09.CAPITAL - CHARACTERISTICS - CAPITAL FORMATION; ORGANIZATION OF BUSINESS FIRMS – TYPES AND CHARACTERISTICS - CONCEPT OF SHARES &DEBENTURE.

Capital

Capital in a man-made material. Man produces capital equipments or goods to help him in the production of other goods and services. Capital is, therefore, defined as “the produced means of further production”. The word ‘capital’ is often interchangeably used for concepts like money, wealth and land. Hence, the definition of capital is made clearer in the following section:

1.a) Capital and Money: Money can be used to buy consumer goods (rice) as well as capital goods (tractor). Money used to buy capital goods is also called capital, while money used to buy consumer goods is not capital.

b) Capital and Wealth: Wealth included both consumer goods and capital goods. Hence, all capital is wealth, but all wealth is not capital.

c) Capital and Land: Land is a free gift of nature but capital is man-made. Capital is perishable, i.e., it can be destroyed. But land is indestructible and permanent. Capital is mobile when compared with land. The quantity of capital can be changed depending upon its price. But the land area is fixed and limited in supply.

2) Characteristics of Capital

a) Capital is man-made (artificial)

b) It increases the productivity of resources

c) Supply of capital is elastic. It can be produced in large quantity when its requirement increases.

d) Capital is perishable as it can be destroyed.

e) Capital is highly mobile.

3) Types of Capital

a) Fixed capital and working capital: Fixed capital can be used many times in the production process. The level of fixed capital does not vary with the level of production in a very short period, (E.g.) farm buildings, tractors, farm tools, etc. Working capital or variable capital or circulating capital can be used only once and they are not available for further use. The level of working capital increases (decreases) with the increase (decrease) in the level of production, (E.g.) raw cotton or lint used to spin yarn, fertilizer used to produce paddy, etc.

b) Sunk capital and floating capital: Sunk capital is meant only for a specific purpose, (E.g.) cane crusher, paddy thrasher etc. They cannot be used for any other purpose. Floating capital can be employed for any use, (E.g.) money.

c) Social capital and private capital: Private capital is owned by individuals and the income or benefit derived from these assets are available only to the individuals who own them (E.g.) tractors, private factories etc. Social capital is owned by the society as a whole and the benefits derived from these assets are shared among the members of the society, E.g. bridge, dam, government owned factories, etc.

4) **Capital Formation:** Capital formation or capital accumulation means the

increase in the stock of real capital in a country. In other words, capital formation involves making of more capital goods such as machines, tools, etc, which are all used for further production of goods. Also, capital formation creates employment at two stages. First, when the capital is produced, some workers have to be employed to make capital goods like machineries, tools, etc. Secondly, more labour has to be employed when capital has to be used for producing other goods.

a) Phases of capital formation: There are three phases in the process of capital formation or capital accumulation.

i) Creation of savings: In order to accumulate capital goods some current consumption has to be sacrificed. If people are willing to reduce their present consumption, they can devote more resources to build up capital goods for the use in future. The level of savings in a country depends upon the power to save and the will to save. The power to save depends upon the level of income of people. The higher the level of income, the greater will be the amount of saving. Apart from the power to save, the total amount of savings also depends upon the will to save. People save in order to provide financial security against their old age and unforeseen emergencies. People also save to start business or make provision for their children’s education, marriage, etc. Savings may be either voluntary or forced. Voluntary savings are those, which people do of their own free will. Voluntary savings depend upon the interest rate, power to save and will to save. On the other hand, taxes by the Government represent forced savings. Savings may be done not only by households but also by business enterprises and government. Government savings constitute the money collected as taxes and the profits of public undertakings. Foreign capital also forms another source of investment. Foreign capital can be of 1) direct private investment by foreigners, 2) loans or grants by foreign governments and 3) loans by international agencies like the World Bank, International Monetary Fund (IMF), etc.

ii) Mobilization of capital: The savings must be mobilized and transferred to businessmen or entrepreneurs who require them for making investment. In the capital market, funds are supplied by the individual investors (share holders), banks, investment trusts, insurance companies, government, etc.

iii) Investment of savings in real capital: Investment is done by entrepreneurs. The level of investment or capital accumulation is determined by the cost or supply price of capital (interest and other cost of acquiring capital), the expectations of profits and the size of market for goods to be produced.

iv) Enterprise or Organization

An entrepreneur is the co-coordinator of all other factors of production. He has to plan, organize and direct other factors of production, arrange for marketing the produce and take risks and uncertainties.

a) Functions of an Entrepreneur

1) Function of initiation: An entrepreneur makes proper assessment of markets (both input and output markets) and decides upon what, when and how with regard to production and marketing of a commodity.

2) Function of choice of location: He decides upon the particular place to locate the concern or unit where facilities regarding production and marketing are available.

3) Function of co-ordination: The entrepreneur has to co-ordinate, direct and supervise the functioning of other factors of production.

4) Function of innovation: The entrepreneur has to introduce new technologies, machineries and tools in order to increase the labour productivity and also to reduce the cost of production.

5) Function of bearing risk and uncertainty: Taking risks means accepting a probability that things will turn out badly. Under risk the occurrence of future events can be predicted fairly accurately by specifying the level of probability, E.g. prediction on monsoon rain, storm, etc. In the case of uncertainty, the future occurrences of an event cannot be predicted accurately. E.g. price fluctuation. In both cases, the entrepreneur may likely to incur losses. So, he has to anticipate risk and uncertainties and provide necessary alternatives to face them.

b) Forms of Business Organization

Business organization is a trading concern or producing unit. A business organization may be owned either by a single person or by many people. The primary aim of a business organization may be either earning profit or promotion of general welfare of the people. On the basis of the above two criteria, business organizations can be classified into five categories as follows:

a) Individual Entrepreneur (Individual Proprietary System)

A business organization owned by a single person is known as the individual proprietary system. In this case, personal attention on all consumers by the proprietor is possible. He himself takes the entire risks and hence, wastage of all kinds is eliminated. However, large-scale business is not possible, as the capital at the command of the sole proprietor is generally meagre. In the event of failure, not only the assets of business but also the other private assets and properties of the proprietor can be claimed against by creditors. E.g. Retail shops.

b) Partnership

In this case, two or more persons join together; contribute share capital and share profit or loss in agreed proportions. It establishes wider personal contacts and hence, large-scale production is possible. The existence of unlimited liability curbs the speculative or risky tendencies of the partners and prevents the starting of risky enterprises. However, unlimited liability makes the business unenterprising, because all partners are liable for the firm's debts irrespective of the amount of capital each has invested. Further, in actual practice, partners behave in a selfish manner, i.e., doing the minimum and trying to get the maximum out of the business. Any action taken by one partner is legally binding on all other partners and this makes the business more complex. E.g. Small transport operators, textiles business firms, etc.

c) Joint - Stock Company

The joint-stock company is owned by a large number of share holders who contribute to the share capital. They are entitled to get the profits (dividends) of the company. The share holders elect a board of directors among themselves. The board appoints one of its members as the managing director. The board directs and supervises the affairs of the company. The joint stock company is based on the principle of limited liability. That is, each share holder is liable for the debts of the company only upto the value of the share he has bought from the company. His other properties cannot be attached by the creditors of the company. Hence, the word 'Limited' (Ltd) is written after the name of any joint stock company. (E.g.) Karur Vysya Bank Ltd. Shares are transferable from one person to another through stock exchanges. In general, there are two types of shares: 1) ordinary share and 2) preference share. There is no special privilege attached to the ordinary share and the ordinary share holder gets a dividend out of the net profits of the company. The preference shares are guaranteed by a certain fixed dividend, which is paid out of the net profits before dividends are paid on any other kind of shares. Joint stock companies are of two kinds, viz., private and public. A private company has to satisfy the following conditions: i) neither share holders nor debenture holders exceed fifty in number; ii) Shares are not offered for sales by public issue; iii) directors can disapprove any proposed transfer of shares; and iv) no body outside the company is in a position to control its policies.

Besides the shares, the companies usually raise funds by floating 'debentures'. Debentures or security bonds are not shares of the company but they are promissory notes on the basis of which the company raises additional funds in the form of loans. The debenture holders are the company's creditors and they must be paid the agreed rate of interest whether the company makes profit or not.

1) Advantages: i)As the company can raise a large sum of capital, large-scale production is possible.

ii) As the company is based on the principle of limited liability, the share holder's risk is reduced.

iii) It promotes research and development facilities in order to improve the quality of goods and to minimize the costs.

iv) Shares can easily be transferred through stock exchanges. A share holder can withdraw whenever be likes without disturbing the company.

2) Disadvantages: i) The directors are practically self appointed and the share holders do not have much influence in the decisions taken by the company.

ii) Share capital is owned by the share holders but risk is taken by the board of directors. Hence, some directors start risky enterprises and this results in inevitable losses to the company.

(iii) The liability being limited and the shares being transferable, the share holders take no interest in development of the company.

d) Co-operative Enterprises

Co-operation is a form of economic organization where people voluntarily work together for a business purpose on the basis of mutual benefit. It is a voluntary organization designed to promote economic interests of its members. Members have equal rights and responsibilities. The co-operative society has the motto of 'each for all and all for each'. Co-operation is supposed to teach virtues like self-sacrifice, discipline, honesty and fairness in dealings, mutual help and self-reliance. However, co-operative enterprise suffers from the following defects: i) There is a lack of incentive and initiative. ii) Business leadership is lacking in co-operatives. iii) In general, members do not have honesty. E.g. Primary Agricultural Co-operative Credit Society.

e) State Enterprises

A commercial undertaking owned by the government is public undertaking or state enterprise. Public undertakings have been started for the following reasons:

i) It brings about rapid economic development.

ii) It ensures that the benefits of development are shared by all the people.

iii) The state can raise huge capital, which could not be raised by the private sector.

iv) As a monopoly enterprise, it enjoys several advantages.

Disadvantages: (i) State enterprise when compared with private enterprise is not run and managed efficiently.

ii) Red-tapism and lack of initiative are prevalent.

iii) Inefficient management of the administrators results in loss of under utilization of resources. E.g. Tamil Nadu State Transport Corporation.

Chapter 4: Questions for Review:

Fill up the blanks:

1. According to Malthus, the food production increases in ——— ratio and population increases in ———— ratio.

2. Land is a nature's free gift, while capital is ———— .

3. Labour has a weak bargaining power, as it is highly———— .

4. Labour has relatively lesser mobility than ———— .

5. Late marriage is an example of ———— check.

6. Tamil Nadu State Transport Corporation is a ————.

7. The control of population due to famine is a ————check.

8. If the value of M is greater than zero, then the country is said to be ——— .

9. In partnership firms, ——— liability is followed, while in joint stock company, ——— liability is followed.

10. The debenture holders are the company's ——— and they must be paid the agreed rate of interest.

II Differentiate the following:

1. Positive and preventive checks.
2. Land and capital.
3. Labour and capital.
4. Capital and money.
5. Capital and wealth.
6. Social capital and private capital.
7. Will to save and power to save.
8. Private company and public company.
9. Fixed input and variable input.
10. Share and debenture.

III Answer the following:

1. What are the factors of production? Define them.
2. What are the characteristics of land?
3. Explain division of labour- its merits and demerits.
4. What are the characteristics of labour?
5. What are the factors that influence the quality of labour?
6. Describe mobility of labour.
7. Describe the Malthusian theory on population
8. Explain the Optimum theory on population
9. Explain the impact of technological progress on the size of optimum population.
10. Explain the criticism on population theories.
11. What is capital formation? What are the different ways of capital formation?
12. Explain the functions of an entrepreneur.
13. Explain the different forms of business organizations. Describe in detail the merits and demerits of different forms of business organizations.