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**Capital Formation & Economic Development**

The word ‘capital formation’ is used in narrow sense as well as in a broader sense.

However, in a narrow sense, it refers to physical capital stock which includes machines, machinery etc.

In a broader sense, it includes non-physical capital or human resources consisting of public health, efficiency, craft, visible and invisible capital.

According to Prof. Colin Clark, capital goods **“are reproducible wealth used for purpose of production. But capital formation refers to the net addition made to the existing stock of capital in a given period of time.”** Therefore, it is said that capital formation involves a sacrifice of immediate consumption for obtaining more consumable goods in future while ‘capital’ is that part of the current product which is used for further production instead of being immediately consumed.

Here, we must make a clear cut distinction between ‘maintaining capital intact’ and ‘capital formation’. The process is known as maintaining capital intact when resources are used to replace the worn out assets including wear and tear of machinery as it does not add to productive capacity of the economy.

On the contrary, capital formation refers to increasing the stock of real capital which obviously helps in raising the level of production of goods and services. Therefore, the essence of the process of capital formation is the diversion of a part of society’s currently available resources to the possible an expansion of consumable output in future.

In this way, the concept can be extended to cover human capital formation. In fact, it is only real physical assets and not financial assets such as shares, bonds, currency notes and bank deposits are included in capital formation as they increase the productive capacity of the economy.

The quote Prof. Nurkse, **“The meaning of capital formation is that society does not apply the whole of its productive activity to the needs and desires of immediate consumption but directs a part of it to make capital goods, tools and instrument, machines and transport facilities plant and equipment—all the various forms of real capital that can so greatly increase the efficiency of productive effort.”**

According to Prof. Simon Kuznets, “Domestic capital formation would include not only additions to construction, equipment and inventories within the country, but also other expenditure expect those necessary to sustain output at existing lands.

It would include outlays on education, recreation and material luxuries that contribute to the health and productivity of individuals and all expenditures by society that serve to rase the morale of employed population.”

### Significance of Capital Formation in Economic Development:

Capital formation or accumulation is regarded as the key factor in economic development of an economy. The vicious circle of poverty, according to Prof. Nurkse, can easily be broken in under developed countries through capital formation. It is capital formation that accelerates the pace of development with fuller utilisation of available resources. As a matter of fact, it leads to an increase in the size of national employment, income and output thereby the acute problems of inflation and balance of payment.

#### 1. Formation of Sound Infra-Structures:

The foremost significance of capital accumulation specially in its initial stages is that it promotes the establishment of social overheads in the poor country as these countries need these infra-structures at a priority level. In this way, capital accumulation goes a long way in the development of basic capital goods in under developed production.

#### 2. Use of Round-about Methods of Production:

In a backward country, process of capital formation makes possible the use of roundabout or complex methods of production which makes the division in different stages on the basis of modern techniques and production process leads to specialization. This further leads to rapid growth in production.

#### 3. Maximum Utilisation of Natural Resources:

In under developed countries, there is an increase in the capacity of risk taking by capital formation by which fresh natural resources are made available. It is made possible through proper and thoughtful exploitation.

#### 4. Proper Use of Human Capital Formation:

Capital formation plays an extraordinary role in the qualitative development of human resources. Human capital formation depends on the people’s education, training, health, social and economic security, freedom and welfare facilities for which sufficient capital in needed. Labour force needs up-to-date implements and instruments is sufficient quantity so that with the increase of population there will be optimum increase in production and increased labour is easily absorbed.

#### 5. Improvement in Technology:

In under developed countries, capital formation creates overhead capital and necessary environment for economic development. This helps to instigate technical progress which make impossible the use of more capital in the field of production and with increase of capital in production, the abstract form of capital changes. It is seen that present changes in the capital structure lead to changes in structure and size of technique and public is thereby more influenced.

#### 6. High Rate of Economic Growth:

The higher rate of capital formation in a country means the higher rate of economic growth. Generally, the rate of capital formation or accumulation is very low in comparison to advanced countries. In the case of poor and under developed countries, the rate of capital formation varies between one percent to five percent while in the latter’s case, it even exceeds to 20 percent.

#### 7. Agricultural and Industrial Development:

Modern agricultural and industrial development needs adequate funds for adoption of latest mechanised techniques, input, and setting of different heavy or light industries. Without sufficient capital at their disposal, leads to lower rate of development thus, capital formation. In fact, the development of these both sectors is not possible without capital accumulation.

#### 8. Increase in National Income:

Capital formation improves the conditions and methods for the production of a country. Hence, there is much increase in national income and per capital income. This leads to increase in quantity of production which leads to again rise in national income. The rate of growth and quantity of national income necessarily depends on the rate of capital formation. So, increase in national income is possible only by the proper adoption of different means of production and productive use of same.

#### 9. Expansion of Economic Activities:

As there is increase in the rate of capital formation, productivity increases quickly and available capital is utilized in more profitable and extensive way. In this way, complicated techniques and methods are utilized for the economy.

This results in the expansion of economy activities. Capital formation increases investment which effects economic development in two ways. Firstly, it increases the per capita income and enhances the purchasing power which, in turn, creates more effective demand. Secondly, investment leads to an increase in production. In this way, by capital formation, economic activities can be expanded in under developed countries, which in fact, helps to get rid of poverty and attain economic development in the economy.

#### 10. Less Dependence on Foreign Capital:

In under developed countries, process of capital formation increases dependence on internal resources and domestic savings by which dependence on foreign capital is declined. Economic development leaves burden of foreign capital, hence to give interest on foreign capital and bear expenses of foreign scientists, country has to be burdened by improper taxation to the public. This gives a setback to internal savings. Thus, by the way of capital formation, a country can attain self sufficiency and can get rid of foreign capital’s dependence.

#### 11. Increase in Economic Welfare:

By the increase in rate of capital formation, public is getting more facilities. As a result, common man is more benefited economically. Capital formation leads to unexpected increase in their productivity and income and this improves their standard of living. This leads to improvement and enhancement in the chances of work. This helps to raise the welfare of the people in general. Therefore, capital formation is the principal solution to the complex problems of poor countries.

### Process of Capital Formation:

**Capital formation or accumulation undergoes three main stages:**

(i) Creation of saving;

(ii) Mobilisation of saving; and

(iii) Investment of saving.