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M.A Economics(Sem-2)
Paper – CC-6
Economics of Growth and Development.**(Module-2)**

Capital Formation

The meaning of "capital formation" is that society does not apply the whole of its current productive activity to the needs and desires of Immediate consumption, but directs a part of it to the making of capital goods, tools and instruments, machines and transport facilities, plants and equipment - all the capital that can so greatly increase the efficiency of productive effort.

Capital formation consists of both tangible goods like plants tools and machinery and intangible goods such as high standards of education, health, scientific tradition and research.

❖ Process of Capital formation:-

➢ Capital formation undergoes three main stages.

(i) Creation of savings.

(ii) Mobilization of savings.

(iii) Investment of savings.

(I) Creation of Savings - The creation of savings is the first stage of capital formation. It means that there must be an increase in the volume of real savings. Thus, for capital formation, some current consumption has to be sacrificed for obtaining a large part of flow of consumer goods. Therefore it is essential that people should save from the present consumption.

(II) Mobilization of savings- The next process of saving is that it must be mobilized converting into investible funds Banking facilities give considerable helps to promote high rate of mobilization and channelization of savings.

(III) Investment of saving - The final stage is the investment of savings into capital goods. It needs a class of efficient and skilled entrepreneurs.

❖ Reasons for Low Rate of Capital formation:-

Low rate of capital formation has been the result of the interaction of Various reasons like economic, social and cultural which are operating in underdeveloped countries. These are discussed under the following heads:

(1). The root cause of capital deficiency in underdeveloped countries is low level of real national and per capita income which limits the motives of savings and investments.

(2). Lack in demand of capital is another cause of low rate of capital formation.

(3). Like demand of capital, lack of supply of capital is responsible for low capital formation.

(4). Due to small size of domestic market, investment is not encouraged in poor countries.

(5). Basic overheads like roads, buildings, communication, education, water, health etc. are generally lacking in underdeveloped countries and provide an improper atmosphere for the capital formation and slow process of capital formation.

(6). Efficient entrepreneurs are not available in underdeveloped countries. It is very important reason for low rate of capital formation.

(7). Due to backwardness of technology, under developed countries have low productivity and per capita production and less quantity of income as a result lower the rate of capital formation.

(8). Lack of Effective fiscal policy or financial policy in underdeveloped countries also retards capital formation.

(9). Due to demographic reasons, in underdeveloped countries, the growth rate of population is very high which keeps the rate of capital formation at a low level.

❖ Steps to raise the rate of Capital Formation:-

According to Prof. Nurlse, "Due to low productivity in underdeveloped countries, people have low real income and thus, purchasing power is low and so due to low demand, investment has bad effect which again reduces national income and productivity and rate of capital formation remains low."

Thus the most important problem facing an underdeveloped country is to raise the rate of capital formation. This problem is two-fold. First, how to increase the propensity as to save the common man in the lower income groups and secondly, how to utilize current savings for capital formation.

➢ **Therefore, the rate of capital formation can be raised by**

(i) Domestic saving as well as

(ii) External resources.

❖ A Domestic Savings

Domestic savings represent a community's surplus of production over its minimum consumption requirements. The large the size of the surplus, the greater will be possibility of attaining a higher level of formation. Domestic saving is the most reliable source of investment which helps to break the vicious circle of poverty and underdeveloped.

➢ The following measure can be adopted to increase the domestic savings:

(i).. Drive to save- Science drives go a long way in solving the acute problem of augmenting savings. Efforts should be made through propaganda and social education. Common masses can be persuaded to save in their own interest of their family. Issuing of saving certificates, bonds are also helpful in mobilizing savings. The profits of saving should be advertised so that general people may tend to change their attitude.

(ii).. Establishment of Financial Institutions- In poor and less developed countries, people hoard their unspent current income and invest in jewels, gold, property, etc. Therefore, such countries must have well organized financial institutions where countrymen may easily deposit their unspent money with confidence. Moreover, money collection process should be simple so that even the layman does not find any hardship in depositing and getting loans. Special attention should be made to establish various institutions on sound footing like insurance, compulsory provident fund, Provident-cum-Pension schemes and opening of new banks especially in rural areas and cooperative societies.

(iii).. Reduction in Income Inequalities- This method is also regarded as the measure adopted in order to achieve high rates of saving and investment. It is a common fact that the people in underdeveloped countries possessed lower marginal propensity to save. High income group spend more money on luxury goods, thus their savings are less. Therefore, riches should be equally distributed in these countries so that low income groups may have more income and this may lead to increase in the size and quantity of domestic savings.

(iv).. Fiscal measures- The government can mobilize the resources through fiscal policy. These measures are in the form of a budgetary surplus, taxation, reduction in government expenditure, expansion of export section, loans and deficit financing, Besides, growth oriented long-term saving policy should be evolved. Taxation is an effective instrument of fiscal measure for reducing consumption and transferring resources for productive investment. Taxation helps capital formation two ways (i) by transferring private resources to the state for utilization in the desired channels and (ii) by providing incentives to the private sector to increase production. Furthermore, public borrowing is another method of diverting resources form unproductive to productive gainful channels. But, its scope is also restricted in such countries as there is lack of organized capital and money markets.

(v).. Reduction in Consumption- Prof. R. Nurkse and Prof. W.A. Lewis are of the opinion that saving can be raised through restricting consumption. It is argued that the level of consumption of the common people in underdeveloped countries is extremely below the subsistence line. Therefore, the rate of savings can be increased by curtailing the conspicuous consumption of the rich and by diverting an increasing percentage of the increments in national income to capital formation.

(vi).. Proper Utilization Natural Resources- The main drawback within the underdeveloped counties is the proper utilization of resources. With the proper development of technical knowledge education and training faculties. Productivity of labor can be enhanced and model techniques can be put to their best use. This will lead to rise in the rate of saving and capital formation.

(vii).. Utilization of Hoarded Resource – In underground countries, people invest their extra saved income in hoarding ornaments, precious gold, jewels and in productive religious institutes. It is, therefore, necessary that government in such counties should steps to prohibit law to process above stipulated quantity. Proper care should be taken to stop the smuggling of gold into the country. In this manner, hoarded resources like gold can be utilized for making investment in productive channel, which in turn leads to capital formation.

(viii).. Utilization of Disguised Unemployment – It is a widely accepted view that there exists a saving potential in the disguised unemployment in over populated countries of the world. Of this potential is effectively utilized, it can become a major source of capital formation and furthermore of economic development.

❖ External Sources

Domestic sources for capital formation are generally scarce and they are required to be supplemented by external sources which are discussed below:

(1). Private Foreign Investment. The less developed and poor countries take the advantage of the foreign investment form private foreign investment which is in the shape of private business firms or persons. In modern times, this system is not much favored as private foreign investors invest only in capital import industries in which they are interested and do not take care of public welfare.

(2). Loans, Grants and Aid from Foreign Government- These methods are used for foreign governments through heavy machines, instruments, and other capitalized goods by imports. Furthermore, loans grants are also given to the needed countries but foreign loans and grants generally have deep burden on the domestic government and major portion of national income goes as interest to the concerned country. Therefore, proper care should be made to use these loans for productive purposes and follow the policy to encourage export and restrict imports.

(3). Restriction of Imports – It means that restriction should be imposed on all luxury imports if the domestic income saved on imported consumer goods is not invested on luxury and semi-luxury goods at home. But this saved amount should be diverted into productive channel on public utility services. This process will certainly lead to increase in capital formation.

(4). Terms of Trade – Another vital source for achieving means for capital formation in underdeveloped countries is the favored terms of trade. It means if the terms of trade are made in favor of such counties, then they are in a position to import large quantities of capital goods. The main benefit of this form of capital formation is that neither leads to increase in the burden of intentional debt nor one has to struggle through the domestic lands grants. Domestic economy is also saved from instability.