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Basic Aspects of Capital Formation in India

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Abstract

The role of savings, investment and capital formation has become very crucial in the present economic scenario. The economic meltdown that took place in USA in the year 2008 had wide repercussion all over the world. There were evidences of almost all economy of the world severely hit by the global meltdown that basically originated in USA. The two major banks of the country completely failed because of excessive lending on the basis of insufficient mortgage and non–repayment of dues by the public. Even during that point of time Indian economy succeeded in facing the consequences of the deflationary trends prevailing world wide. It can be, though, argued that the deflation that prevailed throughout the world also affected the Indian economy. The Indian economy which was growing at around 9% and 9.5% during that time witnessed a setback and the growth rate fell down to around 6.5% later on. This rate was considered quite satisfactory in view of slowdown that prevailed in the other parts of the world. India was able to counter the ill effects of deflation and sustain a steady growth rate only because of the traditional nature of savings of the country. The steady rate of savings to the extent of 35% led to a steady growth rate in investment and capital formation in the country. Therefore, the study of different dimensions of capital formation becomes necessary to analyse the effects of capital formation.

Keywords: Capital Formation, Gross Domestic Capital Formation, Gross Domestic Savings, Investments.

Introduction

Inclusive growth and sustainable development are the two fundamental issues which have assumed prime importance throughout the world in the recent past. It is the mostly debated and discussed matter in global economic forum now-a-days. In fact, the changing economic scenario and socio-cultural transformations that has been taking place worldwide has made the issue of economic growth more challenging for every nation of the world. On the basis of economic growth the world can be presently divided into two parts: developed and developing nations. It is very interesting and amazing that at one point of time there were wide differences between the functioning of the two categories of nations. They differed in their approach of attaining development and, in fact, they also differed in devising their means of attaining those goals and objectives. But with several developments especially in the wake of implementations of policies of the world trade organization, group of eight nations, group of twenty nations, BRICS, and many other global trading and economic organizations, there has been structural changes in the approach of both the developed as well as developing nations regarding achievement of economic goals and objectives. Today, instead of competing with each other they have become complementary to each other. One common measure adopted by the world for achieving growth and prosperity is to initiate the process of capital formation in an effective and efficient manner. It is now universally admitted that rate of capital formation and more especially gross domestic capital formation is crucial in present day global economic challenges.

Capital and Capital Formation

The term capital refers to include the monetary resources, technology, machines, tools and instruments, plants and equipments, transportation facilities, and all forms of real capital which goes to contribute in one way or the other in enhancing the productive capacity of a country. Today, with a lot of debate and discussion human resource has also been included in capital. Capital formation has always been considered as an important element in the economic development of a country. It is strongly proved that a country can progress and prosper in the present day atmosphere of global competition only with a strong capital base. Having a strong capital base is not enough to sustain and survive competition but a country must always look forward and take steps to increase the already existing stock of capital. Thus, the rate of capital growth i.e. capital formation is very crucial in diverting productive resources towards meaningful ends. Capital and capital formation is, therefore, a comprehensive term used to denote and include every factor that can contribute towards enhancing the production efficiency.

Capital Formation Process

In view of the above, it becomes essential to understand the process of capital formation. Capital, which is so vital in achieving growth objectives is a function of variety of factors such as income, expenditure, production, savings, gross domestic product, consumption and investment. All these factors go to play a predominant role in determining the rate of capital formation in any economy. A high rate of capital formation is an indicator of healthy production and income of a country. It leads to increase in production, income, expenditure and savings. With increased income earned by the factors of production, there is always a chance that they may be left with some sort of surplus over their expenditure. This surplus of income over expenditure is known as savings and this savings forms the base of the process of capital formation in a country. The next factor that contributes to the process of capital formation is the establishment and expansion of banking and other financial institutions which can mobilize the savings available in the country. In the third process there must be a business and economic infrastructure and efficient entrepreneurship so as to utilize the savings available with the lending institutions and increase the already existing stock of capital. Thus, capital formation is an all inclusive process intended to increase the present potentials and present amount of capital stock available in the country.

The Indian Scenario

Several countries have evolved varied means of increasing the savings and capital formation. Initially Russia adopted the means of restricting consumption to increase the savings and Britain resorted to cutting down wages and thereby increasing the profit base of the industrial and business sector. However, these means could no longer prevail in a democratic set up and more especially in a democratic country like India. In India process of capital formation comprised of two basic factors: firstly, the major part for economic development has to be created through gross domestic savings and secondly, in case of additional requirement foreign inflow of capital may be resorted to so that sufficient amount of capital could be made available for achieving the target of planned economic growth and development.

Gross Domestic Savings

In India, the data relating to Gross Domestic Savings is prepared and presented by the central statistical organization. The Gross Domestic Savings is calculated as a percentage of the Gross Domestic Product in India. The source of savings in India comes from the household sector, private corporate sector and the public sector. The status of gross domestic savings as a has been presented is the following table:

Table - 1
Components of Gross Domestic Savings as percent of GDP at market prices 1999-00 series

Year (1)	Household (2)	Private Corporate Sector (3)	Public Sector (4)	Total (2+3+4) (5)
1950-51	5.7 (66.3)	0.9 (10.5)	2.0 (23.2)	8.6 (100.00)
1960-61	6.5	1.6	3.1	11.2
1970-71	9.5	1.5	3.3	14.2
1980-81	12.9	1.6	4.0	18.5
1990-91	18.3 (80.3)	2.7 (11.8)	1.8 (7.9)	22.8 (100.00)
2000-01	21.6 (91.1)	3.9 (16.5)	-1.8 (-7.6)	23.7 (100.00)
2004-05 Series				
2004-05	23.3	6.6	2.3	33.2
2005-06	23.2	7.5	2.4	33.1
2006-07	22.9	8.0	3.6	34.4
2007-08	22.6	8.7	5.0	36.4
2008-09	23.6	7.4	1.0	32.0
2009-10	25.2	8.4	0.2	33.7
2010-11	23.5	7.9	2.6	34.0
2011-12	24.0 (72.5)	7.7 (23.3)	1.4 (4.2)	33.1 (100.0)

Note : Figures in brackets are percentage share of different sectors in total saving.
Source: Government of India, Economic Survey (2011-12), National Account Statistics, Central Statistical Organization, 2013

The data presented in the above table clearly indicated that there has been a continuous increase in the gross domestic savings (GDS) as a percentage of gross domestic product (GDP) : The GDS which was 8.6% in 1950-51increased to 33.1% in 2011-12. The household sector is the largest contributor to the GDS. It's share increased from 5.7% in 1950-51 to 24% in 2011-12. The share of private corporate sector which was as low as 0.9% increased to 7.7% in 2011-12. The share of public sector savings which was 2%

in 1950-51 increased to 4% in 1980-81 and to 5% in 2007-08 has declined to a low level of 1.4% in 2011-12. Of the total savings in India, in the year 2011-12, the share of household sector was 72.5%, that of private corporate sector was 23.3% and that of public sector was 4.2%.

Gross Domestic Capital Formation

The utilization of savings follows a interlinked and intermixed pattern which means that savings of one sector can be utilized for investment in other sector and vice-versa. Gross Domestic Capital Formation (GDFC) is a composite factor of two elements: GDS and Capital Inflow (CI) in a country. The actual position of GDFC in India from 1950-51 has been presented in a tabular form below:

Table - 2

Gross Domestic Capital Formation as percent of GDP at Market Prices (1999-00 series/2004-05 Series)

Year (1)	Public Sector (2)	Private Sector (3)	Valuables (4)	Total (2+3+4) (5)	Errors & Omissions (6)	Adjusted Total (5+6) (7)
1950-51	2.9	7.4	n.a	10.3	-1.9	8.4
1960-61	7.2	7.2	n.a	14.4	-0.4	14.0
1970-71	6.7	8.9	n.a	15.6	-0.5	15.1
1980-81	8.9	9.6	n.a	18.5	1.4	19.9
1990-91	10.0	14.2	n.a	24.2	1.9	26.0
2000-01	6.9	16.6	0.7	24.2	0.1	24.3
2004-05 Series						
2004-05	7.4	23.8	1.3	32.5	0.4	32.8
2005-06	7.9	25.2	1.1	34.3	0.4	34.7
2006-07	8.3	26.4	1.2	35.9	-0.2	35.7
2007-08	8.9	28.1	1.1	38.0	0.1	38.1
2008-09	9.4	24.8	1.3	35.5	-1.2	34.3
2009-10	9.2	25.2	1.8	36.1	0.5	36.6
2010-11	8.8	24.9	2.1	35.8	-0.7	35.1
2011-12	7.9	24.9	2.7	35.4	-0.4	35.0

Source: Economic Survey (2011-12)

The table depicts that the Gross Domestic Capital Formation (GDFC) has been quite remarkable in the Indian context. The GDFC which was 8.4% of GDP in 1950-51 has shown a sustained growth and reached to 35% of GDP in 2011-12. The share of public sector in the GDFC has gradually increased from 2.9% in 1950-51 to 7.9% in 2011-12 and that of the private sector rosed from 7.4% to 24.9% during the same period. Valuables accounted for 2.7% of GDFC in 2011-12. Since it is argued that valuables are acquired mainly as a store of value and are not used in production or consumption it is not a correct measure to include them in the estimates of GDFC. Even if the valuables are not accounted for the GDFC in 2011-12 will be 32.3% which again is a remarkable achievement according to Indian economic Condition.

Trend of Savings and Investment in India

The Gross Domestic Savings (GDS) have increased in India continuously from an average growth rate of 9.6% of GDP during the 1950s to an average growth of 35% by the year 2011-12. Over the same period the domestic investment rate has also shown the same trend as GDS. The domestic investment which was 10.8% in the 1950s increased to reach to nearly 35% by 2011-12. An interesting feature about the trends in savings and investment in India is that the financial need of economic growth and development has been predominantly made available by domestic sources of savings and investments. The domestic Savings and investment in comparison to the saving investment gap has been presented in the following table:

Table - 3

Saving and Investment in the Indian Economy

As percent of GDP

	1950s	1960s	1970s	1980s	1991-92 to 1996-97	1997-98 to 2003-04	2004-05 to 2011-12
Gross Domestic Capital formation	10.8	14.3	17.3	20.8	23.9	24.9	35.3
Gross Domestic Saving	9.6	12.3	17.2	19.0	22.7	24.9	33.5
Saving Investment Gap	-1.2	-2.0	-0.1	-1.0	-1.2	0.0	-1.8
Real GDP Growth	3.6	4.0	2.9	5.6	5.7	5.7	8.2

Source: Economic Survey 2012-13

The data provided in the above table gives a clear picture of the sources of savings, capital formation and the saving investment gap. The difference between Gross Domestic Savings and Gross Domestic Capital Formation is known as the Saving Investment Gap. The gap which was to the extent of 1.2% of GDP in 1950-51 reached to as high as 2% in 1960. It even declined to 0.1% of GDP and even to zero level in the time period between 1997-98 and 2004-05 and during the year 2004-05 to 2011-12 the gap was around 1.8% of GDP. The real growth of GDP which was 3.6% in 1950s increased to 8.2% during the period of 2004-05 to 2011-12. India is among the fastest growing economies of the world and it goes in our country's favour that majority of its financial needs of for funding plans of economic growth and development comes from domestic sources. Due credit should be given particularly to the increased savings of the household sector.

Conclusion and Recommendations

The role of savings, investment, and capital formation is hidden to non and it is widely accepted that these economic indicators have occupied a pivotal place in the quest of economic growth and development. The rate of capital formation is the most real and accurate indicator of the economic development of a country. A high rate of capital formation reflects a high level of efficiency of physical, financial, and human resource of a country. There has been a common consensus among every nation of the world that all forms of capital i.e., physical, financial and human, are equally important in determining the GDP growth rate of a country. In absence of adequate amount of surplus of resources, countries are forced to resort to inflow of foreign capital which has its own repercussions on the functioning of an economy. The growth of 35% of savings and investment in any country will certainly contribute towards a high rate of capital formation. The following suggestions are offered in order to improve the economic condition of a developing nation like India in regards to savings, investment, and capital formation:

1. The formulation of human capital has assumed great prominence. As such for a developing nation like India, it becomes essential to increase expenditure on education, social service, social welfare, and technical and professional courses. This with lead to enhance the productive capacity of the human capital.
2. According to NSSO report there were 2.34 crores unemployed out of the total work force in India. The problem of chronic unemployment and underemployment can be solved through increased investment in human capital.
3. The increase in expertise of the human resource will lead to generate employment opportunities for them and hence will lead to increase in incomes thereby solving the problem of poverty persisting in the country.
4. There should be measures to promote foreign inflow of capital in order to bridge the fiscal deficit gap and at the same time add to the already existing infrastructural base to add to productive efficiency.
5. The process of creating special economic zones and exporting zones should be enhanced further so as to increase the exports. The increase in exports will help to solve the problem of foreign exchange and provide stability in exchange rate.
6. The monetary authority must also accommodate the features of increased capital formulation while framing its monetary policies.
7. The extent of banking and non-barking financial institutions must be enlarged further so that people are not deprived of savings and investment avenues.

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