

Capital Formation for Economic Development

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Outlines of the Lecture:

- Capital formation and its importance
- Source of Capital Formation,
- Causes of Low Capital Formation in LDCs
- Measures to increase Capital Formation

Capital Formation:

The act of increasing the stock of capital in the economy is given the name of Capital Formation.

Capital formation means a situation where the society does not consume whole of its current income but directs a part of it for making capital goods like instruments, machines, plants, equipments, transport facilities, finished & semi-finished good.

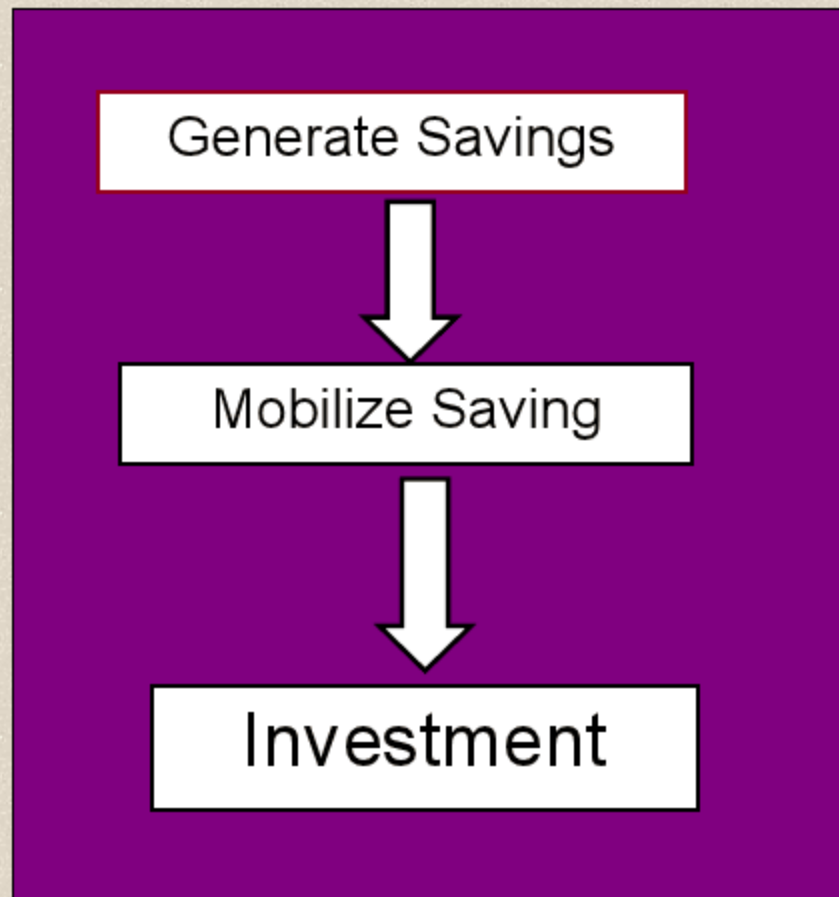
All this means that capital formation is the process whereby a part of society's available resources are diverted to increase the stock of capital goods so that the output could be expanded in the future.

Capital Formation:

Capital formation results when some portion of society's present income is saved and invested in order to increase material as well as human capital.

In words of Singer “ Capital formation consists of both tangible goods like plants, tools and machinery and intangible goods like high standard of education, health, scientific tradition and research.

Process of Capital Formation



Importance of Capital Formation:

The importance of capital formation as one of the factors in economic development is discussed below:

1. Increase productivity of various sectors:

capital formation increases the stock of material and human capital. The productivity in agriculture, manufacturing and mineral sector etc increases.

2. Increase in National Income:

Capital formation helps in raising national output which in turn raises the rate and level of national income.

3. Increase employment:

The increased investment in various sectors of the economy leads to increase employment opportunities in a country.

Importance of Capital Formation:

4. Break the vicious circle of poverty:

it helps in breaking the vicious circle of poverty in the LDCs.

5. Expansion of market:

Capital formation makes it possible to produce the goods on large scale. As the good of one industry will be the inputs of other and so on. Thus the size of the market will be extended.

Importance of Capital Formation:

6. Control Inflation:

Capital formation increases the supply of goods in the country. It thus helps in controlling inflation and bringing stability in the economy in the long-run.

7. Self-Sufficiency:

A country engaged in capital formation will be able to produce a variety of goods and make the country self-sufficient. This will reduce a country's dependence on foreign countries.

8. Correct Balance of Trade:

Capital formation helps in building import-substitution industries. The reduced demand of the foreign goods helps in solving the problems of adverse balance of trade.

Importance of Capital Formation:

9. Proper Utilization of Natural Resources:

The adequate volume of capital formation makes it possible to utilize the natural resources of a country to the maximum extent and thus increase the rate of economic growth rapidly at a higher rate.

10. Technological Progress:

Technological progress requires higher rate of capital formation. The technological improvements helps in getting more output from the same resources.

11. Building up of infrastructure:

The building up of sound infrastructure like road, railways, communication system, power etc is an vital significance of capital formation which helps in breaking Vicious Circle of poverty.

Sources of Capital Formation

There are two sources of capital formation

A. Domestic Sources:

- a. *Voluntary savings* by household and business sectors
- b. *Involuntary saving* by transferring resources from consumers and producers to government through taxation.
- c. *Government borrowing*
- d. *Use of idle resources*
- e. *Deficit financing*

B. External Sources:

- a. *Foreign Aid*
- b. *Restrictions of imports*
- c. *Direct Foreign Investment*

Causes of Low Capital Formation:

The following are the causes of low capital formation in LDCs:

1. Vicious Circle of poverty:

The low capital formation in LDCs is attributed to vicious circle of poverty which operates in LDCs. It is because of VCP the incomes, savings, investment and productivity of the people remains limited and obstructed.

2. Population explosion <higher birth rate>:

In case of poor countries not only the volume of population is very high but the rate of growth of population is also significantly greater. In such situation all of the incomes have to be devoted to the rising number of children and nothing is left to be allocated for savings.

Causes of Low capital formation.... continued

3. International Demonstration Effect:

According to Prof. Nurkse the biggest obstacle in the way of capital formation in LDCs is the existence of International Demonstration Effect. It means that the people of LDCs have the desire to attain that standard of living which has been attained by Developed Countries (DCs); their consumption pattern must be similar to those of DCs and their educational systems must be like those of DCs. In such situation, the people of LDCs spend all of the increase in their incomes on consumption needs. The propensity to save remains low leading to low capital formation.

Causes of Low capital formation.... continued

4. Lack of proper infrastructure:

In case of LDCs, there is an acute shortage of infrastructure facilities like power, transport, communication etc. thus in the presence of inadequate infra-structure the domestic as well as foreign investors are not prepared to invest. With this the stock of capital and capital formation remains low.

5. Inflation:

In UDCs, inflation is a very common phenomenon. Because of persistent rise in general price level, the real incomes of the people decrease restricting their saving potentials.

Causes of Low capital formation.... continued

6. Unproductive expenditures:

In case of LDCs, the lavish expenditures are made on unproductive fields both by individuals as well as by governments. The individuals waste their precious savings by spending them on traditions, customs and litigations etc. while government make expenditures on unproductive fields for example political purposes. Consequently a little surplus is available for capital formation.

7. Unequal income distribution:

in UDCs, the distribution of income and wealth is very unequal. The rich do not care for saving and the poor have very low MPS. Thus capital formation remains low.

Causes of Low capital formation.... continued

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Causes of Low capital formation.... continued

8. Tax system:

in UDCs, the tax structure is also responsible for low capital formation. In these countries the indirect taxes are imposed in a greater amount rather direct taxes. This situation also discourages the saving potential of the people. In this situation, the poor and middle class of the UDCs hardly contributes to savings and capital formation. On the other hand, the businessmen and industrialists are always found hectic regarding tax evasion.

9. Problems of Money Markets:

Money market is in infancy in the less developed countries which is not fully contributing to capital formation.

Measures to Increase Capital Formation:

The effective measures to increase capital formation in a developing country are:

1. Saving drives:

Savings of both types, voluntary and involuntary can greatly help in capital formation.

2. Setting up financial institutions:

The setting up of financial institutions in urban and rural areas can greatly help the people to deposit their savings in financial institutions rather than keeping them in homes. The small and larger amounts of saving so collected helps in raising funds for development.

Measures to Increase Capital Formation:

3. Public Borrowing:

Public borrowing is an effective method of capital formation. Government raises loans through sale of bonds and saving certificates etc.

4. Development of Capital Markets:

Government can divert resources from unproductive channels by strengthening the capital market in the country. The establishment of stock exchanges etc can go a long way in capital formation.

Measures to Increase Capital Formation:

5. Privatization of financial institutions:

The privatization of financial institutions can also attract savings both at the gross and higher level by providing full range of banking services to customers. The impressive performance of the financial institutions can help in mobilizing resources for development.

6. Utilization of disguised unemployed workers:

If the disguised unemployed workers are employed on various projects like irrigation, roads etc they can be a fruitful sources of capital formation.

Measures to Increase Capital Formation:

7. Foreign Aid:

if the capital is not adequate for meeting the development requirements of the country, then to bridge the savings-investment gap, the country has to rely on foreign aid for economic development.

8. Restrictions on Luxury Imports:

another source of capital formation is the imposition of restrictions on luxury imports. The foreign exchange thus saved could be used for capital formation.

Measures to Increase Capital Formation:

9. Foreign Earning through exports of physical goods:

The foreign earning through boosting the exports of physical goods to the other parts of the world can be utilized for capital formation.

10. Foreign Remittance:

Foreign remittance refers to the earning by services export by the inhabitants of a country. If the government increase the search to find jobs for the people in other countries they will bring foreign remittance to the country which can be utilized for capital formation.

Thank You