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ROLE OF TAXATION SYSTEM AND INTEREST RATE IN CAPITAL FORMATION IN INDIA

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ABSTRACT

India is a developing economy. Its capabilities are in developing stage. Another feature of Indian economy is abundant of labor force but less availability of capital. Policies are designed to balance the situation of labor abundances and relative capital scarcity. India is needed to increase the rate of capital formation. Present article is an attempt to show the role of various economic features in maintaining the growth of economy of India.

Key Words

Labour force, Tax incentives, Capital formation, Interest rate.

Introduction

Investment level in a country directly affects the level of income and employment. Increase in investment also increase level of economic activities, which increase the level of production, income and employment in economy. While decrease in level of investment also decrease the level of economic activities, which decrease the level of production, income and employment. It is the reason why every country wants to increase the investment level in country. Policies of the country are designed in the way, which is most helpful in economic growth. Main features of Indian economy are as under.

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1. **Large size of population** – one of the main features of Indian economy is the large size of its population. It makes the economy a large market of goods and services. Supplier of labor force and provide the production capacity to the economy. And makes various opportunity for growth
2. **Young population** – One of the main features of Indian population is its average age. The average age of Indian population is just 25 years. It is showing the strength of Indian economy.
3. **Developing economy** – India is a developing economy. It means its capability to earn;Infrastructure is still in developing stage. Standard of life is below the average of the world. It is making various opportunities for growth as the infrastructure, capital Investment in facilities are developing in the current situation.
4. **Labourabundant but less capital availability** – Indian economy is labourabundant as the large size of Population and average age of the population, but there is lack of capital in India. Large part of public savings is used in public investment for developing of infrastructure.
5. **High Interest Rate due to the high demand of capital** – Interest rate in most of the developed countries is 3% p.a. It is the minimum in Japan. Which provides interest free loan for in the country, while the rate of Interest in India is about 12% to 20% for various purpose? It is due to the high demand of capital in the country.
6. **Inflation effects** – Inflation is another problem in Indian economy. India is suffering from inflation due to the various reasons like, lack of storage capacity inflates the price of agricultural products in off season. Less developed markets in India also a problem for distribution system. Less developed or unequal developed transport system is another problem in distribution of products.

7. **Devaluation of Home currency** - Devaluation of home currency refers a situation where a country dilutes the value of its home currency in comparison of foreign currencies. Devaluation of home currency increases the opportunity of exports but it increase the cost of imports. It reduces the imports by increasing its price for domestic country. It also increase the competition capacity of the country but by decreasing the relative average price of exports, country gets less average revenue from exports in comparison of average revenue before devaluation

Investment function

Investment level in an economy is affected by various factors, it include economic factors as well as non-economic factors. If we talk about only economic factors, the main factors are as under.

1. **Interest Rate** – there is inverse relationship between interest rate and Investment level. Increase in interest rate means increase in cost of capital, which reduce the profitability margin of business. Therefore it also reduces the demand of capital for investment. Decrease in rate of interest reduce the cost of capital and increase the profitability of the investment, The live example of using the lower rate of interest for promoting the investment is Japan, where rate of interest is about zero % of the loan. This policy is not suitable for all economy. First limitation of the zero interest rate policy is limitation of capital in that economy and another limitation is chances of HIGH RATE inflation may suffer by that country.
2. **Rate of return on Investment (Marginal rate of return)** - rate of return also play an important role in determining the level of investment in firm, industry and economy. In simple language investment is increased till the level, where marginal rate of return on capital is equal to the marginal cost of capital, where marginal rate of return is reducing with every increase in capital. Tare of return is depending on various factors like efficiency of labour, technology Upgradation, quality of raw material, wastage level, capacity utilization Infrastructure development etc.
3. **Rate of Taxes** - Rate of axes also play an important role in determination of investment level in economy. Decrease in rate of taxes increase the net profitability after tax while

increase in tax is reducing the net profitability of firm. Due to the change in profitability decrease in tax is helpful in increasing in investment level as well as level of production, income and employment.

4. **Availability of inputs and theirprice** - Availability of inputs and their price also affect the level of investment in an area. Easy availability ensures the smooth production activity and increase the level of investment while decrease in price of investment increases the profitability of business.
5. **Market forces**– Market forces play important role in determination of production level and investment level in an economy. Expected demand of a product affects the planning of production of producers. Higher expected demand induce the producers to plan a higher level of production as well as a lower expected demand induce the producers to make a lower level of production plan in economy. Producer's plan of production also affects the level of investment accordingly.

Strategy of India to Increase GDP growth rate

Some features of Indian economic policies are as under.

1. Higher Interest rate for promoting the savings.
2. Devaluation of home currency to increase the exports.
3. Tax incentives for promoting savings and investment.
4. Attract foreign direct investment.
5. Public Investment in Infrastructure

Conclusion

India is developing country. It is developing by a very high rate of growth. Its rate of GDP growth is about 8% per annum. Various other feature make it a unique situation in world like large size of labour force, abundant of natural resources, large part of younger population in total population, growing share in world trade etc. Priority of the policy makers of India is to maintain the savings and investment rate in the economy. Main need of the Indian economy is the generation of capital. India is abundant of labor force but lack of capital. Due to the lack of capital we can see the various efforts in economy to increase the savings of the population. Interest rate is therefore very handsome in Indian economy.It is about 9% p.a. for fixed deposit in India. While average rate of interest in developed countries is about 3% to 4 %. India is needed of capital formation to maintain its growth prospective. If we study the taxation system of the India, we can easily see that the lots of incentives are given for savings and investment.

Finally the long term anticipated features that will owned by the Indian economy are as under.

1. High interest rate to promote savings.
2. Incentives in taxation system to promote investment in India.
3. Moderate inflation rate to maintain profits.
4. Undervalued home currency to make opportunity of exports from India.

Above features are the key anticipated features for Indian economy for next 20 years.

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