Chapter-4

CAPITAL FORMATION AND ECONOMIC DEVELOPMENT

1. WHAT IS CAPITAL FORMATION? ITS ROLE IN ECONOMIC DEVELOPMENT

Capital formation is one of the major factors in economic development. It is the increase in the stock of both material and human capital by making available a part of society's currently available resources. Capital formation results when some proportion of society's present income is saved and invested in order to increase material as well as human capital. In the words of Prof. Ragnar Nurkse, "The meaning of capital formation is that society does not apply all its resources 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 various forms of real capital that can so greatly increase the efficiency of productive effort."

Significance of Capital formation

The importance or significance of capital formation in the process of economic development of a country is briefly given below:

(1) **Building up of infrastructures.** The building up of sound infrastructure like, roads, railways, communication system, power etc. is an important form of capital formation. It greatly helps in breaking the vicious circle of poverty in the country.

(2) **Adoption of modern techniques of production.** Capital formation helps in the use of modern techniques and adoption of complex methods of production for rapid growth in production in large scale industries.

(3) **Qualitative improvement of human resources.** Capital formation plays an important role in the qualitative improvement of human resources. The expenditure incurred on human resource development like educations, health, environmental protection, social welfare etc., contributes to better health of the people and to total productivity of the country.

(4) **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.

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

(6) **Development of agriculture and industrial sectors.** Capital formation helps in the modernization of agriculture and industrial sectors in a country. The use of latest techniques of production helps in lowering cost of production and increasing production.

(7) **Higher rate of growth in national income.** Capital formation is playing an important role in raising the real per capital income and GDP of the country through improved productions in different sectors of the economy.

(8) **Expansion of economic activities.** Capital formation helps in increasing the supply of goods in a country. It thus helps in controlling inflation and bringing stability in the economy in the long run. Capital formation leads to increase in effective demand.

(9) **Building import substitution industries.** Capital formation helps in building and expansion of import substitution industries. The reduced demand of the foreign goods helps in solving the problem of adverse balance of trade.

(10) **Reduction of foreign debt.** Higher rate of capital formation makes a country self sufficient in the production of goods and reduces the burden of foreign debt.

2. SOURCES OF CAPITAL FORMATION

There are two sources of capital formation (1) Domestic sources and (2) External sources. These two sources of financing economic development are now discussed in brief.

1. Domestic Sources:

Domestic sources play an important part in promoting development activities in the country. These sources in brief are: (1) Voluntary Savings (2) In-voluntary Savings (3) Government borrowing (4) Use of idle resources (5) Deficit financing. Now a brief description of each source of capital is given which can easily be elaborated by the students.

(1) **Voluntary Savings.** There are two main sources of voluntary savings (1) household (2) business sector. As regards the volume of personal savings of the household, it depends upon various factors such as the income per capita, distribution of wealth, availability of banking facilities, value system of the society etc. etc. In the under-developed countries, the saving potential of the people is low as a greater number of them suffer from absolute poverty. So far as the rich sections of the society is concerned, they mostly spend their wealth on the purchase of real estates, luxury goods, or take it abroad for safe keeping. There is, therefore, very little saving forth-coming from the high income group.

The business sector is an important source of voluntary saving in the less developed countries. They usually hesitate in assuming the risks associated with investment. The fear of nationalization and political instability further hampers their incentive to save and invest in the country. In Pakistan, the ratio of national saving to GDP is about **10.7%** which is very low. The low rate of saving is mainly due to high propensity of the people to consume. With this low rate of saving, it is not possible to even maintain the present standard of living of the masses.

(2) Involuntary Savings. In the developing countries, the income per capita of the people is low. Their propensity to consume, mainly due to 'demonstration effect' is very high. As the flow of savings is inadequate to meet the capital needs of the country, the governments, therefore, adopt certain measures which restrict consumption and increase the volume of savings. The traditional methods, used for increasing the volume of savings are (1) taxation (2) compulsory schemes for lending to the government. The two fiscal measures stated above are very sensitive and delicate. They should be devised and handled carefully. For instance, if the people of low and middle income groups are heavily taxed through various forms of taxation, their power, (whatever little) to save will be further reduced. Similarly, the rich class should not unnecessarily be burdened with taxes. The tax structure should be devised in such a manner that it should provide incentive to work, save and invest for various levels of income groups.

(3) Government Borrowing. The volume of domestic savings can also be increased through government borrowing. The government issues long and short term bonds of various denominations and mobilizes savings from the general public as well as from the financial institutions. In the developing countries, there are many obstacles which stand in the way of government borrowing. For instance, the money and capital market is unorganized. The rural sector is not provided with adequate financial institutions. People being illiterate, prefer to invest their savings in gold, jewellery etc. The government of developing countries should, therefore, evolve a workable programme of mobilizing the un-utilized savings of the people both in the urban and the rural sectors.

(4) Use of Idle Resources. In the developing countries of the world, there are many resources which remain unutilized and underutilized. If they are properly tapped and diverted to productive purposes, the rate of capital formation can increase rapidly. For instance, in most of the low income countries there is a disguised unemployment in the rural sector. If the surplus farmers are employed at nominal wages in or near their villages for the construction of roads, tube-wells, canals, school buildings etc. or their services are acquired on self-help basis for capital creating projects, they can be a valuable source for capital formation in the country.

(5) Deficit Financing. Deficit financing is regarded an important source of capital formation. In the developed countries this method is used for increasing effective demand and ensuring continued high levels of economic activity. In the less developed countries, it is used for generating savings by activating unemployed or underemployed resources.

2. External Resources:

Foreign aid. The developing countries also finance domestic capital formation with the help of foreign capital. Foreign capital can be obtained from a number of sources such as government to government aid programmes, export credit agencies, international financial institutions including the World Bank Group and Regional Development Banks, the IMF, the UN agencies, private investment by multinational corporations and commercial banks.

Here an important question arises whether external capital is useful for the developing countries of the world or not. The writers here have difference of opinion. A number of writers agree that foreign capital is helpful for accelerating the rate of capital formation in the less developed countries. External assistance, they say, is necessary because (1) it supplements domestic saving in increasing the rate of growth (2) It provides technological methods and ideas which greatly help in breaking the vicious circle of poverty (3) it provides capital goods which a developing country cannot afford to purchase due to unfavourable terms of trade and the balance of payment difficulties (4) it builds up basic infrastructure which is essential for creating the momentum of growth (5) the investment in human resources brings about a change in attitudes, social relationship, institutions and organizations which is necessary in economic development.

External borrowing as an aid to economic development has been criticised on several grounds. According to some writers, the inflow of foreign capital which may take the form of loans, grants, technical assistance or direct investment etc. has not carried with it economic benefits to the developing world. The countries of the South are still deficient in food production. The rate of growth in agriculture, industry, transport communication, education, health, minerals and energy is very slow. (2) Further, the bilateral and tied' aids provided by the advanced countries is a new form of colonialism (3). The quantity of external capital is so small that it is not of any real importance to the developing countries (4) The recipient country cannot adopt independent economic and political policies (5) The history of developing countries shows that once they involve themselves in debt, they are never able to clear it. The dependence on loan continues increasing. Taking the case of Pakistan, foreign economic assistance started flowing here in 1951. Pakistan's total external debt stand at about **Rs. 10,437** billion by end of **March 2019**.

The arguments advanced for and against the foreign capital have their weight. The solution suggested is that the North should have an earnest dialogue with the South in solving their problems of hunger, poverty, illiteracy, technology etc. etc. North should contribute at-least **3%** of their GNP to the developing countries without interest and the repayment should be spread over a fairly long period. Further, the industrial goods of the less developed countries should be liberally imported by the advanced world.

3. Restriction of imports

Another external source of financing economic development is the restriction of luxury consumption imports. The foreign exchange thus saved should be utilized in importing capital good for rapid economic development of the country.

3. CAUSES OF LOW RATE OF CAPITAL FORMATION IN PAKISTAN

The main causes of low rate of capital formation in Pakistan are the higher interest rates and low volume of savings. The poor rate of savings is responsible for low rate of investment. The main factors responsible for the low rate of capital formation in the country are as follows:

(1) **Low level of national income and per capita income.** Majority of the people are living on subsistence level and do not have the power to save and invest.

(2) **The propensity to consume of the people is high and as a result** thereof the propensity to save is low which adversely affects capital formation.

(3) **International demonstration effect** and conspicuous consumption reduces the urge and ability of the people to save and invest.

(4) **Due to stiff competition under the present WTO regime** of globalization, the demand for capital in small scale industries has gone down.

(5) The businessmen are in the **habit of hoarding** the goods. The supply of capital is diverted to unproductive channels which results in the shortage of capital and low rate of capital formation in the country.

(6) **The infrastructure facilities** like roads, rail net work, communication, power etc. are not adequately developed. The movement of capital thus slackens and ultimately adversely affects the process of capital formation.

(7) **The size of market** in Pakistan is narrow. This also retards the process of capital formation in the country.

(8) Due to **technological backwardness**, the rate of productivity in all sectors of the economy is low. This factor also stands in the way of higher capital formation.

(9) Direct and indirect financial **burden of multiple departments** on business enterprises slows down the process of capital formation.

(10) The time and again **changes in fiscal policies** during a year are also responsible for low rate of capital formation.

(11) **Political instability,** mass killings, unrest among the labour class are also important factors in retarding the rate of capital formation.

(12) **Poor banking facilities** in the rural areas also stand in the way of capital formation.

Measures to increase capital formation

The effective measures to increase capital formation in a developing country like Pakistan are as under:

(1) **Saving drives:** Saving drives like prize bond schemes, saving certificate carrying higher rates of profits, tax exemptions on saving schemes, creating awareness of the importance of savings etc. can greatly help in mobilizing savings.

(2) **Setting up financial institutions:** The setting up of financial institutions in rural and urban areas can greatly help the people to deposit their savings in financial institutions rather than keeping these in homes. The small and larger amounts of saving so collected helps in raising funds for development. In Pakistan the Directorate of National Savings is engaged in the mobilization of saving at the grass root level.

(3) **Fiscal measures:** In low income countries, the voluntary savings are not sufficient for productive investment. The government, therefore, realizes funds through fiscal and monetary measures. The main measures usually adopted are, reducing budgetary deficit through increase in taxation, reducing government expenditure on establishment, bank borrowing.

(4) **Public borrowings:** Public borrowing for investment purposes is also an effective method of capital formation. Government raises loans through the sale of Investment Bonds.

(5) **Development of capital market:** Government can also divert resources from unproductive to productive channels by strengthening the capital market in the country. The establishment of brokerage houses, venture capital companies, stock exchanges, Investment advisory companies etc. can go a long way in capital formation.

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

(7) **Development of Secondary financial market:** The main purpose of the development of 'secondary market' is to provide liquidity to the holders of securities. It also provides a pool of investors to whom, securities/debt may be resold. The development of 'secondary market' helps the investors in the purchase and sale of securities; thus an encouragement for capital formation.

(8) **Utilization of disguised unemployed workers:** Nurkse is of the view that if disguised unemployed workers are employed on various capital projects like irrigation, roads, etc. they can be a fruitful source of capital formation.

(9) **Checking demonstration effect:** The Government and the Ulamas can help in persuading the people to resist the evils of consumerism and growing propensity to consume. The amount thus saved can be made available for capital formation.

(10) **Rationalization of tax structure:** The rationalization of tax structure can help in providing investment incentives.

(11) **Control of inflation:** The controlling of inflationary pressures help in raising the capacity to save of the people.

(12) **Reduction in the rate of growth of population:** The reduction in the rate of growth of population can also help in increasing the saving capacity of the people.

(13) **Curtailment of luxury imports:** The banning or curtailment of luxury imports can increase saving and raise the investment level.

(14) **Foreign aid:** If domestic capital is not adequate for meeting the development requirements of the country, then to bridge the saving investment gap, the country has to rely on foreign economic aid for economic development.

QUESTIONS

1. Define capital formation. Describe its importance as one of the factors of economic development.

2. **What is meant by capital formations? Discuss the sources of capital formation in developing countries like Pakistan.**

3. What are the main sources of capital formation available to a developing country? Suggest effective measures to increase capital formation.

Short Answer Questions

Q.1. Define capital formation.

Ans. It is the increase in the stock of both material and human capital by making available a part of society's currently available resources.

Q.2. Does international demonstration reduces the propensity to save of the people?

Ans. Yes. People in lower income groups try to follow the living style of the people in advanced countries and in doing so, their consumption expenditure tends to rise and propensity to save falls.

Q.3. Name three domestic sources of capital formation.

Ans. (i) Domestic savings (ii) Taxation and (iii) Deficit financing.

Q.4. Name three external sources of capital formation.

Ans. (i) Loans, grants and aids from foreign governments and international institutions (ii) Direct private foreign investment and (iii) Imposing restrictions on import of luxury items.

Q.5. What is the contribution of domestic savings and national savings to the domestic investment in the country in 2018-19?

Ans. (i) Domestic savings contribution = 4.2% of GDP

(ii) National savings is = 10.7% of GDP