CHAPTER : XII

SAVINGS AND INVESTMENT

Capital includes all forms of reproducible wealth that are used directly or indirectly in production. Specifically, capital consists of goods produced for use in future production. It includes such items as physical plant and stock of equipment, construction and the producers' inventories of raw materials and of semi-finished and finished goods. But this view of capital is too, narrow. It should also include investment in technical knowledge and improvements in education, health, and skills. It should generally include resources that increase the productive powers of a community and the skill and abilities of its inhabitants. Capital has been broadly classified into physical capital, human capital and financial assets. The important role of capital in raising productivity and incomes per head is indisputable. More precisely, capital is created in the process of development. It is also true that development is a function of capital accumulation. The effect

of capital is both interactive and cumulative. Capital accumulation leads to increase in income, which increases savings and leads to additional capital formation. Even though increased capital may be a necessary concomitant of economic growth, it is not a sufficient condition for it. Merely to supply a backward country with capital funds or with supplies of the most modern equipment will not ensure economic development. Capital has to be transformed into facilities either in the form of machinery and equipment for industry, irrigation and fertilizers for agricultural production, social overheads in the form of roads, transport and communications, or to increase human skills and capabilities through education and health.

Capital accumulation means the use of resources to increase the stock of future resources, and hence to contribute to future levels of satisfaction rather than directly to current satisfaction. How much capital will in fact be accumulated depends in the first instance on how much, out of current income, is saved rather than consumed.

The role of savings in promoting development is rarely called into question. Many writers cite the paucity of savings as the principal cause of under-development. They point to the link between savings and investment and in turn, between investment and the growth of income. This chain of reasoning is substantially valid. Saving must precede all capital formation. If saving is defined as abstention from current consumption out of the national product, then a surplus over the amount consumed must be generated to allow saving to occur. It is that surplus, transformable, in turn, into durable producers' goods which permit capital formation.

The sources of capital in financial terms are voluntary savings, forced savings and foreign loans. This is particularly true of household savings, which in pre-industrial societies, are a kind of residual.

The level of income is the most important determinant of private savings. The most widely known hypothesis about the determination of savings is perhaps

the 'current income' or 'absolute income' hypothesis. This hypothesis was stated by Keynes as follows "......Men are disposed, as a rule and on the average, to increase their consumption as their income increases, but not by as much as the increase in their income". The ratio of savings to income rises with the level of income. Hence, once a developing country succeeds in achieving accelerated growth, the saving ratio will tend to rise, thus helping the financing of the development process.

Another hypothesis on saving behaviour has come to be known as the relative income hypothesis, developed by Duesenberry. This states that one's consumption and hence one's savings, depends not on one's absolute level of income but rather on one's income relative to those of others, because consumption patterns are influenced by consideration of social status. This suggests that for community as a whole the proportion of savings out of national income will depend at any given time on the distribution of income within the community rather than on the level of income as such. In contrast to these

hypothesis, permanent income hypothesis is advocated by Milton Friedman.

A variety of influences affects the total amount of personal savings in a country. The national propensity to save may depend on (a) The country's level of income, (b) The distribution of income, (c) The prevalence of institutions associated with savings such as the habit of life insurance, the practice of amortizing home mortgages, and the influence of the nuclear family in which each generation is expected to provide for its own future security, (d) The perceived existence of incentive and opportunities for social advance through economic betterment, and (e) The value system of the society, which may attach special importance to accumulating wealth, whether for religious or secular reasons.

Although there are serious obstacles to capital formation in under-developed countries stemming from sheer poverty, political instability, or certain institutional limitations, there are often present reservoirs or potential sources of capital formation which are available once the process of development has begun.

If people will not voluntarily forego consumption to avoid the excess demand for commodities, the authorities can impose additional taxation to generate the
necessary abstinence forcibly. Apart from its redistributive functions, taxation is a more efficient and equitable method of financing investments. The use of the proceeds of taxation to finance accelerated capital or investment expenditure is usually termed compulsory savings or 'the socialisation of savings'. The advocacy of compulsory saving is, as a rule, based on three propositions: economic growth as such is desirable; economic growth is in large measure a function of capital accumulation and compulsory saving necessarily increases capital accumulation. An added argument for compulsory savings implies that the government has a better appreciation than the citizens, about the productivity of the competing uses to which their funds can be put. Therefore, advocates of compulsory savings prefer that important decisions be made by the government rather than by dispersed individuals. Conversely, heavy taxation is likely to impinge on the economy with dis-incentives on productive efforts.

Economic growth entails not just a greater disposition of save but effective inducements to a high rate of investment in productive enterprises. Where official savings are a large part of total savings, they
are likely to be used to finance state undertakings. Private savings will enhance the dispersal of local entrepreneurship. Private investments are conducive to economic growth because the growth of the 'capitalist sector' itself tends to increase the savings ratio in the economy. Different sectors of the economy tend to have different savings ratios. For example, in the traditional sector, the prospects of savings are relatively poor and the modern industrial sector is regarded as the chief source of savings. Usually the household sector accounts for the largest share of total savings in the economy. There a marginal increase in the savings rate of this sector could significantly raise the overall absolute level of savings in the community. There is again the problem of directing such savings into productive investments rather than the purchase of land, gold or jewellery.

Household savings are held in various forms. Gold happens to be favoured in many underdeveloped countries. There is also a noticeable preference for 'tangible' as against 'financial' assets. Instead of holding deposits with banks, shares and other financial investments, householders hold their savings in physical form: bullocks, residential property, grain, farm
improvements and so on. Both these patterns of saving-behaviour have an economic rationale. Gold is preferred as a hedge against inflation. Moreover, tangible assets are held in the absence of banks and other institutional arrangements necessary for the creation of financial assets. In conditions of inadequate banking and financial facilities capital market, etc., the transfer of funds from those who save to those who wish to invest is rarely smooth and sometimes impossible. In many under-developed countries this provides a major brake on the ability to invest.

The use of savings to purchase tangible household assets beyond certain limits is socially unproductive. The sale and purchase of land (real estate business) leads to inequalities and mal-distribution of land.

Investment in industrial and transport enterprises or in plantation, agriculture, etc., is much more readily undertaken if political conditions are stable and institutional arrangements more favourable to long-term investments, and when inflation is controlled or removed and supplies of factors complementary to capital expand. When these changes take place larger savings become available for industrial and commercial investment.
Unemployment and underemployment in under-developed countries represents a potential source of savings and investment. Social institutions in these countries often secure for the unemployed and underemployed a level of consumption in excess of the value of their contribution to output. Some people are producing an output in excess of their own consumption and the resultant savings, serve to sustain the unemployed or underemployed members of the social group. Apart from the resource set free for saving and investment as a result of the absorption of unemployed and underemployed into gainful employment the breakdown of the extended family and kindered social institutions is likely to foster saving and investment in other ways as well. Keeping these consideration in view professor R. Nurkse developed the concept of disguised savings potential.

Since most of the developing countries have a mixed economy structure the necessity of distributing the national funds between the public and private sector is of

crucial importance. Sometimes, state enterprises make it difficult for new or small private firms to develop because they are serious competitors for a similar undertaking. Managerial and entrepreneurial talent in the economy should not be deprived of funds. Public investment should be directed by cost-benefit approach and should be unwasteful. Private investment will be based on quick rates of returns because they are profit-oriented and should therefore be cost-effective and efficient. The problems of economic investment are not merely those of collecting quantities of capital but of deciding the forms it should take so as to be most productive and instrumental in economic growth.