

Economic Growth: Islamic Economics

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Investment in the form of machines, equipment, and workforce, is an engine of growth in that it increases the economy's capacity to produce goods and services. Islamic scholars, however, generally maintained that 'accumulation [of capital] is rigorously condemned in all its forms.' Little did they realize that thereby the gate to economic growth got closed.

The scholars said: 'On the international level, we find ourselves obliged to admit that there does not exist today a specific, Islamic model or behavioural example. We can identify, at the national level, some attempts, here and there, to create institutions and structures respectful to Islamic principles; but things are far from clear.' Savants had recognized that most Muslims lived in conditions which were often abysmal. In fact, 85 percent of the people are poor, and 60 percent are illiterate.¹ Negligence of economic growth is at the root of this massive poverty and deprivation.

Some verses of holy Koran are precise in meaning, while others are ambiguous, as they were meant to be. The text often speaks in terms of signs — for example, some facts of nature would be cited and readers would be called upon to acknowledge the underlying sign and to appreciate its deeper significance.

This essay aims at showing that the Koran contains certain verses and signs which could be read so as to determine the contours of a model of economic growth, in the modern sense of the term. Economics, as we know it today, was inaugurated in 1776 with two main principles on the 'causes' of the wealth of nations, namely, the division of labour, and the social diffusion of knowledge.²

Now, in the light of Koran, the sketch of a model of economic growth will be drawn here; the model would appear consistent with the conclusions of modern economics. It would establish that the scripture is not indifferent to economic matters, nor is it adverse to investment in agriculture, industry and trade: rather the holy book hints specifically at certain activities like horticulture and cultivation of bee-hive for nectar. This finding should inspire Muslim countries to pay greater attention to economic growth and distributive justice. There is a tenable theory now on how to do it.

1. *Dynamics*: Imagine a family with an income of Rs 100 per year. It spends three-fourths of it, which comes to Rs 75, on food, shelter, clothing, education, etc. In economics such current expenditure is called 'consumption'. Clearly, the family saves one-fourth of income, i.e. Rs 25.

Suppose the family has a business of making utensils. With its saved money, it buys capital goods like machinery and raw materials to increase production of

utensils: such capital expenditure is called 'investment'. Note that in this example savings and investment are equal in amount. A family is a replica of the whole economy of a country. These three equations hold for a family and also for the economy: income = consumption + savings; investment = savings; and income = consumption + investment.

At any given point of time, the economy has a certain stock of capital goods consisting of machinery and raw materials, which factories would use to produce goods and services. Investment, by definition, means annual addition to the country's stock of capital.

Families do saving first in the form of money; then through the medium of banks and share markets companies borrow family-savings for the purpose of investment in production projects. This is how the economy runs. Its internal circuit is known as the circular flow of income.

Now we shall discover a general rule about economic growth. Let the percentage of income saved and invested be represented by letter s , the productivity of capital (also called here the rate of return on investment) by letter p , and the growth rate of income by letter g . It has been proved that the equation describing the growth rate of the economy is as follows: $g = sp$.

For illustration, suppose the rate of investment is 25 percent, and the productivity of capital is 40 percent. Then the growth rate of national income per year is given by the product of the two ratios, which comes to 10 percent. Should either the rate of investment or the productivity of capital go up, the growth rate will rise.

A similar story is found in the Islamic scripture. The following verse in the Koran describes in words the circular flow of income and its growth.

'You shall sow for seven consecutive years. Leave in the ear the corn you reap, except a little which you may eat. There shall follow seven hungry years which will consume but a little of what you stored. Then will come a year of abundant rain, in which the people will press the grape' (12:47).

This verse narrates how the economy functions: you sow, and wait for a while for the production process to run its course, meanwhile you survive on your saved grain.

The recent record of rapid growth in East Asian countries, namely, China, South Korea, Malaysia, Thailand and Indonesia can be seen in the light of this theory. Their amazing growth can be explained by referring to the high rate of investment and the improvement of capital productivity through mass education and better healthcare.

Here is another verse advising, for example, dairy farming, horticulture, industry, and medicinal effects of certain products of nature.

'In cattle too you have a worthy lesson. We give you to drink: pure milk, pleasant for those who drink it. And the fruits of the palm and the vine, from which you derive intoxicants and wholesome food. Surely in this there is a sign for men of understanding.

'Your Lord inspired the bee, saying: "Make your homes in the mountains, in the trees, and in the hives which men should build for you. Feed on every kind of fruit." From its belly comes forth a syrup of different hues, a cure for men. Surely in this there is a sign for those who would take thought' (16:65-69).

This verse definitely indicates investment in the cultivation of bees as an important branch of the economy. It also implies that investment has productivity, a real rate of return in the shape of output. This is a remarkable aspect of an economic system: it allows you to reap more than what you sow. Suppose in one project you invest Rs 100; after a year it brings Rs 105. In another project the same amount of investment generates Rs 110. The first project has a rate of return of five percent, while the other makes 10 percent. If you have a total investment budget of Rs 100, on economic ground the second project is preferable to the first one, as its rate of return is higher. This leads to a rule about how to make a selection from among available investment projects: compare the rates of return of projects and choose the one with the highest score.

2. *Technology*: As more and more capital is invested in an economy the rate of return on additional investment tends to be less and less. If it were not the case, the whole world could have been fed with the crop of a single acre of land by putting sufficiently high amounts of seeds and fertilizer. Diminishing returns is an unavoidable tendency of production, other things remaining same.

But historical records do not show a falling trend in the rate of return in course of time. What could account for the observed phenomenon of steady or rising productivity of capital?

Economists put forward a hypothesis that advancement of science and technology has kept the rate of return from falling. Both theoretical and empirical investigations have upheld its statistical significance. There is a special kind of technological change which gets induced from within the economy by economic forces. It has interesting characteristics, namely, the new technology can be copied any number of times at practically no extra cost; used by an entrepreneur again and again without incurring depreciation, and without diminishing its benefit to accrue to other users freely operating it any time. This entity has a complex designation: non-rival, non-excludable innovation. Technology of creating website in the internet is an example; the free encyclopedia, Wikipedia, available in the web is another. The economic theory about non-rival, non-excludable technology was discovered as recently as 1990.³

The Koran calls upon man to explore the mystery of nature. Nature has granted some of the wishes of man, but not all. Now it is for man to derive more from nature through scientific endeavour. Below are two relevant verses.

'In the creation of the heavens and the earth; in the alteration of night and day; in the ships that sail the ocean with cargoes beneficial to man; in the water which God sends down from the sky and with which He revives the earth after its death, dispersing over it all manner of beasts; in the disposal of the winds, and in the clouds that are driven between sky and earth: surely in these there are signs for rational men' (2:164).

The verse suggests an orderly prevalence of laws in the universe — laws, if discovered, would enrich man's knowledge and enable him to invent machine, equipment and tools, expanding his capability. A more immediate inference from the verse is the practical idea of irrigation to nourish crops in the event of drought.

'He has subdued the rivers for your benefits. Of everything you have asked for He has given you some' (14:35). Here is a sign that signals harnessing of river water for cultivation. The last sentence of the verse offers a challenge by saying that man must strive to derive greater benefits from nature.

3. *Division of Labour* : The first theory of international trade and inter-country specialization, formulated in the early nineteenth century, was based on considerations of one country's resource endowments relative to others'. It was known as the theory of comparative advantage, based on the assumption of constant technology and perfect competition in markets. After a series of refinement and experiments, the latest theory has come to allow monopolistic competition in markets and differentiation of products, with technology playing a substantial role.

The Koran too has comparable structures in respect of trade. 'He could have made you one community: but it was His wish to prove you by that which He has bestowed upon you. You vie with each other in good works' (5:49). The two-century-old economic theory of comparative advantage would correspond to this statement.

Subsequently product differentiation is brought into the picture. 'And in the land there are adjoining plots: vineyards and cornfields and groves of palms, the single and the clustered. Their fruits are nourished by the same water: yet we make taste of some more favoured than the taste of others. Surely in this there are signs for men of understanding' (13:4). Such product differentiation takes international trade to a more complex stage.

Division of labour is of two types: one occurs among nations, the other refers to what is done on the premises of a factory where a job is split into several tasks and assigned to workers according to required specialization. The Koran has highlighted the former.

4. *Concluding Remarks* : Evidently, the Muslims in history had remained oblivious to economic messages of the scripture. And they had paid a price for their indifference which had brought upon them massive poverty and deprivation.

The economic dynamics, developed in section 1 above, insists on savings and investment. To expedite growth people have to save more and channel the savings towards productive investment. Savings kept in the form of precious metals like gold and silver is unproductive from the perspective of social wellbeing. The Koran expresses the anguish thus: 'do not consume your wealth yourselves in vanity, but trade with it' (4:28). 'To those that hoard up gold and silver and do not spend it in God's cause, proclaim them a woeful punishment' (9:35).

The act of trading now presupposes the production of goods which are to be traded, and that involves investment in machines, equipment and other material inputs. So there must be the sufficient economic inducement for companies to invest.

In line with this injunction of Koran, modern economics makes the following observation. 'The destruction of the inducement to invest by an excessive

hoarding was the outstanding evil, the prime impediment to the growth of wealth, since certain of the risks and hazards of economic life diminish the rate of return of capital whilst others serve to increase the hoarding.’⁴ In other words, excessive hoarding of savings in the form of gold and silver harms investment in two ways: one, it reduces the quantity of funds that could have been otherwise available to companies for investment; and two, it raises the cost of borrowing by companies which has the effect of discouraging investment in relatively low-profit projects.

To conclude, the foundation of Islamic economics was prepared by Sayyid Abul Ala Maududi in an address delivered at the Aligarh Muslim University on 20 October 1941. Meanwhile, over two centuries the economics started by Adam Smith has amply explored the nature of the wealth of nations and causes of its growth. This note has highlighted that so long as all human beings are equal, Islamic economics and the Smithian economics need not conflict.

NOTES :

1. Tariq Ramadan, 2001. *Islam, the West and the Challenges of Modernity*, pp 137,151, and 319.
2. Adam Smith, 1776. *An Inquiry into the Nature and Causes of the Wealth of Nations*.
3. Paul Romer, 1990. “Endogenous Technological Change”, *Journal of Political Economy*, 98(5).
4. John Maynard Keynes, 1936. *The General Theory of Employment, Interest and Money* p.351. Keynes used the term ‘liquidity preference’ as equivalent to ‘hoarding’ (p 174); and ‘the marginal efficiency of capital’ as synonymous with ‘the rate of return’ on investment (p 141). The quotation here uses the substitutes of Keynes’ terms in order to maintain compatibility with the expressions which had appeared earlier in this note.