**STUDY MATERIAL 1 Module -20 ECONOMICS GENERAL B.A./B.Sc. Part-III GENERAL, PAPER-IV I+I+I SYSTEM 2019-20**

**Reason for low capital formation in an underdeveloped economy:**

The lack of real capital is so characteristic a feature of all under-developed economies that they are often called “capital-poor economies”.

Low productivi­ty, in under-developed countries, is mainly due to the small amount of capital per head of population.

Not only is the existing stock of capital very small, but the current rate of capital formation is also very low. In most under-developed countries, investment is only 5% to 8% of the national income, whereas in the United States, Western European countries and in Japan, it generally varies from 15% to 20% of the national income and even higher.

**The low rate of capital formation in under-developed countries is due to the following reasons:**

(a) Domestic savings are very small.

(b) There is a dearth of daring, honest and dynamic entrepreneurs who should perform the task of making investment and bearing risks.

(c) Inducement to invest is very weak.

We shall now explain each of the above factors in some detail.

**(a) Low Level of Domestic Savings:**

In under-developed countries, the level of savings is very low. In other words, these countries save a very small proportion of their current national income. In most of the underdeveloped countries the rate of savings is between 5% and 10% in India, the level of domestic savings has in- Teased to about 20% of the national income in recent years, only because of the sti­mulus provided by the planned development under the Five-Year Plans.

The level of savings in underdeveloped countries is very small mainly because their level of national income or per capital income is very low. As a result much of the income is consumed and little is left for investment purposes. Under-developed countries are, in fact, caught up in the vicious circle of poverty Low income—small savings—low investment—less capital—less productivity, ending in low income.

Apart from the low level of absolute income, the low relative level of real income in under-developed countries as compared with the advanced and rich countries also reduces their capacity to save. There are great and growing inequalities between the income levels and, therefore, living standards of different countries. Increasing awareness of these inequalities have pushed tip the general propensity to consume of the under-developed countries.

This has reduced their capacity to save. This tendency of the people of under-developed countries to copy the higher levels of consumption prevailing in the advanced countries has been called “international demonstration effect” by Nurkse.

Generally, there exist glaring inequalities in the distribution of income in an under-developed country. This should have resulted in a greater volume of savings available for capital formation. But the people, who get large incomes, generally use much of their income for conspicuous consumption, investment in land and real estate, speculative transactions, inventory accumulation and hoarding of gold and jewellery rather than using it for productive investment.

#### (b) Lack of Entrepreneurship:

Another factor responsible for the low rate of investment in under-developed countries is the lack of good entrepreneurs who can invest the savings and carry out innovations. Schumpeter, an economist of repute, attached great importance to the role of good and daring entrepreneurs in the process of economic development.

The entrepreneurs in under-developed countries are interested in quick returns and are not daring enough to bear large risks involved in making capital goods. If then investment is to be stepped up in under-developed countries, the government must assume an active entrepren­eurial role.

#### (c) Weak Inducement to Invest:

Another reason why investment and capital formation are low has been advanced by Nurkse. He argues that just as division of labour is limited by the size of the market, similarly inducement to invest is also limited by the size of the market. The size of the market in under­developed countries is very small due to the low incomes of the people. The incomes of the people are meager because there is limited use of capital in production process in underdeveloped countries.

The use of capital equipment in the’ production of goods and services for the domestic market is discouraged by the small size of the market. Thus a vicious circle also operates on the demand side of capital formation. “The inducement to invest may be low because of the small buying power of the people, which is due to their small real income, which, again is due to low productivity. The low level of productivity, however, is a result of the small amount of capital used in production, which in its turn may be caused at least partly by the small inducement to invest.” —Nurkse.