CAPITAL FORMATION AND ECONOMIC DEVELOPMENT

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Abstract

Almost all economists lay emphasis on capital formation as the major determinant of economic growth. “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, plant and equipment— all the various forms of real capital that can greatly increase the efficacy of productive effort. The essence of the process then, is the diversion of a part of society's currently available resources to the purpose of increasing the stock of capital goods so as to make possible an expansion of consumable output' in future.”[1] Nurkse's definition relates only to the accumulation of material capital and neglects human capital. A proper definition must include both material and human capital. According to Singer, 'capital formation consists of both tangible goods like plants, tools and machinery and intangible goods like high standards of education, health, scientific tradition and research.' The same view has been expressed by Kuznets in these words: "Domestic capital formation would include not only additions to constructions, equipment and inventories within the country, but also other expenditure, except those necessary to sustain output at existing levels. It would include outlays on education, recreation and material luxuries that contribute to the greater health and productivity of individuals and all expenditures by society that serve to raise the morale of employed population." Thus the term capital formation covers material as well as human capital.

IMPORTANCE OF CAPITAL FORMATION

Capital formation (or accumulation) is regarded as one of the important and principal factors in economic development. According to Nurkse, the vicious circle of poverty in underdeveloped countries can be broken through capital formation. Due to low level of income in such countries, demand, production and investment are deficient. This results in the deficiency of capital goods which can be removed by capital formation. The supplies of machines, equipment and tools increase. The scale of production expands. Social and economic overheads are created. It is capital formation that leads to fuller utilisation of available resources. Thus capital formation leads to increase in the size of national output, income and employment thereby solving the problems of inflation and balance of payments, and making the economy free from the burden of foreign debts.

We will discuss below the importance of capital formation in detail. The main purpose of economic development is to build capital equipment on a sufficient scale to increase productivity in agriculture, mining, plantations and industry. Capital is also required to construct schools, hospitals, roads, railways, etc. In fine, the essence of economic development is the creation of economic and social overhead capital. This is possible only if there is a rapid rate of capital formation in the country, that is, if a smaller proportion of the community's current income or output is devoted to consumption and the rest is saved and invested in capital equipment. As aptly pointed out by Lewis, the central problem in the theory of economic development is the process of raising domestic saving and investment from 4-5 per cent to 12-15 per cent of national income.

Investment in capital equipment not only increases production but also employment opportunities. Capital formation leads to technical progress which helps realise the economies of large-scale production and increases specialisation. It provides machines, tools and equipment for the growing labour force. Thus capital formation also benefits labour. Capital formation leads to expansion of market. It is capital formation which helps remove market imperfections by the creation of economic and social overhead capital, and thus breaks the vicious circles of poverty both from the demand side and the supply side. Further, capital formation makes development possible even with increasing population. In overpopulated underdeveloped countries the increase in per capita output is related to the increase in capital-labour ratio. But countries aiming at raising the capital-labour ratio have to face two problems. First, the capital-labour ratio falls with increase in population so that large net investment is needed to overcome the diminution of capital-labour ratio. Second, when population is increasing rapidly, it becomes difficult to have sufficient savings for the required quantity of investment, reason being that a low per capita income keeps the propensity to save at a low level in such a country. The only solution to these problems is a rapid rate of capital formation.

Under-developed countries are faced with the problem of balance of payments because they mostly export primary products like raw materials and agricultural products, and import almost all types of manufactured, semi-manufactured and capital goods. Domestic capital formation is one of the important solutions to this problem of adverse balance of payments. By establishing import-substitution industries, the import of manufactured and semi-manufactured goods are reduced. On the other hand, with increasing production of all types of consumer and capital goods the composition of exports changes. Along with agricultural products and industrial raw materials, the exports of manufactured articles also start. Thus capital formation helps in solving the problems of balance of payments. A rapid rate of capital formation gradually dispenses with the need for foreign aid. In fact, capital formation helps in making a country self-sufficient and reduces the burden of foreign debt. When a country borrows from foreign countries for long periods, it imposes a heavy burden on the future generations. With every loan the debt charges increase day-by-day which can only be repaid by levying more or/and higher taxes. The burden of taxes increases and money flows out of the country in the form of debt repayments. Therefore, it is capital formation that brings freedom from foreign aid, reduces the burden of foreign debt and makes the country self-sufficient.

The strains of inflationary pressure on a developing economy can be removed to a considerable extent by increased capital formation. The output of agricultural products and manufactured consumer goods tends to increase with a rise in the rate of capital formation. On the other hand, when income increases with capital formation, it raises the demand for goods. In the short run, it is not possible to match this increased demand by increase in supply and this results in the development of inflationary pressure in the economy. It is, however, a steady rise in the rate of capital formation in the long-run that augments the supply of goods, controls inflation and brings stability in the economy.

Capital formation also influences the economic welfare of a country. It helps in meeting all the requirements of an increasing population in a developing economy. When capital formation leads to proper exploitation of natural resources and the establishment of different types of industries, levels of income increase and the varied wants of the people are satisfied. They consume a variety of commodities, their standard of living rises and their economic welfare increases.

Lastly, an increase in the rate of capital formation raises the level of national income. The process of capital formation helps in raising national output which in turn raises the rate and level of national income. Thus the rise in the rate and the level of national income depends on the increase in the rate of capital formation. Thus capital formation is the principal solution to the complex problems of underdeveloped countries, and is the main key to economic development.

REASONS FOR LOW RATE OF CAPITAL FORMATION

The rate of capital formation is low in LDCs. The reason is that they lack in those factors which determine capital formation. In fact, capital formation depends upon savings, on the institutions mobilising these savings and on the investment of these savings. The failure of these three stages of capital formation to operate properly is responsible for the low rate of capital formation in such countries. The rate of capital formation in LDCs is about 5 per cent, whereas in America it is 15 per cent and in West Germany and Australia about 25 per cent.

The main reasons for low rate of capital formation in LDCs are the following:

Low Income. Large savings are essential for capital formation and savings depend upon the size of income. Since agriculture, industry and other sectors are backward in underdeveloped countries, the national output is low and so is the national income. As a result, per capita income is also low. On the other hand, the propensity to consume is very high, it is near unity. So almost the entire income is spent on consumption. Thus saving is not possible and the rate of capital formation remains low.

Low Productivity

Since the level of productivity is very low in such countries, the rate of growth of national income, saving and capital formation are also low. Their natural resources are either unutilised or misutilised due to lack of efficient labour and technological knowledge. non-availability of capital, etc. These factors stand in the way of increasing the income of the resource-owners so that they are unable to save and invest more and the rate of capital formation does not rise.

Demographic Reasons

LCDs possess such demographic features which keep the rate of capital formation at a low level. The growth rate of population is very high. On the other hand, the per capita income is low. As a result, the entire income is spent on bringing up the additional numbers, and little is saved for capital formation. Besides, the rapid increase in numbers aggravates the shortage of capital because large investments are required to equip the growing labour force even with obsolete equipment. Moreover, in such economies a large percentage of children in the total population entails a heavy burden on the parents in bringing them up and they are unable to save for capital formation. Lastly, such countries have a shorter life expectancy which means a smaller fraction of their population is available as an effective labour force. Since workers die in the prime of their lives, there are few adults to provide for large number of children. This brings down the per capita income further. Thus demographic reasons inhibit the rate of capital formation.

Lack of Enterprise

The lack of entrepreneurial ability is another factor responsible for low rate of capital formation in LDCs. 'In fact entrepreneurship is regarded as the focal point in the process of economic development. But in LDCs the small size of market, deficiency of capital, lack of private property and contract, etc., retard enterprise and initiative, thus there is low rate of capital formation.

Lack of Economic Overhead

Existence of economic overheads is essential to make fruitful investment and to encourage enterprise, for capital formation depends on them to a considerable extent. But economic overheads like power, transport, communications, water, etc., are lacking in LDCs which retard enterprise, investment activities and the path of capital formation.

Lack of Capital Equipment

In such countries the rate of capital formation also remains low due to lack of capital equipment. Here, not only the capital stock is low, but even capital is deficient. The total capita! investment is hardly 5 to 6 per cent of the national income in LDCs whereas it is 15 to 20 per cent in developed countries. Due to shortage of capital, it is not possible to replace the existing capital equipment and even to cover its depreciation in such countries. As a result, the rate of capital formation remains at a low level.

Inequalities in Income Distribution

There are extreme inequalities in income distribution which keep the rate of capital formation low in such countries. But income inequalities do not imply larger savings. In fact, larger savings are possible only in the case of the top 3 to 5 per cent of the people in the income-pyramid. But these people invest in unproductive channels like gold, ornaments, precious stones, rearestates, foreign currency, etc. This distorts real investment and, the rate of capital formation is low.

Small Size of the Market

The small size of the market is another reason for the low rate of capital formation in LDCs. It is a big hindrance in the way of enterprise and initiative. People are poor in such countries. The demand forgoods is limited due to their low income. Hence it is the small size of the domestic market to absorb the supply of new products. This keeps the rate of capital formation at a low level.

Lack of Financial Institutions

Another reason for the low rate of capital formation in such countries is the lack of financial institutions to procure funds for investment. Larger capital expenditure is required for productive purposes. But this is not possible because of the lack of properly developed capital and stock markets, and credit and banking institutions. As a result, sufficient savings cannot be mobilised for investment purposes and the rate of capital formation remains low.

Economic Backwardness

Economic backwardness is also responsible for the low rate of capital formation in LDCs. Low labour efficiency, factor immobility, limited specialisation in occupation and in trade, economic ignorance, traditional values and social structure retard saving and investment, and prevent the rate of capital formation from increasing.

Technological Backwardness

Technological backwardness also stands in the way of capital formation. Obsolete techniques of production are used in such countries. As a result, per unit labour productivity and per unit capital productivity remain low. This situation keeps the national output and income low, and the rate of capital formation fails to rise.

Deficit Financing

One of the important sources of capital formation in such countries is deficit financing. But if it crosses the limits of safety then it tends to lower the rate of capital formation. It happens when deficit financing leads to an inflationary situation in the country. When prices rise, goods become dearer. As a result, consumers are required to spend a larger portion of their income on buying goods, and it becomes difficult to save. This retards capital formation.

Increase in Taxes

Taxes also retard and reduce capital formation. When governments increase the number and rates of taxes as a means of forced savings, the income of consumers is reduced. This may be due to both direct and indirect taxes. Direct taxes reduce income directly while indirect taxes reduce income by raising their prices. Thus savings and capital formation are retarded.

Demonstration Effect

According to Nurkse, one of the important reasons for low rate of capital formation in LDCs is the demonstration effect. Everybody has an urge to imitate the standard of living of his prosperous neighbours. Similarly, there is a tendency on the part of the people of such countries to emulate the higher consumption standards of advanced countries. This demonstration effect is usually caused by foreign films, magazines and visits abroad. As a result, the rise in income is spent on increased expenditure on conspicuous consumption and thus savings are almost static or negligible. Thus, the rate of capital formation fails to rise.

References:

1. R. Nurkse, op. cit., p. 2.

2. UN, World Economic Survey, 1966, pp. 29-30.

3. Lewis, Op. cit.

4. World Economic Survey, op. cit, p. 26.

5. W.A. Lewis, op. cit. p. 239