Drop in Private Investments

Why in news?

The decline of private investment, indicated by the Gross Fixed Capital Formation has been a concern for the Indian economy since 2011-12.

Status of private investment in India
• Private investment in India began to significantly pick up after the economic reforms of the late 1980s and early 1990s, which improved private sector confidence. • **Pre-Liberalization era**- Prior to economic liberalization, private investment remained either slightly *below or above 10% of GDP*. • **Post-Liberalization**- After liberalization, private investment took on the leading role in fixed capital formation. • **Public investment**- Public investment as a percentage of GDP steadily rose over the decades, from less than 3% of GDP in 1950-51 to eventually overtake private investment in the early 1980s. • **Global financial crisis-** The growth in private investment continued until the global financial crisis of 2007-08, during which it rose to around 27% of GDP. • **Current status-** From 2011-12, private investment began to decline and hit a low of 19.6% of GDP in 2020-21. • **Recent Trends**-However, from 2011-12 onwards, private investment began to decline and hit a low of 19.6% of GDP in 2020-21.

Why there is a need of private investment for an economy?

- **Multiplier effect**- Private investments create both *direct and indirect employment opportunities*, stimulate consumption, and contribute to overall development.
- **Effective collaboration**- Faster development can be achieved when the *public and private sector collaborate* effectively, especially in critical areas such as infrastructure and long term investments.
- **Essential development**- India has established public-private partnerships to *channel private sector funds* effectively, it is crucial for directing investments into essential development areas like airports, industrial parks, higher education, and skill development.
- **Long term growth**- Countries with higher private investment tend to experience *greater rates of growth* over the long term. To boost economic growth and welfare, it's essential to implement public policies that encourage sustained increases in private investment rates.
- **Foster innovation**- The investments are driven by *competition*, contribute to economic progress and technological advancement by enhancing efficiency, output,

and innovation.

- **Environment efficiency**- It is crucial for both *ecological conservation* and economic growth, with resources like cash, budgets, communication systems, and infrastructure playing a significant role.

Gross Fixed Capital Formation
• It is the spending towards investments in boosting the *productive capacity* of the economy which typically accounts for 30% of the GDP. • It is often used as an indicator of the level and quality of investment in a country, as well as its competitiveness and innovation. • GFCF refers to the growth in the *size of fixed capital* within an economy. Fixed capital includes assets like buildings and machinery, which are essential for production and require investment to be created. • *Private GFCF* serves as a rough indicator of how much the private sector in an economy is willing to invest. It reflects the private sector's commitment to expanding its productive capacity. • *Overall GFCF* also includes capital formation resulting from government investment. Government spending on infrastructure, education, and other areas contributes to the overall fixed capital base. • Fixed capital plays a crucial role in boosting economic growth. By enabling workers to produce more goods and services each year, it improves living standards. • Developed economies such as the U.S. possess more fixed capital per capita than developing economies such as India.

Why private investment has fallen?

- **Low private consumption**- It is the key reason for the lack of growth in private investment, especially since the pandemic as robust consumption is necessary to assure businesses of demand for their products, which would encourage investment in fixed capital.
- **Challenges in financial sector**- Issues in financial sector such as *non-performing assets (NPAs)* in banks and liquidity constraints can hinder private investments.
- **Reluctance of bank**- They resist to lend to businesses, *especially small and medium enterprises (SMEs)* can restrict access to capital needed for investment.
- **Infrastructure deficit**- The cost and risk of investment is increased due to unreliable power supply, poor transportation networks and bureaucratic delays in obtaining permits which limits efficiency and competitiveness of businesses.
- **Global economic factors**- Economic downturns or slowdowns in major global economies can impact investor sentiment and lead to reduced investment flows into emerging markets like India.
- **Policy inertia**- Delays or lack of progress in implementing structural reforms and policy initiatives aimed at improving the business environment, *enhancing ease of doing business*, and attracting investment can contribute to declining private investment.

What are the consequences of low private investment?

- **Slower economic growth-** When private investment remains low, it hampers the expansion of the fixed capital base. This, in turn, leads to slower economic growth.

- **Crowding out effect**- It is a scenario where the increased government spending ultimately decreases private sector spending.
- **Impact on capital allocation**- Private investors are often considered better allocators of capital than public officials as they are driven by profit motives, hence if low private investment this could mean less efficient capital allocation.
- **High taxation**- If private investment is low, the government may need to raise taxes to make up for the investment shortfall, which can further slow economic growth.
- **Financial instability-** Low levels of private investment can be associated with greater instability, increasing the risk of firms going bankrupt or experiencing slower growth.
- **Impact on Infrastructure**- It can lead to a decline in private capital, which might affect wages and productivity.

What lies ahead?

- The government should increase consumption by transferring more money to the people, which could, in turn, stimulate private investment.
- A healthy balance between private and government investment is crucial for sustainable economic growth.
- Private investments is crucial as it is profit driven hence encourages efficient resourceful utilization and help avoid wasteful spending.

Reference

The Hindu- Explained why private investment dropped