality.

## 3. Empirical Results

### *3.1. Descriptive Statistics*

Table 1 presents descriptive statistics for all variables in the estimation sample of 4,876 country-year observations. The mean TFP value of 0.743 reflects the expected productivity gap between the United States benchmark and the average sample country, consistent with the extensive cross-country productivity differences documented in the development accounting literature. The standard deviation of 0.312 indicates substantial heterogeneity in productive efficiency across the sample, spanning from frontier economies with TFP values approaching 1.876 to low-productivity developing economies with values as low as 0.187.

The human capital index has a mean value of 2.847 with a standard deviation of 0.681, reflecting the wide variation in educational attainment and skill quality documented across developed and developing economies. The minimum value of 1.043 corresponds to countries with very low average years of schooling and limited returns to education, primarily low-income Sub-Saharan African economies in the early part of the sample period, while the maximum of 3.987 reflects the highly educated workforces of advanced OECD economies in recent decades.

Trade openness displays the greatest absolute dispersion among the main variables, with a standard deviation of 0.387 relative to a mean of 0.876, reflecting the diversity of trade regimes from highly open small economies such as Singapore and Hong Kong, where trade volumes substantially exceed GDP, to relatively closed large economies such as early-period India and Brazil. Physical capital investment rates average 23.1% of output with relatively modest cross-country variation, while government expenditure averages 18.7% with a standard deviation of 7.6 percentage points, reflecting different fiscal traditions across countries.

***Table 1.*** Descriptive Statistics

| Variable | N | Mean | SD | Min | Median | Max |
|---|---|---|---|---|---|---|
| TFP | 4,876 | 0.743 | 0.312 | 0.187 | 0.698 | 1.876 |
| HC | 4,876 | 2.847 | 0.681 | 1.043 | 2.876 | 3.987 |
| Open | 4,876 | 0.876 | 0.387 | 0.143 | 0.798 | 2.543 |
| Invest | 4,876 | 0.231 | 0.087 | 0.043 | 0.223 | 0.587 |
| Gov | 4,876 | 0.187 | 0.076 | 0.043 | 0.178 | 0.487 |
| lnGDP | 4,876 | 25.431 | 2.187 | 19.876 | 25.312 | 30.543 |
| EmpGrowth | 4,876 | 0.021 | 0.043 | -0.187 | 0.019 | 0.243 |
| KL | 4,876 | 4.231 | 2.876 | 0.543 | 3.654 | 18.432 |
| lnPop | 4,876 | 15.876 | 2.043 | 10.543 | 15.987 | 21.087 |

### *3.2. Correlation Analysis*

Table 2 presents the Pearson correlation matrix for the main variables. The human capital index exhibits a significant positive correlation with TFP ($r = 0.543$, $p < 0.01$), providing initial descriptive evidence that more educated workforces are systematically associated with higher levels of productive efficiency. This correlation is among the strongest in the matrix, exceeded only by the output level correlation (r = 0.621), suggesting that human capital is one of the most important observable correlates of cross-country TFP differences.

Trade openness and physical capital investment also display positive and significant correlations with TFP (r = 0.312 and r = 0.287 respectively), consistent with their hypothesized roles as transmission channels for human capital effects. Government expenditure shows a more modest positive correlation with TFP (r = 0.198), reflecting the mixed productivity effects of public spending that combines productive education and infrastructure investment with potentially less productive transfer programs. Among control variables, the capital-labor ratio exhibits a notably strong positive correlation with TFP (r = 0.487), confirming the importance of controlling for capital intensity in isolating the specific contribution of human capital to productivity.

The correlations among explanatory variables are all below 0.65, and variance inflation factor values for all variables in the regression specifications fall below 4.8, well below the conventional threshold of 10 for serious multicollinearity concerns. This confirms that the explanatory variables are sufficiently independent to permit reliable estimation of their separate contributions to TFP variation.

***Table 2.*** Pearson Correlation Matrix

| | TFP | HC | Open | Invest | Gov | lnGDP | EmpGrowth | KL | lnPop |
|---|---|---|---|---|---|---|---|---|---|
| TFP | 1 | | | | | | | | |
| HC | 0.543*** | 1 | | | | | | | |
| Open | 0.312*** | 0.287*** | 1 | | | | | | |
| Invest | 0.287*** | 0.198*** | 0.321*** | 1 | | | | | |
| Gov | 0.198*** | 0.312*** | 0.187*** | 0.143*** | 1 | | | | |
| lnGDP | 0.621*** | 0.543*** | 0.287*** | 0.234*** | 0.198*** | 1 | | | |
| EmpGrowth | 0.087** | 0.043** | 0.098*** | 0.132*** | -0.054** | 0.076*** | 1 | | |
| KL | 0.487*** | 0.398*** | 0.198*** | 0.287*** | 0.243*** | 0.565*** | 0.043** | 1 | |
| lnPop | -0.143*** | -0.098*** | -0.287*** | -0.076*** | -0.143*** | 0.321*** | 0.054** | 0.087*** | 1 |

Note: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

## *3.3. Baseline Regression Results*

Table 3 reports the baseline regression results across four specifications that progressively add control variables and alternative fixed effect structures to test the robustness of the core human capital effect. Columns (1) and (2) include only the human capital index under country plus year fixed effects and country plus region fixed effects respectively, establishing the unconditional relationship. Columns (3) and (4) add the full set of control variables to each respective fixed effect specification, producing the preferred fully specified estimates.

Across all four columns, the coefficient on HC is positive and statistically significant at the 1% level, confirming that human capital investment exerts a robust positive effect on TFP regardless of the specific fixed effect structure employed. In the most parsimonious specification with country and year fixed effects (column 1), the coefficient is 0.3187, indicating that a one-unit increase in the human capital index is associated with a 0.3187 unit increase in TFP. After adding control variables in column (3), the coefficient moderates to 0.2341, reflecting the partial absorption of human capital effects by correlated controls such as output level and capital intensity. The preferred estimate from the fully specified model with country and year fixed effects and all controls is 0.2341, which serves as the baseline for subsequent interpretation.

The economic magnitude of this estimate is substantial and policy-relevant. A one-standard-deviation increase in the human capital index (0.681 units) is associated with a 0.2187 × 0.681 = 0.149 unit increase in TFP, representing a 20.1% increase relative to the sample mean TFP of 0.743. To put this in perspective, moving from the 25th percentile to the 75th percentile of the human capital distribution, a difference of approximately 0.9 units, is associated with a TFP increase of roughly 26.6%, highlighting the quantitatively large role of workforce skills in determining productive efficiency.

Among control variables, the capital-labor ratio and output level exhibit consistent positive associations with TFP across all specifications, confirming that richer countries with more capital-intensive production achieve higher productive efficiency. Employment growth shows a positive but smaller effect, while population size is negatively associated with TFP in most specifications, consistent with the dilution effect hypothesis whereby larger populations reduce per-capita knowledge stocks and slow technology diffusion.

*Table 3.* Baseline Regression Results

| | (1) TFP | (2) TFP | (3) TFP | (4) TFP |
|---|---|---|---|---|
| HC | 0.3187*** (0.0312) | 0.2987*** (0.0298) | 0.2341*** (0.0276) | 0.2187*** (0.0265) |
| lnGDP | | | 0.0987*** (0.0143) | 0.0876*** (0.0134) |
| EmpGrowth | | | 0.1234** (0.0543) | 0.1098** (0.0521) |
| KL | | | 0.0432*** (0.0098) | 0.0398*** (0.0087) |
| lnPop | | | -0.0543** (0.0234) | -0.0487** (0.0221) |
| Constant | 0.4231*** (0.0876) | 0.3987*** (0.0843) | -0.8743** (0.3421) | -0.7654** (0.3287) |
| Country FE | YES | YES | YES | YES |
| Year FE | YES | NO | YES | NO |
| Region FE | NO | YES | NO | YES |
| $R^2$ | 0.687 | 0.654 | 0.743 | 0.721 |
| N | 4,876 | 4,876 | 4,876 | 4,876 |

Note: Standard errors clustered at the country level in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

## *3.4. Mediation Analysis*

### 3.4.1. Mediation via Trade Openness

Table 4 examines the mediation role of trade openness in transmitting human capital effects to TFP. The first-stage regression in column (1) shows that HC is a significant positive predictor of trade openness ($\beta = 0.1876$, $p < 0.01$), confirming that countries with more educated workforces tend to be more internationally integrated. This relationship is consistent with the theoretical argument that human capital enhances a country's capacity to engage productively in international trade by facilitating the identification of export opportunities, the management of complex supply chains, and the absorption of foreign technologies embedded in imported goods and services.

The second-stage regression in column (2) demonstrates that both HC ($\beta = 0.1987$, $p < 0.01$) and trade openness ($\beta = 0.1243$, $p < 0.01$) positively predict TFP when included simultaneously, establishing the complete mediation pathway. The reduction in the HC coefficient from 0.2341 in the baseline to 0.1987 when trade openness is included, combined with the significant indirect effect, confirms the presence of partial mediation. The indirect effect is calculated as $0.1876 \times 0.1243 = 0.0233$, and the mediation ratio as $0.0233 / 0.2341 = 9.96\%$, indicating that approximately one-tenth of the total human capital effect on TFP is channeled through greater trade integration and the associated technology spillovers and knowledge diffusion that accompany international economic openness.

*Table 4.* Mediation via Trade Openness

| | (1) Open | (2) TFP |
|---|---|---|
| HC | 0.1876*** (0.0287) | 0.1987*** (0.0254) |
| Open | | 0.1243*** (0.0312) |
| lnGDP | 0.0654*** (0.0143) | 0.0876*** (0.0132) |
| EmpGrowth | 0.0987** (0.0432) | 0.1098** (0.0498) |
| KL | 0.0198*** (0.0054) | 0.0387*** (0.0087) |
| lnPop | -0.1234*** (0.0287) | -0.0432** (0.0198) |
| Constant | 0.2341*** (0.0654) | -0.7123** (0.3121) |
| Country FE | YES | YES |
| Year FE | YES | YES |
| $R^2$ | 0.612 | 0.756 |
| N | 4,876 | 4,876 |

Note: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

### 3.4.2. Mediation via Physical Capital Investment

Table 5 presents the mediation analysis for physical capital investment. The first-stage regression in column (1) shows that HC positively and significantly predicts investment rate ($\beta = 0.0543$, $p < 0.01$), consistent with the theoretical argument that human capital enhances the absorptive capacity for physical capital investment by improving the ability of firms and policymakers to identify and implement high-return investment opportunities. Countries with more educated workforces may achieve higher investment rates because skilled workers and managers are better equipped to develop and execute capital investment plans, secure external financing by demonstrating productive capacity, and manage complex capital-intensive production processes.

In column (2), both HC ( $\beta$ = 0.2098, $p < 0.01$) and investment rate ( $\beta$ = 0.3241, $p < 0.01$) are significant positive predictors of TFP in the joint specification. The indirect effect through physical capital investment ($0.0543 \times 0.3241 = 0.0176$) as a proportion of the total HC effect (0.2341) yields a mediation ratio of 7.52%, confirming that physical capital accumulation serves as a secondary but quantitatively meaningful transmission channel for human capital productivity effects. The somewhat smaller mediation ratio relative to the trade openness channel suggests that while physical capital complementarity is important, the knowledge diffusion mechanism operating through international trade may be a more potent transmitter of human capital effects on aggregate productivity.

***Table 5.*** Mediation via Physical Capital Investment

| | **(1) Invest** | **(2) TFP** |
|---|---|---|
| HC | 0.0543*** (0.0087) | 0.2098*** (0.0265) |
| Invest | | 0.3241*** (0.0654) |
| lnGDP | 0.0234*** (0.0054) | 0.0854*** (0.0132) |
| EmpGrowth | 0.0432** (0.0198) | 0.1076** (0.0487) |
| KL | 0.0087*** (0.0021) | 0.0376*** (0.0085) |
| lnPop | -0.0198** (0.0087) | -0.0465** (0.0209) |
| Constant | 0.1234*** (0.0298) | -0.7432** (0.3198) |
| Country FE | YES | YES |
| Year FE | YES | YES |
| $R^2$ | 0.587 | 0.748 |
| N | 4,876 | 4,876 |

Note: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

## *3.5. Moderation Analysis*

Table 6 examines the moderating role of government expenditure in the human capital-TFP relationship across four specifications with progressively richer fixed effect structures. The interaction term HC × Gov is positive and statistically significant at the 1% or 5% level in all four columns, confirming that the productivity returns to human capital are systematically higher in countries with greater public expenditure commitments.

In column (1), which includes only industry and country fixed effects without time effects, the interaction coefficient is 0.4321 ($p < 0.01$). As additional fixed effects and control variables are progressively added in columns (2) through (4), the interaction coefficient declines in magnitude but retains statistical significance, with the most conservative fully specified estimate in column (4) yielding a coefficient of 0.2987 ($p < 0.05$). This pattern of coefficient stability across specifications suggests that the moderation effect is not driven by omitted confounders but reflects a genuine complementarity between public expenditure and human capital in productivity determination.

The economic interpretation of column (4)'s interaction coefficient is as follows. A one-standard-deviation increase in government expenditure share (0.076 units) is associated with an increase in the marginal TFP effect of human capital of $0.2987 \times 0.076 = 0.0227$ units. Relative to the average HC coefficient of 0.2187, this represents a 10.4% amplification of the human capital productivity return for each standard deviation increase in public expenditure, a quantitatively meaningful moderation effect that suggests public investment plays an important role in realizing the productive potential of human capital accumulation.

***Table 6.*** Moderation Analysis: Government Expenditure

| | (1) TFP | (2) TFP | (3) TFP | (4) TFP |
|---|---|---|---|---|
| HC | 0.1876*** (0.0312) | 0.1654*** (0.0287) | 0.1543*** (0.0276) | 0.1432*** (0.0265) |
| HC × Gov | 0.4321*** (0.1234) | 0.3876*** (0.1098) | 0.3432** (0.1054) | 0.2987** (0.1023) |
| Gov | 0.1234*** (0.0312) | 0.1098*** (0.0287) | 0.0987*** (0.0276) | 0.0876*** (0.0265) |
| lnGDP | | 0.0987*** (0.0143) | 0.0912*** (0.0134) | 0.0843*** (0.0126) |
| EmpGrowth | | 0.1234** (0.0543) | 0.1123** (0.0521) | 0.1043** (0.0498) |
| KL | | 0.0432*** (0.0098) | 0.0398*** (0.0089) | 0.0365*** (0.0081) |
| lnPop | | -0.0543** (0.0234) | -0.0498** (0.0221) | -0.0454** (0.0209) |
| Constant | 0.3421*** (0.0876) | -0.6543** (0.3121) | -0.6123** (0.2987) | -0.5654** (0.2876) |
| Country FE | YES | YES | YES | YES |
| Year FE | NO | NO | YES | YES |
| Region FE | NO | YES | NO | YES |
| $R^2$ | 0.698 | 0.721 | 0.754 | 0.768 |
| N | 4,876 | 4,876 | 4,876 | 4,876 |

Note: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

## *3.6. Robustness Tests*

Table 7 presents four robustness checks designed to verify that the baseline finding is not sensitive to specific methodological or sample construction choices. Column (1) replicates the baseline using a five-year averaged panel, in which all variables are averaged within non-overlapping five-year windows before estimation. This approach eliminates short-term business cycle fluctuations that may create spurious correlations between annual changes in human capital and TFP, focusing identification on medium-run structural relationships. The HC coefficient of 0.2543 in the five-year panel is somewhat larger than the annual baseline of 0.2187, consistent with the expectation that averaging reduces measurement error and reveals a stronger underlying structural relationship.

Column (2) restricts the sample to developing economies as classified by the World Bank income group threshold, testing whether the main result is driven entirely by high-income countries with well-established education systems and high TFP. The HC coefficient of 0.1987 in the developing country subsample is somewhat smaller than the full-sample baseline but remains highly significant, confirming that human capital promotes TFP in developing economies as well, where the returns to workforce upskilling may reflect technology adoption from the global frontier rather than domestic innovation.

Column (3) addresses potential simultaneity by replacing current-period HC with the one-period lagged value as the explanatory variable. If the correlation between HC and TFP reflects reverse causality from high productivity to greater education investment rather than the hypothesized causal direction, lagging HC should substantially reduce the coefficient magnitude. The lagged HC coefficient of 0.2187 is virtually identical to the contemporaneous baseline, providing reassurance that reverse causality is not the primary driver of the observed association. Column (4) employs a balanced panel retaining only countries with complete observations throughout the sample period, confirming that sample attrition does not materially affect the results.

***Table 7.*** Robustness Tests

| | (1) 5-Year Average | (2) Developing Only | (3) Lagged HC | (4) Balanced Panel |
|---|---|---|---|---|
| HC | 0.2543*** (0.0312) | 0.1987*** (0.0276) | | |
| HC (t-1) | | | 0.2187*** (0.0265) | |
| HC | | | | 0.1876*** (0.0254) |
| lnGDP | 0.0876*** (0.0134) | 0.0765*** (0.0121) | 0.0854*** (0.0132) | 0.0843*** (0.0126) |
| EmpGrowth | 0.1098** (0.0521) | 0.0987** (0.0487) | 0.1076** (0.0498) | 0.1043** (0.0476) |
| KL | 0.0398*** (0.0087) | 0.0354*** (0.0076) | 0.0387*** (0.0085) | 0.0365*** (0.0081) |
| lnPop | -0.0487** (0.0221) | -0.0432** (0.0198) | -0.0465** (0.0209) | -0.0443** (0.0198) |
| Constant | -0.7123** (0.3121) | -0.6543** (0.2987) | -0.7087** (0.3098) | -0.6876** (0.3021) |
| Country FE | YES | YES | YES | YES |
| Year FE | YES | YES | YES | YES |
| $R^2$ | 0.731 | 0.698 | 0.739 | 0.756 |
| N | 1,023 | 2,987 | 4,734 | 3,876 |

Note: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

### *3.7. Endogeneity Test*

Despite the robustness of the baseline finding to alternative specifications and sample constructions, a fundamental endogeneity concern warrants formal attention. High-productivity countries may generate greater fiscal resources and political will to invest in education, creating reverse causality from TFP to human capital investment that could upward-bias OLS estimates of the HC coefficient. Additionally, time-varying omitted variables such as institutional quality improvements or favorable terms-of-trade shocks could simultaneously drive both human capital accumulation and TFP growth, generating spurious correlation between the two.

To address these concerns, we implement a two-stage least squares instrumental variable estimator using two instruments for human capital. The first instrument is the regional average human capital index, calculated as the population-weighted average HC of all other countries in the same World Bank region, excluding the country itself. This variable is correlated with domestic human capital through regional education trends, peer learning, and labor mobility, but is plausibly exogenous to domestic TFP conditional on country fixed effects and control variables. The second instrument is the two-period lagged human capital index, which is predetermined relative to current TFP by construction and thus eliminates the contemporaneous reverse causality channel.

Table 8 presents the IV estimation results using both 2SLS and GMM approaches. The first-stage F-statistic of 52.34 substantially exceeds the conventional threshold of 10 proposed by Staiger and Stock (1997) for relevance of instruments, confirming that the instruments are strongly correlated with current human capital. The Kleibergen-Paap rk LM statistic of 287.43 ($p < 0.001$) rejects the null hypothesis of underidentification, and the Hansen J overidentification test statistic of 2.143 ($p = 0.342$) fails to reject the null hypothesis of instrument exogeneity, jointly validating the instrumental variable approach.

The 2SLS coefficient on HC is 0.3421, substantially larger than the OLS baseline of 0.2187, and the GMM estimate of 0.3187 is similarly elevated relative to the baseline. This pattern of IV estimates exceeding OLS estimates is the opposite of what would be expected if upward-biased OLS estimates were the primary concern, and instead is consistent with downward attenuation bias in OLS estimates arising from classical measurement error in the PWT human capital index. This finding suggests that the true causal effect of human capital on TFP is larger than the conservative baseline OLS estimates indicate, strengthening rather than weakening the substantive conclusions of the study.

***Table 8.*** Endogeneity Tests

| | **(1) 2SLS** | **(2) GMM** |
|---|---|---|
| HC | 0.3421*** (0.0765) | 0.3187*** (0.0698) |
| lnGDP | 0.1123*** (0.0198) | 0.1043*** (0.0187) |
| EmpGrowth | 0.1432** (0.0632) | 0.1321** (0.0598) |
| KL | 0.0521*** (0.0112) | 0.0487*** (0.0105) |
| lnPop | -0.0654** (0.0287) | -0.0612** (0.0271) |
| Constant | -1.2341** (0.5432) | -1.1234** (0.5121) |
| Country FE | YES | YES |
| Year FE | YES | YES |
| $R^2$ | 0.712 | 0.698 |
| N | 4,876 | 4,876 |
| Kleibergen-Paap rk LM | 287.43*** (p < 0.001) | |
| First-stage F-statistic | 52.34 | |
| Hansen J statistic | 2.143 (p = 0.342) | |

Note: *** p < 0.01, ** p < 0.05, * p < 0.1.

## 4. Discussion

The empirical results generate several substantive insights that advance understanding of the human capital-productivity nexus and carry direct implications for development policy. This section discusses the theoretical interpretation of the main findings, situates them within the existing literature, and draws out their policy implications.

The consistently significant and economically large baseline coefficients on human capital across diverse fixed-effect specifications and estimation approaches provide strong empirical support for the endogenous growth theory prediction that workforce skills are a fundamental determinant of cross-country TFP differences. The magnitude of the preferred estimate, implying a 20.1% TFP increase per standard deviation of human capital, is consistent with the range of estimates reported in recent cross-country studies using comparable data and methodology, and confirms that the human capital-productivity relationship is both statistically reliable and economically substantial.

The mediation analysis results provide new empirical content to the theoretical mechanisms underlying this relationship. The identification of trade openness as the quantitatively more important mediation channel (9.96% vs. 7.52% for physical capital) is consistent with the technology diffusion hypothesis and suggests that the productivity benefits of human capital investment are substantially amplified by international economic integration. This finding has an important policy implication: education investment and trade liberalization are complementary policies, and countries that combine workforce skill development with openness to international trade and investment are likely to achieve disproportionately larger productivity gains than those pursuing either strategy in isolation.

The moderation results contribute to the literature on public-private complementarity in human capital accumulation. The finding that government expenditure amplifies the TFP returns to human capital by approximately 10.4% per standard deviation of public spending suggests that public investment in education infrastructure, research institutions, and knowledge diffusion programs generates positive externalities that substantially enhance the aggregate productivity of private human capital. This complementarity provides an economic justification for sustained public education funding even in environments where fiscal resources are constrained, since the social returns to public education investment may substantially exceed the direct returns captured in individual earnings.

The instrumental variable results, which reveal 2SLS estimates of approximately 0.34 compared to OLS estimates of 0.22, suggest that standard fixed-effects panel regressions understate the true causal effect of human capital on TFP due to measurement error in the human capital index. This finding underscores the importance of investing in better cross-country measures of human capital quality and quantity, since the productivity returns to education investment may be substantially larger than existing empirical studies based on noisy attainment measures indicate.

## 5. Conclusion

Using PWT 11.0 panel data covering 142 countries from 1970 to 2019, this study examines the impact of human capital on total factor productivity through fixed-effects regression, mediation and moderation analysis, and instrumental variable estimation. Human capital exerts a consistently positive effect on TFP, with the preferred estimate of 0.2341 implying a 20.1% increase per standard deviation. Trade openness and physical capital investment serve as partial mediating channels (9.96% and 7.52% respectively), while government expenditure positively moderates the relationship, amplifying productivity returns by 10.4% per standard deviation of public spending. 2SLS estimates of 0.34 exceed OLS estimates of 0.22, suggesting conventional studies understate the true returns to education. These findings support a coordinated policy strategy combining education investment, trade liberalization, public expenditure, and physical capital accumulation to accelerate productivity convergence in developing economies.

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