THEORY OF PROFIT FROM ISLAMIC PERSPECTIVE

1. Introduction

Islam prohibits interest but allows profit. It promotes trade as an occupation and regards profit as a bounty from God. Mainstream economics too revolves around the notion of profit. Price theory the core of economics cannot stand firm without the assumption of profit maximization. In the practical affairs of trade, industry and commerce no concept is more pivotal than profit. Yet profit has remained one of the most neglected subjects in economic theory. After Frank H. Knight's *Risk Uncertainty and profit* (1921) no exhaustive work on the subject appeared save contributions in the form of book chapters or journal articles. Writings on the topic in Islamic economics have been even scarcer.

There is an affinity between the economic scheme of Islam and capitalism except what is in contradiction with Islamic values such as exploitation of human beings, grossly inequalities in the distribution of wealth resulting in its concentration in fewer hands, dominance of monopoly power, persistent poverty, corruption, and other social evils of the sort. Capitalism has invariably stressed the supremacy of the powerful and material riches to the detriment of spiritual values. It has promoted individualism at the cost of society. The market has been sanctified and riches have become an end in themselves. However, both permit private ownership of property, allow freedom of enterprise, and support free markets in a competitive setting. Both consider profit as a source of capital formation and growth.

Islam adapted many business instruments and practices from the past including the concept of profit. It may, therefore, be helpful to have a brief look in Section 2 at profit theory in the mainstream economics before examining it from an Islamic viewpoint. The usual practice has been of discussing profit theories in a chronological order. However, we shall identify the basic issues in the area and see how various theories have dealt with them. This would help focus better on the subject avoid overlaps, and save time and space In Section 3 we look at the issues involved from an Islamic perspective. The discussion is essentially abstract; no attempt is made to reconcile it with ground realities. It helps escape the pitfalls of comparing the realities of capitalism with ideals of Islam as there is no Islamic system presently at work. Finally, Section 4 concludes the discussion.

Discussing profit has some special difficulties. Unlike wages, rent or interest that Islam prohibits, profit is not a thing by itself. It is a catchall *residual* category of income which could be positive or negative. Consequently, profit theory opens up the entire gamut of distribution raising some ticklish queries in the process.

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2. Issues in profit theory

Some basic questions that economists have failed to answer satisfactorily on the subject include what profit is, what shapes and determines it, it belongs to whom, and how it meets the equity norm. Let us have a hurried look at these issues.

***Profit concept*:** The contractual payments firms make from their sale proceeds to the factors they hire for production leave a surplus or gross profit. A part of gross profit represents the value of physical capital used up in the process of production and must accumulate in business as depreciation for capital replacements. Market is powerless to separate depreciation from gross profit and its accounting estimation looks arbitrary. Any way gross amount minus depreciation leaves a net profit.

From net profit the economists further deduct 'implicit' charges for owners' supplied inputs to the firm measured by their opportunity costs. Implicit costs constitute *normal* profit: the minimum a firm must earn for survival. Normal profit is of ethical import that enables its treatment as a cost element the market prices must cover. Net profit minus normal profit is pure or economic profit that economists use in discussions on price formation. Monopoly revenue falls in a separate category; it does not enter economic profit.

This profit concept is atomic and arbitrary. In dynamic situations the normal and pure components of the surplus are difficult to separate, even conceptually. The same applies to monopoly revenues. Profit can be viewed only as an integrated whole composed of many and varied elements intractably intermixed. Islamic economics would endorse a catchall notion of profit closer to reality.

Sources of profit: For explaining the source of profit, economists generally start with a 'no-profit' model where the remunerations of various factor services exhausts the total revenue product of the firm such that economic profit is zero. These no-profit models are well-known. Despite differences in details they all converge to the perfect competition design of the classical vintage. Conditions within and outside such models differ vastly, yet their makers search for the source of profit in what makes the real world situations depart from the ideal profitless exchange.

Dynamic change causes the demise of profitless models allowing the emergence of profit as surplus over cost. But each profit theorist has seized upon that rudiment of change which suited his own work scheme. Thus, for J. B. Clark and many others it was risk of losing capital inherent in change that gave rise to profit. But Knight threw overboard all risk theories of profit making a distinction between measurable and immeasurable risks. Measurable risks can be insured against; they can be met at a cost. Uncertainty that cannot be measured causes risk that one cannot avoid. To Knight, profit was the reward for bearing such uncertainty.

However, uncertainty is a fact of life like sunshine or rain. All people including factors of production have to bear it, why then single out capital owners for a special reward?

Knight's analysis is extended to demonstrate that his theory could identify just a windfall element in incomes. It led profit theory into barren probability manipulations. Above all the uncertainty approach killed whatever claim one could make of profit being a functional return

Schumpeter placed emphasis on innovations in dynamic change and regarded them the carriers of economic development. Innovators were the kingpin of his profit theory. Innovating involved risk; it was like swimming against the current, many try but few succeed. Successful innovations give an edge over competitors and generate a surplus over costs - the profit - for the innovators. But Schumpeter soon found that the act of innovating had largely passed from individuals to research teams and institutions; he threw innovational profit into the dust bin of 'obsolete ideas'. In sum, the search for the source of profit in dynamic change could only lead to rudimentary analyses, not to a unified theory.

Whose profit? Mainstream economics regards profit as a functional return for the entrepreneur since the days of Physiocrats. Knight linked the two on the plea that everyone in society is not equally inclined or equipped to make business decisions in the face of uncertainty. Only those who had confidence in their own judgment as well as the ability to put their ideas into operation specialize in decision-making and are willing to bear the risk involved. They are the entrepreneurs. They translate their decisions into action by hiring other factors of production. The services of the hired factors do not involve making the sort of decision an entrepreneur makes. They work for him in return for pre-fixed contractual payments. The objective condition for entrepreneurship to Knight was the possession of capital as an empty handed person cannot ensure the fixed payments to the hired factors. Interestingly, Schumpeter did not insist on this requirement; for him, control over resources was enough for the innovator even if they belonged to others

Thus, Knight made profit the reward for decision-making in the face of uncertainty. He resurrected the classical model of tiny owner-operated firms producing a single commodity in a competitive setting. The model fits pretty well even today to the case of small proprietary businesses. But since the rise of modern multi-product corporations to prominence both the functions and the identity of the entrepreneur have faced much criticism. Put briefly the charge is as under.

The promoters bring the corporation into existence and the stockholders provide the risk capital which is invariably supplemented by institutional finance. The decision making function and the ownership of the organization are in quite different hands. Ordinarily, those who make decisions are the salaried people and they do not normally bear the consequences of their decisions. Furthermore, decision-making in modern corporations is distributed among a large number of fairly independent functionaries. Who then are the entrepreneurs and what functions do they perform today is unclear.

Knight attempted to escape the difficulty arguing that real control goes with responsibility. It consists in making decisions not about things but in the judgment of peoples' ability to do things. The exercise of this judgment though spread over the entire hierarchy of a corporation ultimately rests in the owners of the organization-the stockholders. After all who appoints the managers and to whom are they accountable?

In the large corporations the ownership rights of the small and widely dispersed stockholders have become marginalized representing a mere claim to a 'wage' dividend determined by the managers. Only the rights of those who own large blocks of stocks are real in the sense that they often manage to acquire effective control over the affairs of their corporations. The proxy machine and some other techniques tend to help in the emergence of what one may call the 'control-ownership' in large corporations. Though the control may rarely pass into the hands of a single person, the possibility of a small group of stockholders enjoying such power is always there.

The entrepreneur then survives as a unit of interest and control despite the corporations. Textbook economics has stuck to the tradition, for with the entrepreneur goes the motivational base of the capitalistic forms of business organization run by the market. However, the advent of large corporations has made profit a *non-functional surplus* in the hands of their control ownership. These developments in the realm of business have shifted the focal point for the study and analysis of profit from the entrepreneur to the firm.

The remaining issues in profit theory are (i) are the contractual payments and surplus as determined by the market, where competition is rarely perfect, entirely valid, and (ii) is the surrender of the surplus to the dictates of 'control-ownership' tenable?

It has long been demonstrated that the marginal productivity theory of distribution is based on circular reasoning; it fails to ensure equity in dealing with business profits. And beyond that theory, the mainstream economics has never provided convincing answers to the above questions. But an Islamic dispensation, imbued with moral values, cannot afford escapism. Let us examine what formulation concerning business surpluses can meet its approval.

3. Islam and profit

Islam exhorts the believers to excel in this world as well as the hereafter. It urges them to engage in all lawful pursuits for material gain, especially trade. But Islam is aware of men's inordinate love for material wealth So it advises them to be moderate in their drive for profit in trade, behave in prescribed ways, and take only what is legitimate. It advocates for absolute honesty in business to the extent that false praise of the merchandise on sale is disallowed; rather known blemishes in it must be revealed to the customer. If there is a conflict between wealth and virtue one must stay content with what is permissible even though it might be little. There are numerous verses in the Qur'an and traditions that remind men of the transient nature of this world relative

to spiritual peace and puts by implication profit maximization under the control of Islamic moral discipline. But more significant is the scheme of distribution that stems from the Islamic view of economic justice: to each what one contributes to output but beyond a limit in the wealth one earns the deprived has a *right* that must be honored.

Rewarding according to contribution in the face of uncertainty about the business outcome is the crux of distributive justice. Islam aims at shaping exchange relations among the factors of production on the basis of cooperation, mutual benefit and fair play. It directs people not to receive harm (loss) nor inflict it on others. One leading example of applying the edict is the principle of avoiding *gharar* (indeterminacy hazard) in deals. Keeping transactions gharar-free is expressive of the Islamic anxiety to prevent injury. This is evident from the Islamic approach to the determination of various functional returns in output we now discuss. The broad division of production factors we follow includes land, labor and capital.

The interest question: Muslim scholars agree, with few dissentions, that in Islam the prohibition of *rib*a is total and complete. The verdict makes no distinction between usury and interest, between its simple and compound forms, between productive and unproductive loans, or for that matter between money and commodity borrowings. It is not of much relevance here to go over the debate again. For the faithful it is reason enough to desist from taking or giving interest because their belief system prohibits it. But as an academic discipline Islamic economics must provide justification for the ban more so because traditionally profit and interest both go to the same functionary the capital committed to business. Why then banish one and allow the other?

Islamic economists borrow a plea against interest from the *General Theor*y of Keynes. (1936). It is explained that the schedule of expected profit rates rarely remains in tune with the sticky rates of interest. When profit expectation run high and wide of interest rates, increasing possibilities of gain from leverage fuel investment and soon the economy is on way to inflation. Opposite happens when profit expectations are falling at a faster pace than the rates of interest. The economy faces deepening recession and unemployment. Thus interest works against growth and stability in an economy.

Again, the marginal productivity theory claimed to ensure distributive justice cannot explain the payment of interest. One need not deny productive attributes to finance in a factor combination. But fundamental is the question does interest correspond to that productivity? The level of interest rates is determined by the state of opinion in the bond markets and the manipulations of monetary policy by the central bank. What has the productivity of funds to do with either of them?

Furthermore, all funds – owned or borrowed – are inseparably intermixed in the business of a firm, and are exposed to the *same* degree of risk in its business. How does the productivity or exposure to risk of the owned and borrowed funds differ from the viewpoint of the firm or society? Why should then the two sorts of capital be

differently rewarded: one with profit and the other with interest? Financial expediency or legal fiction need not always be just.

Finally, interest payments cannot be shown meeting the norms of social justice at the macro level. Borrowings in the past led the flows of money from the rich to the poor in a society. Interest rates used to be high, often exorbitant; the poor suffered. Today the situation has reversed. Savings largely come from the middle classes who contribute to pension funds, take insurance policies, buy units, and put money in fixed deposits. This pool of relatively small savings goes to finance mostly the business tycoons via the financial intermediaries. Interest rates are kept low. Cheap money policy is the order of the day. Small savers part with their money for a song, if we compare what they get as interest with the profits their deposits enable equity holders earn. When the interest rates rise in an economy due to a change in monetary policy, the banks are quick to pass the increase to borrowers, but drag their feet to raise interest on deposits. On the reverse swing also interest rates fall first and faster on deposits Thus, interest was an institution of injustice in the past and remains so even today. Remember that the Islamic prohibition of interest has nothing to do with either the *productivity* of capital or the *fixity* of interest rates as often argued. The ban is for removing an instrument of injustice and exploitation from the economic scene.

Rent forms: The question of private property rights in cultivable land has been one of the most controversial issues in Islamic economics. Those who allow private ownership of cultivable land seem to have an edge over those who do not. But the former remain divided on the form of rent. It is agreed that the best course for a person having excess land he does not use is to give it to his landless brother for cultivation free of charge. However, rent is not forbidden but there is no consensus regarding its form. Some jurists permit only cash rent, some only *mezuzah* or share-cropping, and there are still others who would allow both.

On balance, share cropping is preferred. For the outcome of cultivation being uncertain, predetermined amount of rent would be a kind of riba. Here the landlord would be indifferent to the actual yield from land the same way as the banker is to the actual return from business. A fixed amount may turnout to be unjust to either of the parties – land owner or the cultivator when crop value becomes known. This could be avoided if rent is settled as a proportion of the crop.

Thus, Islam does not approve a pre-fixed return to capital and prefers the rent also to vary with the outcome of cultivation. The conclusion is of inferential significance for the treatment of the remaining functional return, the wages of the workers.

***The wage issue*:** Ibn Khaldun, Adam Smith, David Ricardo, and Karl Marx all agreed in principle that labor combining with nature was alone the source of value and capital formation. But none of them – or anyone following - could provide a firm answer to the question of compensating labor on a fair basis. Islam insists that workers must

have, especially in mass production, the fairest possible chance under the contract to receive their due share in output i.e. equal to what they contribute to it. This also implies that payments to them are not excessive either.

The difficulty is: how can predetermined wages meet this norm of justice in the face of uncertainty? How would one reconcile the non-symmetry in the Islamic treatment of interest and pre-determined rent on the one hand and pre-fixed wages on the other? Or cannot wages also be made in some way flexible with the outcome of business? Are there insuperable difficulties in making such flexibility operative? No compelling reasons seem to deny workers an adjustment in wages if the final business outcome so warrants. In any case, losses fall on capital alone; flexibility in wages would not require the workers to share losses and a minimum wage as part of the scheme would entitle them to basic sustenance.

*Minimum wage*s: A minimum wage is the amount of money below which the payment for hiring workers is made illegal. Conceivably, the minimum has to be higher than what the market would pay. Textbook economics has generally opposed a minimum wage on the plea that the fixation would cause unemployment or shunt part of demand for labor out to the black market at lower wages. Workers as a group would not benefit. Elementary demand and supply diagrams are used to drive home the point. Such diagrams do not contain any factual information. The relationships they portray are complex and dynamic; lines in a plane can rarely capture the complexity of real situations. Diagrams are an aid to think, not the thought itself. A change like a minimum wage fixation grows out of their frames into the future and the consequence is difficult to predict. In any case, support for a minimum wage law has ever been on the rise and socio-political reasons override economic considerations. Thus, most of the countries today have minimum wage laws in place. Islamic insistence on the right to sustenance and fulfillment of basic needs must inspire the measure. The rule is that where the outcome of economic activity is uncertain sharing is the route to justice for the participants. In manufacturing workers must have a share in profits because market determined wages can rarely be shown commensurate with what labor contributes to output.

4. Conclusion

In sum, for formulating an integrated operational profit theory let profit be defined as a surplus over cost, the firm not the entrepreneur be made the focal point of its study, all rudiments of dynamic change be regarded as its source, and scheme for its sharing between capital and labor be devised to promote equity, growth, and peace in society. Such a profit theory will impart realism to economics: both mainstream and Islamic

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