

Capital Formation and Economic Growth



Part D

Factors responsible for lower capital Formation

- ❖ **Low Per Capita Income**- Low per capita income in less developed countries results in lower saving which is the primary source of capital formation
- ❖ **Large Size of Population** - Large size population is an impediment for capital formation. Because of large size population there is increase in consumption expenditure. Higher consumption expenditure means lower saving
- ❖ **Inflation** - Higher inflation means less surplus of income for further investment, implying a low rate of capital formation

Factors responsible for lower Capital Formation

- ❖ **Demonstration Effect-** Consumption expenditure tends to be high and the rate of capital formation tends to be low due to Demonstration Effect in the less developed countries. The low-income group people imitate high-income group's way of life and start spending much of their income on expensive consumer durables. It causes lower rate of capital formation

Factors responsible for lower Capital Formation

- ❖ **Lack of Investment-friendly Environment-** Lack of investment-friendly environment suppress the investment
- ❖ **Complex Tax-structure-** Complex tax-structure in less developed economies lowers the capital formation.
- ❖ **Limited Extent of Market-** Demand in small size market is low. Lower the demand, lower investment for capital formation.

Capital formation and Economic Growth in India

- ❖ In India also Capital Formation or rate of investment has played a significant role in generating higher economic growth rate
- ❖ The 1990s represent a very important period in economic growth in India because far reaching economic reforms of liberalising and privatisation were carried out during this period
- ❖ However, after, higher growth rate could not be maintained and in fact Indian Economy went into recession despite the continuation of economic reforms

Measures to Promote Capital Formation in Underdeveloped Countries

- ❖ Rate of capital formation is an important determinant of economic growth
- ❖ Therefore, all efforts should be made to raise the rate of capital formation in the country, if the twin problem of mass poverty and unemployment are to be solved
- ❖ In order to raise capital formation in the economy we have first to raise ratio of surplus to capital or rate of surplus or national income

Measures to Promote Capital Formation in Underdeveloped Countries

- ❖ There are some measures to promote capital formation, these are:
- ❖ **Increase in Voluntary savings-** Increase in rate of voluntary savings is a prime requirement in less developed countries. Increase in interest rate can encourage more voluntary savings.
- ❖ **Expansion of Banking Institutions-** Banking facilities expansion in rural areas can increase the savings in rural areas.
- ❖ **Forced Saving through Taxation-** Government can increase the capital formation by imposing direct and indirect tax on economic activities.

Measures to Promote Capital Formation in Underdeveloped Countries

- ❖ **Encouraging private Enterprises-** Generally, private enterprises are efficiently run when compared to public enterprises. Encouraging private enterprises can increase the capital formation.
- ❖ **Reduction in Non-developmental expenditure-** the government should reduce non-developmental expenditure related to administration and defence. Their reduction will result in more savings to be invested in the Public sector

Measures to Promote Capital Formation in Underdeveloped Countries

- ❖ **Price Stability-** Price stability is conducive to both the supply of capital as well as demand for capital
- ❖ **Liberal government Policies-** Liberal fiscal and credit of the government encourages saving and investment for capital formation
- ❖ **Surplus through International Trade-** International trade can encourage the flow of capital to the less developed countries

Thank You