What is 'Capital Formation '

Capital formation is a term used to describe the net [capital accumulation](http://www.investopedia.com/terms/c/capitalaccumulation.asp) during an [accounting period](http://www.investopedia.com/terms/a/accountingperiod.asp) for a particular country, and the term refers to additions of [capital stock](http://www.investopedia.com/terms/c/capitalstock.asp), such as equipment, tools, transportation assets and electricity. Countries need capital goods to replace the current assets that are used to produce goods and services, and if a country cannot replace capital goods, production declines. Generally, the higher the capital formation of an economy, the faster an economy can grow its aggregate income.

#### Meaning of Capital Formation:

Capital formation means increasing the stock of real capital in a country.In other words, capital formation involves making of more capital goods such as machines, tools, factories, transport equipment, materials, electricity, etc., which are all used for future production of goods.

#### Process of Capital Formation:

In order to accumulate capital goods some current consumption has to be sacrificed. The greater the extent to which the people are willing to abstain from present consumption, the greater the extent that society will devote resources to new capital formation. If society consumes all that it produces and saves nothing, future productive capacity of the economy will fall as the present capital equipment wears out.

In other words, if whole of the current productive activity is used to produce consumer goods and no new capital goods are made, production of consumer goods in the future will greatly decline. To cut down some of the present consumption and wait for more consumption in the future require far-sightedness on the part of the people. There is an old Chinese proverb, “He who cannot see beyond the dawn will have much good wine to drink at noon, much green wine to cure his headache at dark, and only rain water to drink for the rest of his days.

#### Three Stages in Capital Formation:

Although saving is essential for capital formation, but in a monetized economy, saving may not directly and automatically result in the production of capital goods. Savings must be invested in order to have capital goods. In a modern economy, where saving and investment are done mainly by two different classes of people, there must be certain means or mechanism whereby the savings of the people are obtained and mobilized in order to give them to the businessmen or entrepreneurs to invest in capital.

**Therefore, in a modern free enterprise economy, the process of capital formation consists of the following three stages:**

**(a) Creation of Savings:**

An increase in the volume of real savings so that resources, that would have been devoted to the production of consumption goods, should be released for purposes of capital formation.

**(b) Mobilization of Savings:**

A finance and credit mechanism, so that the available resources are obtained by private investors or government for capital formation.

**(c) Investment of Savings:**

The act of investment itself so that resources are actually used for the production of capital goods.

**We shall now explain these three stages:**

**Creation of Savings:**

Savings are done by individuals or households. They save by not spending all their incomes on consumer goods. When individuals or households save, they release resources from the production of consumer goods. Workers, natural resources, materials, etc., thus released are made available for the production of capital goods.

The level of savings in a country depends upon the power to save and the will to save. The power to save or saving capacity of an economy mainly depends upon the average level of income and the distribution of national income. The higher the level of income, the greater will be the amount of savings.

The countries having higher levels of income are able to save more. That is why the rate of savings in the U.S.A. and Western European countries is much higher than that in the under-developed and poor countries like India. Further, the greater the inequalities of income, the greater will be the amount of savings in the economy. Apart from the power to save, the total amount of savings depends upon the will to save. Various personal, family, and national considerations induce the people to save.

People save in order to provide against old age and unforeseen emergencies. Some people desire to save a large sum to start new business or to expand the existing business. Moreover, people want to make provision for education, marriage and to give a good start in business for their children.

Further, it may be noted that savings may be either voluntary or forced. Voluntary savings are those savings which people do of their own free will. As explained above, voluntary savings depend upon the power to save and the will to save of the people. On the other hand, taxes by the Government represent forced savings.

Moreover, savings may be done not only by households but also by business enterprises” and government. Business enterprises save when they do not distribute the whole of their profits, but retain a part of them in the form of undistributed profits. They then use these undistributed profits for investment in real capital.

The third source of savings is government. The government savings constitute the money collected as taxes and the profits of public undertakings. The greater the amount of taxes collected and profits made, the greater will be the government savings. The savings so made can be used by the government for building up new capital goods like factories, machines, roads, etc., or it can lend them to private enterprise to invest in capital goods.

**Mobilization of Savings:**

The next step in the process of capital formation is that the savings of the households must be mobilized and transferred to businessmen or entrepreneurs who require them for investment. In the capital market, funds are supplied by the individual investors (who may buy securities or shares issued by companies), banks, investment trusts, insurance companies, finance corporations, governments, etc.

If the rate of capital formation is to be stepped up, the development of capital market is very necessary. A well- developed capital market will ensure that the savings of the society-will be mobilized and transferred to the entrepreneurs or businessmen who require them.

**Investment of Savings in Real Capital:**

For savings to result in capital formation, they must be invested. In order that the investment of savings should take place, there must be a good number of honest and dynamic entrepreneurs in the country who are able to take risks and bear uncertainty of production.

Given that a country has got a good number of venturesome entrepreneurs, investment will be made by them only if there is sufficient inducement to invest. Inducement to invest depends on the marginal efficiency of capital (i.e., the prospective rate of profit) on the one hand and the rate of interest, on the other.

But of the two determinants of inducement to invest-the marginal efficiency of capital and the rate of interest—it is the former which is of greater importance. Marginal efficiency of capital depends upon the cost or supply prices of capital as well as the expectations of profits.

Fluctuations in investment are mainly due to changes in expectations regarding profits. But it is the size of the market which provides scope for profitable investment. Thus, the primary factor which determines the level of investment or capital formation, in any economy, is the size of the market for goods.

#### Foreign Capital:

Capital formation in a country can also take place with the help of foreign capital, i.e., foreign savings.

**Foreign capital can take the form of:**

(a) Direct private investment by foreigners,

(b) Loans or grants by foreign governments,

(c) Loans by international agencies like the World Bank.

There are very few countries which have successfully marched on the road to economic development without making use of foreign capital in one form or the other. India is receiving a good amount of foreign capital from abroad for investment and capital formation under the Five-Year Plans.

#### Deficit Financing:

Deficit financing, i.e., newly-created money is another source of capital formation in a developing economy. Owing to very low standard of living of the people, the extent to which voluntary savings can be mobilised is very much limited. Also, taxation beyond limit becomes oppressive and, therefore, politically inexpedient. Deficit financing is, therefore, the method on which the government can fall back to obtain funds.

However, the danger inherent in this source of development financing is that it may lead to inflationary pressures in the economy. But a certain measure of deficit financing can be had without creating such pressures.

There is specially a good case for using deficit financing to utilise the existing under-employed labour in schemes which yield quick returns. In this way, the inflationary potential of deficit financing can be neutralized by an increase in the supply of output in the short-run.

#### Disguised Unemployment:

Another source of capital formation is to mobilize the saving potential that exists in the form of disguised unemployment. Surplus agricultural workers can be transferred from the agricultural sector to the non-agricultural sector without diminishing agricultural output.

The objective is to mobilize these unproductive workers and employ them on various capital creating projects, such as roads, canals, building of schools, health centres and bunds for floods, in which they do not require much more capital to work with. In this way’, the hitherto unemployed, labour can be utilised productively and turned into capital, as it were.

#### Capital Formation in the Public Sector:

In these days, the role of government has greatly increased. In an under-developed country like India, government is very much concerned with the development of the economy. Government is building dams, steel plants, roads, machine-making factories and other forms of real capital in the country. Thus, capital formation takes place not only in the private sector by individual entrepreneurs but also in the public sector by government.

There are various ways in which a government can get resources for investment purposes or for capital formation. The government can increase the level of direct and indirect taxation and then can finance its various projects. Another way of obtaining the necessary resources is the borrowing by the Government from the public.

The government can also finance its development plans by deficit financing. Deficit financing means the creation of new money. By issuing more notes and exchanging them with the productive resources the government can build real capital. But the method of deficit financing, as a source of development finance, is dangerous because it often leads to inflation­ary pressures in the economy. A certain measure of deficit financing, however, can be had without creating such pressures.

Another source of capital formation in the public sector is the profits of public undertakings which can be used by the government for further investment. As stated above, government can also get loans from foreign countries and international agencies like World Bank. India is getting a substantial amount of foreign assistance for investment purposes under the Five-Year Plans.

#### WHAT IS HUMAN CAPITAL? ITS ROLE IN ECONOMIC DEVELOPMENT?

Human capital can be described as the skills training and health acquired through on the job training and education Michael Pakistan Park in defines it as **''The skill and knowledge of human beings.'' It is also defined as the endowment of abilities to produce that exists in each human being. It can be increased through formal education, on the job training and improved health and psychological well being. To be more precise. If the people of a country are well educated, well nourished, skilled and healthy, they are said to have more human capital.**

**Human capital formation:**

Human capital formation as described by Professor Harrison as ''the process of acquiring and increasing the number of person who have the skills, education and experience which are critical for the economic and political development of a country.'' Human capital formation is the act of increasing the productive qualities of labor force  by providing more education and by increasing skills, health and notarization level.

According T.W. Schultz, there are five ways of developing human capital.

(i) Provision of health facilities which affect the life expectancy, strength, vigor and vitality of the people.

(ii) Provision of on the job training which enhances the skill of labor force.

(iii) Arranging education at the primary, secondary and higher levels.

(iv) Study and extension programmer for the adults.

(v) Provision of adequate migration facilities to families to adjust to changing job opportunities.

#### IMPORTANCE OF HUMAN CAPITAL:

Human capital is the fundamental source of economic growth. It is a source of both increased productivity and technological advance. In fact the major difference between the developed and developing countries is the rate of progress in human capital. The underdeveloped countries need human capital to staff new and expanding government services to introduce new system of land use and new methods of agriculture, to develop new means of communication to carry forward industrialization and to build the education system. **Prof. Galbraith is right in saying that ''we now get larger part of economic growth from investment in men and improvements brought about by improved men.''**

**Problems of human capital formation in LDC's**

The main problems of human capital formation in less developed countries (LDC's) including Pakistan in brief are as under.

**1. Faster increase in population.** The population of almost all developing countries of world including Pakistan is increasing faster than rate of accumulation of human capital. As a result thereof, these countries are not making the satisfactory use sector expenditure on education is about 2.5% of GDP for the last over five years.

**2. Defective pattern of investment in education.** In the developing countries of the world, the governments are giving priority to primary education for increasing literacy rate.  Secondary education which provides critical  skills needed for economic developed remains neglected. Another problem related to investment in education is that in the public and private sectors there is a mushroom growth of universities without trying to improve their standard of education. There are also mass failures at primary, secondary & higher levels of education resulting in wastage of the scarce resources of the countries.

**3. More stress on the provision of building and equipments.** Another major problem of investment in human capital in developing countries of the world is the politicians and administrator lay more stress on the construction of buildings and provision of equipments than on the provision of qualified staff. It has been observed that foreign qualified teachers and doctors are appointed in rural areas where there is little usefulness of them.

**4. Shortage of health and nutrition facilities.** In the less developed countries of the world there is shortage of trained nurses qualified doctors medical equipment, medicines etc. The less availability of health facilities pose threat to the millions of the people living there. The people are faced with unsatisfactory sanitary conditions, polluted water, high fertility and death rates urban slums, illiteracy etc. All these deficiencies affect the health of the people reduce their life expectancy.

**5. No facilities of on the job training.** On the job training or in service training is very essential for improving or acquiring of new skills to the persons employed in various importance is given on the job training for the employees. The result is that the efficiency and knowledge of the workers remains technicians etc. is therefore of utmost importance for the efficient use of human resources.

**6. Study programme for adults.** Study programme for adults can also be introduced for improving literacy rate. Programme for adults was introduced in many under developed countries of the world including Pakistan for providing basic education. increasing skills farmers and small industrialists. The scheme has miserably failed as no interest was shown by the adults in getting such training.

**7. Halfhearted measures for promotion of employment.** In most of the world the ratio of unemployed or underemployed persons is very large. For increasing employment and reducing under employment proper investment in human capital is required which is visibly lacking in LDC's. The govt. of Pakistan has taken a number of steps for increasing employment opportunities in the country such as establishment of SME Bank for the promotion of self employment at the grass root level, encouraging domestic and foreign investment for increasing employment opening of technical and vocational training centers etc. etc.

**8. No manpower planning.** Due to non availability of reliable data there is little manpower planning in less developed countries of the world including of course Pakistan. As a result thereof, there is no matching of demand and supply of different types of skills. The result is that large number of skilled and highly qualified persons remain underemployed. The frustration and discontentment among the unemployed or underemployed graduate and post graduates result in **brain drain from the country. It is a huge loss to resources of developing countries.**

**9. Neglect of agriculture education.**In LDC's where agriculture is the major sector of the economy., very little attention is paid for educating the farmers to the use of modern agricultural practices. Unless the farmers are provided agricultural education and training on the fields, they will not be able to raise the agricultural the outlook of the farmers.

**Why is human capital important for development?**

The confluence of rapid technical change, globalisation and economic liberalisation in recent years has prompted governments in developed and developing countries alike to prioritise skills development as a key strategy for economic competitiveness and growth. In developing countries, especially the poorest ones, the challenges are profound and complex. Policy makers acknowledge the critical role of a strong human resource base in complementing other investments and policies to boost productivity and economic progress. Yet while these countries report lower average levels of educational attainment than industrialised countries, in some countries significant numbers of those with high levels of formal qualifications end up unemployed, working in jobs that under-utilise their skills or emigrating to other countries. The result is a misallocation and waste of resources that these countries can ill-afford. Developing countries are therefore in urgent need of new strategies and approaches that focus more explicitly on the links and coherence between investments in skills development and employment and productivity.

**What are the opportunities that human capital provides?**

Skills affect people’s lives and economic and social development in many ways. Skills improve labour market outcomes both in terms of employment rates and earnings. But the positive role of skills extends beyond its impact on career prospects: adults with low levels of foundation skills have a higher likelihood of reporting poor health and participate much less in community groups and organisations; and adults with high levels of foundation skills are much more likely to feel that they have a voice that can make a difference in social and political life. These results are consistent across a wide range of countries, confirming that skills have a profound relationship with economic and social outcomes across a wide range of contexts and institutions. Skills are also key to tackling inequality and promoting social mobility. Investing in human capital is the single most effective way of not just promoting growth but also of distributing its benefits more fairly. Investing in skills is far less costly, in the long run, than paying the price of poorer health, lower incomes, unemployment and social exclusion – all of which are closely tied to lower skills.

**What are the challenges?**

Governments face a number of challenges to make the most of available skills. Getting the best returns on investment in skills requires the ability to assess the quality and quantity of the skills available in the population, determine and anticipate the skills required in the labour market, and develop and use those skills effectively in better jobs that lead to better lives. These represent major challenges in developing countries where data on the available skills is of poor quality and the demand for skills, present and future, is often a black box.

In addition, skills policy requires coherence and co-operation across all areas and levels of government, as well as with the private sector, social partners, teachers and parents. Skills development is more effective if the world of learning and the world of work are linked. Compared to purely government-designed curricula taught exclusively in schools, learning in the workplace offers several advantages: it allows young people to develop “hard” skills on modern equipment in a workplace, and “soft” skills, such as teamwork, communication and negotiation, through real-world experience. Hands-on workplace training can also help to motivate disengaged youth to stay in or re-engage with the education system and to smooth the transition from education into the labour market. Workplace training also facilitates recruitment by allowing employers and potential employees to get to know each other, while trainees contribute to the output of the training firm and earn some income. Employers have an important role in training their own staff; but some, particularly small and medium-sized enterprises, might need public assistance to provide such training. Achieving this co-operation and ensuring it is fruitful is a major challenge in both developed and developing nations. Key issues concern the development and management of a coherent skills strategy, the involvement of the private sector and social partners in the setting of curricula that are more relevant to labour demand, the splitting of financing responsibilities between government, students and their families and the private sector.

Maintaining skills throughout each individual‘s lifecycle is another key challenge as it requires setting up high-quality, easily accessible opportunities for adult learning – both up-skilling and re-training. This is particularly challenging in developing countries where participation in initial education remains an issue for a sizeable share of the population. In these countries, action will have to balance carefully equal access and completion of lower-secondary education and further learning in school and for adults.

Finally, to ensure that firms make the best use of the skills available, both developed and developing countries need to put in place framework policies that help create better skilled jobs in the formal sector. Failure to do this risks generating significant mismatch between the skills of young cohorts and the opportunities that the local labour market offers, increasing the likelihood of brain drain and, ultimately, social unrest.