Finding Domestic Finance For Industrialization

In a period when external financial aid to developing countries is increasing less rapidly than before, one question emerges ever more sharply: how can developing countries mobilize all possible domestic resources for financing their industrialization?

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DEVELOPING countries generally want to produce within their own borders the goods they would otherwise have to import, thereby achieving greater national self-sufficiency. In particular, countries that have a large domestic market but are heavily dependent upon the export of primary products try to promote industrialization with this end in view. Some countries where the domestic market is smaller tend to favor more industries that will produce exports rather than import substitutes. Whatever a country's ambitions may be, industrialization depends on a number of factors: entrepreneurship, technical knowledge, competent accounting, and so on, and last, but of course not least, capital.

Sources of Capital

What are the domestic sources which may be tapped for the capital needed? Usually in the early stage of industrial development, people prefer to stick to commerce, real estate, and agriculture, all fetching quick and easily foreseeable returns compared with long-term investment in industry. In these circumstances a private investor starting a new industrial enterprise is an innovator who is taking on unknown risks. Therefore, the private investor will himself have to provide the larger part of the initial capital from his own savings, the rest often being obtained from relatives and friends.

As industrialization proceeds and the concept of credit becomes more familiar, self-financing will be supplemented by loans and other financial assistance from financial intermediaries and funds raised in emerging capital markets. Furthermore, the government may step in and provide direct or indirect financial assistance to industrialization.

Self-Financing

Self-financing is a primary domestic source of capital for industrial enterprises, especially in countries where enterprises cannot rely on capital markets for their needed funds. In Mexico in 1959 the self-financing of enterprises as a proportion of gross domestic investment was about 40 per cent, in Malawi (then Nyasaland) in 1956 about 50 per cent, and in the Congo in 1957 close to 60 per cent.

The initial capital needed to set up a small industrial enterprise has to come from the entrepreneur's or his family's savings. Sometimes, of course, he may be able to obtain help from others who have both some capital to invest and sufficient confidence in him to entrust him with their savings. Once the new owner has obtained the necessary minimum of initial long-term capital and has set up in business, he will be able to obtain considerable additional short-term finance in one form or another. He can almost certainly rent his premises and perhaps hire part of his machinery. He will be able to obtain the ordinary trade terms from suppliers of his materials; or he may act as a subcontractor, performing operations on materials supplied and owned by a larger firm.

If his small factory prospers, he may improve the strength and earning power of his enterprise still further by reinvesting part of his profit. In the entrepreneur's view, self-financing out of net profits (after depreciation) plowed back into the business has the advantage of reducing outside influences on the enterprise. In practice, however, self-financing sometimes involves a danger of channeling capital to investments of lesser importance.

In addition to financing out of net profits, it is also possible in certain circumstances to finance the expansion of an enterprise out of depreciation reserves. In a period of falling prices, the replacement cost of physical assets is below their original cost. When this happens the allocation to depreciation reserves, being fixed at a level designed to replace the original money cost of the asset by the time it is worn out, will be sufficient not only to replace it with a similar asset but also to provide a margin available for financing an expansion.

Even in a period of stable prices, there is a way whereby part of the capital, which—after depreciation—no longer appears openly in the accounts, can be used to expand the scale of the enterprise. The individual physical assets have lives of varying length, and the amounts depreciated on the whole plant will be much larger than are needed to pay for current costs of replacement of individual items as they wear out. Thus, as the years go by, part of the allowances for depreciation will cease to be required for replacement and can safely be used to finance an increase in the size of the plant.

However, during a period of rising prices, which occurs more often, replacement costs of physical assets are likely to be higher than the initial costs, and financing out of depreciation reserves might have to be supplemented by capital from other sources. Capital for self-financing of industrial enterprises is also set free through rationalization by reducing the enterprise's assets without reducing its productive capacity, for example, through lower stocks and claims on clients.

Private Outside Financing

The expansion of an industrial enterprise requires more and more capital to finance both additional fixed equipment and extra circulating capital to be used in conjunction with it. Self-financing, though an important source of financing, has its limits. If enterprises are to expand, sooner or later they have to rely on additional sources of capital—they must tap the savings of others.

This can be done by having others participate more or less permanently in the enterprise. They share the risks and profits and therefore influence operations at least to some degree. They may even go as far as direct participation in management, depending in part on the legal form of capital participation chosen.

The other possibility for obtaining additional financing is credit from financial intermediaries. In contrast to the former method, there is here no participation in the enterprise and no direct influence on the management, but there is a clearly defined reimbursement obligation. Financial intermediaries may be individuals and nonfinancial institutions but are in the first place banks. The banks' main function is to obtain funds from some and make them available to others, i.e., they help to make surplus funds flow to places where there is a shortage, including industrial enterprises. In most instances, however, the banks do more than act as a pipeline. Within limits, they can give longer credit than they themselves obtain; and, in addition, certain types of banks can extend more credit than they themselves receive, which activity gives rise to the well-known economic effect of banks creating money.

Other financial intermediaries, variously called development finance companies or development banks, have been established in practically all developing countries to mobilize capital and to channel it into emerging or growing industrial enterprises. The funds needed are obtained from subscribed capital and through the issue of bonds, or are supplied by the government. These institutions usually provide medium-term and long-term loans to industries, but they may also participate directly.

Life insurance companies, as they exist now in many developing countries, are another financial intermediary. Contractual savings are their main source of capital, which is used largely for investment in industrial securities.

Financing Through the Government

Government resources also are usually tapped for industrial financing in developing countries. The main domestic source for such funds is public savings. Through the imposition of taxes, budgetary surpluses can be created—provided that government revenue is usually higher than current expenditures—and these surpluses can be invested. A nontax source of capital is royalties paid by oil or mining companies; these are quite often earmarked for a development fund, as in Iran, and thus serve also to finance industrial development.

Government funds may be raised also by issuing bonds, although this is possible, of course, only where a capital market exists and government securites are traded. Government property, such as real estate, is another source of capital. Some governments grant land, under certain conditions, to entrepreneurs who are willing to establish an industrial enterprise. Finally, the authority and power of a government to grant fiscal and legal privileges is an indirect source of capital through which the government can facilitate development of industries.

Development of Domestic Financial Resources

It is widely believed that industrial underdevelopment is, in the first place, a consequence of lack of capital. But this belief calls for searching inquiry, for in fact there is more *potential* capital in most developing countries than is usually allowed for.

Original and derived domestic sources of capital, as described above, exist in all developing countries. Some countries realize this potential with considerable success; others have failed to develop the seeds that exist, so that capital cannot easily be mobilized and brought to bear upon industrial financing. Quite often, because of political uncertainties or permanent inflation, large funds are deposited outside the country. One of the very important problems of international development is how to bring more countries into the group that is able to mobilize capital for industrial development with real success.

Increase of Savings

Private saving, i.e., renunciation of consumption in favor of investment possibilities, is generally small in countries with a low real income. As economic development proceeds and is successful in raising real income, the margins available for savings should increase. Hence, although there appears to be no automatic relationship between the two, economic development will favor an increase in savings.

It might be thought that high interest rates would provide an incentive to increase total savings. But experience shows that they are not in themselves sufficient; they sometimes initiate only a shift from a financial asset bearing low interest to a financial asset with higher yield.

Realizing Potential Domestic Resources

The more practical approach to this problem is the realization of potential domestic resources. This depends largely upon the monetization of the country concerned. When there is still a large subsistence sector, savings are hoarded in the form of precious metals, jewelry, livestock, real estate, or other fixed assets. If the monetized sector expands, coins and notes will be increasingly hoarded, too. Hoarded savings, however, stay out of circulation and do not contribute directly to the aggregate investment of the economy. It is the business of the authorities to change them into some other more productive form.

The incentives to save in forms other than hoarding have to be numerous, otherwise a peasant in a developing country will not be ready to change his traditional savings and investment habits. An essential step toward the creation of such incentives is the improvement of the banking, savings, and insurance institutions. The government and the central bank can play a useful role in the spreading of these institutions, as has been proved by the example of prewar Japan. The creation and central control of an organized banking system, in the context of a favorable environment, have strongly influenced the rapid movement of Japan from an industrially underdeveloped country to a highly industrialized nation.

Measures and policies in developing countries aimed at this purpose should, therefore, include the following: providing incentives for private banks to open in areas that they normally would not have entered; encouraging the creation of cooperative credit societies, thus leading the rural population away from the personally known but often irresponsible private money lender to institutionalized lending (the large board of a cooperative society probably still includes persons known to the depositor or borrower but the society's banking rules are already more sophisticated and can be controlled more easily); creating a system of insured deposits to strengthen confidence in banking institutions; improving remittances and clearing arrangements; and sponsoring the creation of private or government financial institutions with specialized functions, such as savings banks, life insurance institutions, and development banks.

Besides a widespread banking system, the climate within the country must be conducive to the accumulation of private savings; among other desirable effects such a climate may induce the repatriation of private funds held abroad. The creation of the climate depends upon many factors, such as confidence in political stability, social order, and a sound monetary policy. Furthermore, the private depositor who saves for future financial needs may have less incentive to do so if the domestic market is not sufficiently supplied with consumer goods that he might wish to acquire later on. Even more important, from the standpoint of industrial development, is a feeling of absolute certainty on the part of savers and investors that private property in capital goods shall remain unappropriated. The importance of a favorable environment, as well as other important factors, is illustrated by the fact that about 20 years of industrial efforts in mainland China (population 710 million) has led to a share of only 1.41 per cent of world industrial production; Japan, with a population of 98 million, has 7.80 per cent.[1]

Even when such steps have been taken, it is still not an easy matter to attract domestic private savings in developing countries for the purpose of long-term investment. The people are unfamiliar with these fields

[1] Gabriel Aranda, *Entreprise*, No. 678, September 1968, Paris.

and have (or believe they have) other more obvious and quick-yielding investment possibilities. This belief is rooted largely in the attitude to work of many people in developing countries who do not readily think in terms of defined periods of time (of what can be achieved in two years or five or ten years), so that the concept of credit and investment in capital goods is largely unfamiliar to them. To change this way of thinking and to create a middle class which is basically more prone to save is one of the most difficult yet rewarding tasks facing any government that seeks wider industrialization.

The government can play an important role in mobilizing either voluntary or involuntary domestic savings. We have indicated already how much the creation of an adequate banking system with an effective central bank control helps to reach even the small savers in the country. Government propaganda in favor of increased personal saving may help a little. The Governments of Pakistan and India in particular were able to mobilize sizable amounts from small savers through the issue of development saving certificates, some of which had lottery features. Attempts may be made to assure that a maximum of retained business profits be plowed back. The government may also try to increase savings by creating a budgetary surplus via an increase in the tax burden. The tax policy should be directed, therefore, in such a way as to reduce private consumption but, at the same time, to give incentive to larger savings. In developing countries, measures to reduce consumption have to be aimed more at the medium-income and higher-income groups, since the savings of poor people would be a low-yielding source of government revenue. Therefore, the usual tendency in developing countries to shift for various reasons more and more from indirect to direct taxation supports such policy. Foreign capital sources can be tapped through export taxes to supplement domestic savings. However, it makes sense to introduce export taxes only if the burden of the tax can be shifted to the foreign purchaser of the export product, i.e., as long as the product remains competitive in the world market.

Channeling of Domestic Finance into Industrial Development

Not all savings collected by the various institutions are available for investment in industry, since there are also other capital needs in the country. It is largely a matter of government policy to decide how much of the total funds available should be channeled into industrial developments. Nevertheless, this portion has to be substantial, since capital needs for modern industrialization are much larger than they were for the less capital-intensive industrialization in the nineteenth century. If this decision has been taken, the flow of funds into the industrial sector can be stimulated either by banking measures or by fiscal measures.

In a country where the banking system is still simple, industrial enterprises seeking long-term finance may find that they have to choose between short-term borrowing, which may be dangerous, and no borrowing at all. At this stage the introduction of specialized financial institutions, already referred to as a source of credit, becomes necessary. Such institutions, private or public, under the names of development banks or development finance companies, as well as being a source of long-term capital can perform a valuable function by identifying promising fields for investment. The capital provided can be either in the form of a bank credit or a participation in the new or expanding enterprise, depending largely upon the risks involved and the degree of control the bank wants to exercise over the enterprise. On the basis of its participation, the development bank can contribute to the growth of the domestic capital market by selling from its own portfolio securities of enterprises that have survived the initial hurdles and become successful. Through these sales the development bank replenishes its resources from domestic sources and can continue to provide capital for further industrial investments.

Frequently, not long after they are in operation, development banks suffer from a shortage of liquid funds because their capital becomes tied up for a longer period. For example, this happened to an industrial bank in the Sudan, established in 1962 with an initial capital of about £1 million. After 16 months of operations the bank had available for new loans only about 15 per cent of the initial capital. The Government accordingly had to step in and provide means for the period until previous industrial loans were repaid to the bank and its liquid funds were thus replenished. Allowance has to be made in advance for this difficult period.

In a country where a wide variety of financial institutions has been established and the security markets are highly organized and functioning well, changes in the relative interest rates on the various financial assets tend to bring about adjustments in the supply of loanable funds. Thus, for example, comparatively higher interest rates for industrial bonds could increase the demand for such assets and consequently increase the credit supply to industry.

In countries at a less developed stage, market imperfections may prevent interest rates from effecting required adjustments in the flow of loanable funds, and various directive controls have to be introduced to make good this failure. These are specific fiscal measures. The government may support new enterprises financially, with real estate donations, by granting privileges and tax exemptions, etc. A remarkable example of such development policy is Ireland. Although not a "developing country" in conventional terminology, Ireland has demonstrated what a government can do to channel domestic (and foreign) finance into industry. Under its development arrangements, cash grants were made available of up to two thirds of the cost of fixed assets needed. Long-term loans were extended at a low interest rate. Real estate was granted for the establishment of factories in development areas with the provision that, if a similar industry was already supplying the market, output had to be mainly for export. Government grants were also made available to cover the cost of training workers and to cover half the cost of hiring management consultants. All these measures were aimed at easing the financial burden on the emerging industry until the enterprise became competitive.

Indirectly, a government can finance the establishment or expansion of industrial enterprises by temporarily not drawing revenue from such firms, i.e., granting them tax benefits. In general, investment laws provide for tax relief on both imports and income, but the benefits may also include taxes on property, sales, exports, etc. Ireland, again, is an example of a country where tax relief and privileges have contributed substantially to the establishment of a large number of industrial enterprises. Profits earned on new exports were exempted completely from income tax or corporation tax for ten to fifteen years. Import duties on construction materials, machinery, and other needed equipment were exempted. Thus, the capital requirements of the enterprise were reduced and its financing thereby was facilitated during the first years.

Further techniques to relieve the tax burden on the new enterprise are investment allowances or grants, as practiced, for example, in Morocco, which provide for a write-off of depreciable fixed assets in excess of ordinary depreciation allowances. Many countries provide for partial or total tax exemption of profits reinvested in the enterprise. Another possibility is to reduce the base of tax assessment by allowing the offset of previous losses against the profit of the current year.

All these tax benefits are an effective aid for emerging industrial enterprises. However, they are likely to entail a substantial loss in government revenue. They have to be carefully controlled and limited, and the social benefit of exemptions has to be weighed against the loss in revenue to whatever aim is considered best for the economy as a whole.

The government may even play a more active and direct role by financially guaranteeing or participating in new industrial enterprises; this is often done when the project is of particular national importance or in a key industry. From such mixed enterprises it is only one step to enterprises fully financed by government funds. Governments usually run and finance state enterprises if there is not sufficient private initiative to create enterprises, such as public utilities and transportation and communications, facilities which are of particular social interest to the country. In countries which follow a more centrally directed economic policy, state enterprises are often created also in other sectors of the economy, including trade. It is imperative, however, that domestic savings be invested for such purpose only if it is to the maximum benefit of the economy.

I have tried to show both that there are many domestic sources of capital for industry in developing countries and that these sources can be improved. They can be widened, obstacles can be removed, and capital can be encouraged to flow. The process calls for care and good judgment, but it is eminently worthwhile, the more so since the effort made within the country may have great value beyond its borders; once a climate has been created that is favorable to domestic investors, it is likely to be attractive to capital from foreign sources also.

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