# Examining Theories of Growth Development  Policy Response Based on Them from Islamic Perspective

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# EXAMINING THEORIES OF GROWTH & DEVELOPMENT & POLICY RESPONSE BASED ON THEM FROM ISLAMIC PERSPECIVE

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***Abstract***

*Poverty and inequality around the world has been rising over the last three decades and the attainment of the Millennium Development Goals (MDGs) seems a far fetched goal. In explaining underdevelopment, Classical Economics has offered many theories and models including but not limited to Rostow's Stages of Growth Theory, Harrod-Domar Model, Solow's Growth Model, Dependency Theory, Lewis Two Sector Model, Neo-colonial Dependence Model, False-Paradigm Model, and Dualistic-Development Thesis etc. This study analyzes the theories of development proposed in classical literature in the light of Islamic Economics and investigates whether policy response influenced by some of these theories had been effective or not in selected countries and regions. In light of recent developments in growth literature, the last section of the paper also analyzes whether Islamic economics principles have the capacity to ensure that determinants of growth suggested by 'new growth theory' will exist in an Islamic economy and together with these, do Islamic economic principles have other distinctive mechanisms and institutions that can help in the development process.*

**Keywords:** *Interest free economy, Public finance, Taxation, Inequality, Income redistribution, Islamic economic system, fiscal policy, deficit financing.*

**JEL-Codes:** L38, I31, O10

## 1. Introduction

The major problems in economic development of any country include poverty, inequality and unemployment. All other problems are more or less a result, or a symptom of these three problems. Problems like violence and political turmoil that on the surface seem unrelated to economics are also caused by poverty, inequality and unemployment.

When one looks at recent development statistics, a very dismal picture appears. In 2001, there were 1.1 billion people living in poverty. But in Africa, the number of people in extreme poverty rose to 313 million. As people living in extreme poverty increased in number in Africa, they also became poorer. The average daily income or consumption of those living on less than $1 a day declined from 64 cents in 1981 to 60 cents in 2001. In the rest of the developing regions, it inclined from 72 cents to 83 cents. In Africa, the median share of income going to the poorest 20 percent of the population is 4.9 percent, almost 2 percent points less than in other developing regions. Only in Latin America and the Caribbean, do the poorest 20 percent fare worse. (Source: UN Development Research Group). Therefore, the question is that how the broad based

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development would be achieved let alone reducing fiscal deficits as faced by most developing countries at the moment.

In mainstream development economics literature, several theories and models have been proposed in explaining the multidimensional problem of poverty and underdevelopment. These include Rostow's Stages of Growth Theory, Harrod-Domar Model, Solow's Growth Model, Dependency Theory, Lewis Two Sector Model, Neo-colonial Dependence Model, False-Paradigm Model, and Dualistic-Development Thesis etc.

In this backdrop, this study analyzes the theories of development proposed in classical literature in the light of Islamic Economics and also analyzes the policy response based on these theories and its impact on selected countries.

## 2. Brief Analysis of Classical Development Theories

The assumptions and supposed stages in Rostow's Growth Theory are highly simplistic and evidence is against the suggested linear progression to each higher stage. Definition of a traditional society in Rostow's Growth Theory is incongruent with Islamic principles, especially when it comes to the role of religion in a society. In an Islamic society, religion is the core, whereas, Rostow's Growth Theory assumes religion to be a source of primitiveness just like Marx who opined that religion is opium.

Structural transformation, which is considered as a pre-requisite in that theory for the take off stage had been proved to be flawed in many countries whenever it was forced upon by developed countries extraneously with no regard to peculiarities in individual regions.

In Harrod-Domar and Solow's Growth model, the emphasis is on increasing savings and investments and that is supposed to lead to increased productivity corresponding to lower ICOR in Harrod-Domar model and hence higher rate of growth and to higher steady state level of output in Solow's Growth model. But, the savings are much less dependent on real interest rates in LDCs as the empirical evidence shows. Savings feature despite the negative real interest rates.

Plus, in all Structural Adjustment Programmes, IMF and WB insisted on increasing indirect taxes and freeing trade barriers which increased imports, resulted in depreciation of currencies and together with indirect taxes, fueled inflation. Hence, real interest rates in almost all of the developing regions have been negative for quite some time.

Kuznets's inverted U-hypothesis also seems to be missing support from empirical data. Inequality in USA, China and India increased even after the economies experienced continuous rise in per capita incomes. In fact, the empirical data supports the view that inequality is the cornerstone of economies following maxims of neoclassical counter-revolution. The result is best described by Stieglitz who calls this kind of economics, the *'trickle up'* economics than *'trickle down economics'*.

Neo-colonial Dependence Model, False-Paradigm Model, and Dualistic-Development Thesis are all effective political economy explanations of underdevelopment, especially of South Asian, African, Latin American & Middle East countries.

In the next section, we take a brief look at some of policies which were tried taking inspiration from some of these theories and we try to see the impact of these policies in dealing with underdevelopment.

## 3. Development Programmes & their Impact

### 3.1. Case of Pakistan

After its independence, Pakistan followed the policy of import substitution. Haq (1963) gave the concept of functional inequality in 1960s. Based on his praise for Harrod-Domar and Solow growth models, he reasoned:

"The road to eventual equalities may inevitably lie through initial inequalities."

In 1960s, Pakistan witnessed high growth rate, was able to create an industrial class, but later, it was found that this growth only benefitted a very specific small class and created huge income inequality and disparity which eventually led to the separation of East Pakistan from West Pakistan.

Haq (1995) later on accepted that humans are 'means' as well as 'ends' of any development process or initiative. He finally accepted that 'Ends' cannot be sacrificed for the future, even when benefits are certain, and ignoring 'ends' undermines the entire development process.

In the later part of 1980s, Pakistan went to International Monetary Fund (IMF) and World Bank (WB) for Structural Adjustment Program (SAP). IMF and WB recommended privatization, diminished role of government in running businesses, deregulation, liberalization, removal of quotas on international trade, lowering tariffs, expanding list of importable items, removing subsidies, increasing indirect taxes and let the currency be floated freely.

Zaidi (2005, p.328) on analyzing the effects of IMF policies and Structural Adjustment Program pursued in Pakistan, reasoned in following words:

"Such programmes have very serious negative impacts on growth, inflation, income distribution, the social sectors, and poverty. In general, Structural Adjustment Programmes have made matters far worse for countries that have followed them. We have examined the philosophy that governs such adjustment programmes, which is essentially one of liberalization, openness, and greater integration with the new economic world order, and we have found that not just the adjustment programmes themselves, but also the thinking behind them does not take account of specific factors and the context of specific countries."

Anwar (1996) analyzing the SAP in Pakistan and its effect on poverty argued through an empirical research that not only the absolute poverty incidence, but also the intensity and severity of poverty increased significantly by all poverty lines and poverty measures over the period of adjustment. He further noted that SAP created new poor in urban areas amongst the low income groups (mainly clerical and sales workers) whose real wages were eroded over the period. Poverty also increased unambiguously among self-employed and unemployed who seems to have been affected adversely by the overall economic contraction.

Even now, capitalistic democracy in Pakistan is keeping the market in a status quo for the benefit of big monopolists who in collaboration with politicians further their interests and bring barriers to entry for new entrants. 'Functional inequality' episode strengthened the elitist class and people of higher financial standing and political influence of this class can get loans and default on them, can bypass red tapism and avoid taxes.

The country's banks and other financial institutions wrote off over Rs 30 billion during the governments of Muhammad Khan Junejo, Benazir Bhutto and Nawaz Sharif on political basis. (Source: *The News*, March 13, 2000).

Only 2.75 million Pakistanis, or 1.6% of the country's estimated 170 million people, are registered tax-payers, but the Structural Adjustment Programs only emphasized on removing subsidies, raising utility prices and increasing indirect taxes. The policy to lower and subsequently remove import tariffs badly affected the domestic industrial base. Now, government regularly has to trim PSDP (Public Sector Development Program) to finance fiscal deficit. Elitist class has not yet allowed passing of tax on agriculture, real estate and wealth. Crony capitalism led to selling strategic and important public sector corporations at through away prices as part of Structural Adjustment Program.

Currently, Pakistan pays around Rs 1,000 billion in debt servicing. Most of the debt is of the nature of deadweight debt. About half of the tax revenue goes to the lenders in paying of interest.

Politicians in this capitalistic democracy too contribute in maintaining the status quo by providing token benefits to their voters (even without providing in many cases) and by creating an environment where the poor have no choice than to join hands and support them to safeguard their private property rights in absence of ruling class fulfilling its basic responsibility of safeguarding private property rights.

Rodrik (2006) explained that when investment is constrained by poor property rights, improving financial intermediation will not help. Security of property rights has been one of the most important determinants of why some countries developed quickly than others. (Acemoglu et al, 2001).

### 3.2. Case of Africa

Just to put the issue in right perspective, consider these facts. Africa's debt stock in 1970 was $11 billion and Africa's debt stock in 2008 stood at $215 billion. Furthermore, Sub Saharan Africa receives $10 billion in aid but loses $14 billion in debt payments per year (Africa Action, 2008).

Currently, Africa's total external debt stands at $300 billion. Many African countries spend more on debt than either on health or education. For example, Cameroon, Ethiopia, Gambia, Guinea, Madagascar, Malawi, Mauritania, Senegal, Uganda and Zambia all spent more on debt than on health in 2002. GNP per capita in Sub-Saharan Africa is $308 while external debt per capita stands at $365. Just to cite one example, Nigeria borrowed around $5 billion and has paid about $16 billion, but still owes $28 billion. Regrettably, 7 million children die each year as a result of the debt crisis.

To cite another example, Zambia was unable to employ 9,000 qualified teachers because of a public sector wage freeze imposed by the IMF in 2004 as a condition of receiving HIPC (Heavily Indebted Poor Countries) debt relief. Half of African population in Africa doesn't have a meal a day.

Habisso (2009) analyzing the impact of aid on development in Africa commented:

"The continuing failure of official international aid to encourage the emergence of a self-sustaining growth in agricultural and industrial sectors, geared to local needs, has led many to question the appropriateness of aid per se. A number of problems with the current system of aid assistance have been identified: (i) Since some of the aid is in the form of loans rather than direct grants, poorer countries may find themselves getting into increasing debt; (ii) A considerable proportion of any aid package is swallowed up in payments to technical experts, the field-staff of the donor countries, or on the costly housing, transport, and diet arrangements made for them in the host country."

Habisso (2009) further notes that aid often increases dependency by being loaned to a country on condition that it must be used to purchase goods from the donor country, i.e. aid tying. Almost 70% of British aid is loaned on these terms, which means in effect the main beneficiaries of aid are the capitalists in the developed world.

McCord et al. (2005) discussing the effect of SAP on the development of Africa revealed that Africa was the only major developing country region with negative per capita growth during 1980 to 2000; its health conditions are by far the worst on the planet; its soaring population is exacerbating ecological stresses; and despite the policy-based development lending of structural adjustment, it remains mired in poverty and debt.

### 3.4. Case of China

China made progress because it could not be lured into taking excessive debt. Most of the growth owed to localized and indigenous efforts and an active role played by public sector with discretionary intervention when and where necessary. The sustainability of the growth momentum also owed to the fact that China did not allow fiscal bleeding unlike the mantra favored by IMF and WB for developing countries to take on debt and develop infrastructure with it. Indigenous and uncompromising leadership made the growth possible and to keep it sustaining.

Rodrik (2010) explained that there has not been a greater instance of poverty reduction in history than that of China in the quarter century since the late 1970s. Interestingly, he points out that western economists or their piece of research did not play an instrumental role in China's reforms. He mentioned that South Korea, Malaysia and Vietnam all achieved success in development with their own set of reforms and policies. He argued that in none of these Asian cases did economic research, at least as conventionally understood, play a significant role in shaping development policy. The same is true of other long-term successes elsewhere, such as Botswana and Mauritius.

Chang (2006) explaining the role of institutions and governments to steer development efforts successfully cited that countries like France, Austria, Finland, Norway, and Taiwan have extensively used state-owned enterprises (SOEs) in steering their impressive economic developments after the WWII. Citing an example of Korea, he argued that the famous Korean steel producer, POSCO, was set up in the early 1970s as an SOE in a country that did not even produce the raw materials (iron ore or coking coal) at a time when such act was a clear defiance of comparative advantage, but it went on to become the most cost-efficient steel producer in the world within a decade of its establishment.

### 3.5. Case of Ecuador

Working over there, Perkins (2004) revealed that for every $100 of crude oil taken out of the Ecuadorian rain forests, the foreign oil companies receive $75. Of the remaining $25, three-quarters must go to paying off the foreign debt. Most of the remainder covers military and other government expenses which leaves about $2.50 for health, education, and programs aimed at helping the poor. Hence, out of every $100 worth of oil pinched from the Amazon, less than $3 goes to the people who need the money most. With resources taken away from debt servicing, human capital, which is cited as engine of growth and development cannot possibly be given due importance.

### 3.6. Case of Transition Countries

Zawalinska (2004) noted that the most painful effect of SAPs in Transition countries was a high and persistent unemployment resulting from restructuring and privatization processes. Many countries experienced a jump in unemployment from the level close to zero to about 20% over first 5 years.

He further noted that the most immediate influence of SAPs on households was a burst of inflation which occurred as a result of prompt liberalization. This unquestionably heavily hit all the households as their private savings immediately lost value and only higher income households could shift the rest of their savings from the bank to fixed assets. The poor households had to face the substantial decrease in value of their purchasing power without much security.

## 4. Critical Analysis of Free Trade & Comparative Advantage Principle

In this section, we will analyze that has the lacking on implementation front or inadequate institutional framework contributed to underdevelopment and shortcomings in development progress. We will present analysis of why this argument is weak and mention several possible reasons responsible for the underdevelopment which have nothing to do with poor governance and institutions. While poor governance and inadequate institutional framework may have worsened matters, they are not the only factors behind shortcomings in development progress. The policies themselves and the lack of commitment on other ancillary fronts by developed countries have also resulted in underdevelopment of the developing countries.

Coming out of a debt and poverty trap requires consistent growth for a sustainable period. But, international trade restrictions take much of the ability to grow from developing countries. Tariffs charged by high-income countries on goods important to developing countries, such as textiles and agricultural products, remain high. Subsidies of $350 billion a year to agricultural producers in Organization for Economic Co-operation & Development (OECD) countries are another barrier to developing country exports. Global trade is not yet a level playing field.

Other than tariffs, high-income countries accuse developing countries of not following environmental standards, Technical Barrier to Trade (TBT), Sanitary & Phyto-Sanitary Barriers to Trade (SBT), Kyoto Protocol etc and thereby further reduce the ability and capacity of developing countries to gain from exchange and get out of debt and poverty trap. High-income countries account for half the world's Carbon Di-Oxide ($Co_2$) emissions (Source: Carbon Dioxyde Information Analysis Center data). Furthermore, High-income countries account for 36% of emissions of organic water pollution (Source: World Bank).

Due to this, most developing countries are going through a perpetual debt trap which takes away resources that could have been used on development, but instead are used to service compounded debt. Interest payments take up most of the resources of the government. It must be kept in mind that principal amount of debt remains same even if debt is serviced each year. Even if only debt is serviced each year, the debt servicing amount would continue to increase each year with compounding effect.

Total external debt of low-income countries stands at $523 billion. Total debt service being paid every day by low-income countries amounts to $100 million. For every $1 received in aid, low income countries pay at least $2.30 in debt service.

Theory of Comparative Advantage states that resources should be allocated to the efficient sectors of the economy. If U.S.A has a comparative advantage in producing cars and if Pakistan has a comparative advantage in producing wheat; then, Pakistan should allocate its resources on producing wheat and U.S.A should allocate its resources to produce cars. Both Pakistan and U.S.A can gain from exchange and specialization.

But this will only work when the trade is fair and when both countries do actually allocate their resources to their efficient sectors. Instead what happens is that developed countries have absolute advantage in producing most goods over developing countries. Developed countries allocate their resources in producing goods that they can produce most efficiently and use the proceeds from sale to provide subsidies to their inefficient sectors and virtually paralyze the developing economies by depriving them of their chance of gaining through exchange and specialization.

The export subsidies provided by developed countries to their inefficient sectors enable the inefficient sector to become efficient artificially and crowd out the developing countries by overproducing and then dumping these goods in the third world countries. If the supply exceeds demand, developed countries have not been reluctant to dump their production in sea if they can't do it in the developing countries! It is just to fulfill 'get the prices right' mantra espoused from *Washington Consensus*.

By providing export subsidies to their inefficient sectors, developed countries create distortions in trade and misappropriations in resource allocation. The export subsidies paid by the developed countries to their inefficient agriculture sector are funded through the proceeds of exports. Hence, these are in reality cross subsidies. Therefore, effectively these subsidies are paid by the developing countries. Developed countries charge huge premium for value addition that is not in line with their out-of-pocket costs. The difference is especially huge in information technology products, software and pharmaceuticals. Once software or medicine is made, the capacity is virtually unlimited. Unlimited copies can be sold provided there is enough demand. Cost per unit is spread over larger output. At higher levels of output, marginal cost is negligible and constant in these products.

Therefore, developing countries are denied gains from comparative advantage in agriculture through export subsidies provided by developed countries to their comparatively inefficient agriculture sector. Subsidies of $350 billion a year to agricultural producers in OECD countries are a barrier to developing country exports (Source: World Development Indicators 2005). This creates unemployment and poverty in the developing economy. Agriculture is still the most important sector in Less Developed Countries (LDCs) in terms of achieving growth, and sourcing funds for development and redistribution efforts as the evidence from Table 1 shows.

Table 1: Share of Agriculture (%) in GDP and Employment in LDCs

| **Agriculture Share in Less Developed Countries** | | | | |
|---|---|---|---|---|
| | 1980 | 1990 | 2000 | 2006 |
| **In Employment (%)** | 79.5 | 76 | 70.8 | 68.6 |
| **In GDP (%)** | 30 | 29.5 | 30.2 | 28 |

Source: World Development Indicators 2008, World Bank

Brown (2002), former head of the United Nations Development Program, estimated that farm subsidies cost poor countries about $50 billion a year in lost agricultural exports. He concluded that this amount is the equivalent of today's level of development assistance.

Eventually, a developing country will have to submit itself before the international financial institutions that are able to exert extraordinary influence -not limited to economic but also political- in the developing country. Therefore, the role of IMF, WB, World Trade Organization (WTO) and the adaptation of SAP and Free-Float exchange rate systems are all interrelated in their objectives to maintain the status quo of supremacy of developed world over developing countries. Mercantilism stands completely opposite to Free trade theory, but, the former was supported when Europe needed it.

Higher tariffs are levied by developed countries on products involving a higher degree of value addition. In the European Union (EU), processed foods are subjected to a higher tariff than unprocessed foods, and fabrics to a higher tariff than thread. In addition to that, many finished textile goods were not allowed under quantitative restrictions, which is a clear violation of WTO. Even if they can produce processed products more cheaply than the developed countries, tariffs tilted the balance against them.

Through 'Tariff escalation', developing countries are discouraged to enhance their industrial base and capacity and move from their traditional colonial trading pattern of exporting raw materials and simple manufactures to be exporting value added goods.

To summarize, in this section, we analyzed that lacking on implementation front or inadequate institutional framework is not chiefly responsible for the underdevelopment. The policies themselves and the lack of commitment on other ancillary fronts by developed countries with regards to biasness in international trade, tariff escalation, biased and inconsistent resort to environmental excuses etc have also resulted in underdevelopment of LDCs.

## 5. Flawed Theories & Prescriptions Lead to Undesirable Outcomes

The term "Washington Consensus" refers to development strategies centered on privatization, liberalization, and deregulation and built upon a strong belief in free markets and aimed at reducing the role of government. These policies were prescribed for developing countries through various programs including Structural Adjustment Programmes.

Below, we review literature which critically analyzes the prescriptions put forward under "Washington Consensus".

Stieglitz (2004, p. 1) commenting on Washington consensus remarked:

"If there is a consensus today about what strategies are most likely to promote the development of the poorest countries in the world, it is this: there is no consensus except that the Washington consensus did not provide the answer. Its recipes were neither necessary nor sufficient for successful growth."

Woo (2004) reasoned that the Washington Consensus runs the danger of denying the state its rightful role in providing an important range of public goods.

Stieglitz (2004) contrasting the development experience of East Asia with Washington consensus wrote that Washington Consensus inspired development strategy stands in marked contrast to the successful strategies pursued in East Asia, where the development state took an active role. He reasoned that there is no theoretical underpinning to believe that in early stages of development, markets by themselves will lead to efficient outcomes.

Commenting on trickledown economics, Stiglitz (2004) noted that the notion that somehow everybody would benefit is flawed as the evidence against trickledown economics is now overwhelming.

In late 1999, to enhance the contribution of their interventions to international poverty reduction efforts, IMF and the WB adopted a new strategy for their assistance to low-income countries. The main features of this strategy were (a) both institutions were to base their concessional lending and debt relief to low-income countries on Poverty Reduction Strategy Papers (PRSPs) prepared by the countries themselves; and (b) IMF concessional lending was to be provided through a revised lending facility, the Poverty Reduction and Growth Facility (PRGF)—with a stronger poverty reduction focus.

In PRSPs, broad based participation is a well orchestrated desire, but, how this could be made possible with so much direct and indirect political interference of Donor countries and International DFIs in the developing countries is a big concern.

Levinsohn (2002) noted that the suggestion that more open trade is good for the poor is based more on faith than evidence. Although the PRSP documents are peppered with references to molding the particulars of a poverty alleviation program to the details of the country, the discussion of trade policy (as well as some of the macroeconomic prescriptions) seems to come from a one-size-fits-all mentality.

Rodrik (2006) contrasting the perceptual differences regarding security of property rights argued that presumably, investors felt more secure when they were allied with local governments with residual claims on the stream of profits in China than when they had to entrust their assets to private contracts that would have to be enforced by incompetent and corrupt courts in Russia. Whatever the underlying reason, China's experience demonstrates how common goals (protection of property rights) can sometimes be achieved under divergent rules.

To summarize, we can say that the uniformity of problems does not necessitate the use of same remedies as the dynamics of each region and their peculiar context is different.

## 6. Need for a Paradigm Shift in Development Focus

Such unanimity in shortcomings in underdevelopment in varied regions and after so many policies have been tried for so long, hints us towards understanding that merely the lacking in implementation could not have led to such a happening. Governance in less developed countries has been no less poor or better than developed countries. Hence, the inclusive approach envisaged in PRSPs put forward by WB seems a reasonable way to approach development after Millennium Development Goals (MDGs) are increasingly appearing to be underachieved in entirety.

Rodrik (2010) argued that successful countries achieving development identify sequentially the most binding constraints and remove them with locally suited remedies. He favored diagnostics which require pragmatism and eclecticism, in the use of both theory and evidence.

Fundamentally, there is also a need to revisit the indicators and barometers of progress and development. Stieglitz has also been very critical of Gross Domestic Product (GDP) as a sole measure of growth. GDP per Capita cited as a measure of economic development is also not devoid of problems as it is based on GDP and cannot take into account distribution of income, resources or wealth.

## 7. Normative Divide Between Islamic & Capitalistic Development Philosophies

Resources are scarce as compared to unlimited wants. But, the economics of non-rival ideas creation has proved that resources are ample and that physical resources could be used in ways that keeps fulfilling the basic needs of society through the creation of ideas that augment and bring multiplier effect to the availability of given physical resources.

In simple words, the development in science and technology by developing human capital base has enabled the societies through each level in history to make best use of physical resources and avoid resource exhaustion for the basic requirements.

Despite that, problems like poverty have persisted and even got severe in some regions in last century than in the past. Problem is not with resource scarcity, it is with distribution of resources which require an equitable and egalitarian socio-economic system. What is needed is a system that consists of institutions working towards fulfilling this objective.

Capitalism, the way it is practiced as an economic system, has largely allowed and promoted certain institutions and their operations based on free market philosophy and such institutions have been chief reasons behind much of distributional inequity in the world today, both in developed as well as in developing regions.

Interest based financial intermediation in theory and in practice has exhibited increased concentration of wealth in the world. A system is not an end in itself; rather it is meant to serve the needs of society at large amicably.

Indeed, when we glance over statistics of poverty on one hand and rising inequality on the other, we ought to question the merits of such institutions. Indeed, even in free market philosophy, we do not allow certain institutions which bring harm to the society and individual liberty. But, yet, so far, we have turned limited attention towards critically evaluating the intricate system of interest based financial intermediation.

Islamic economic system is a blend of natural features present in Capitalism i.e. right to private property, private pursuit of economic interest, use of market forces etc used along with some distinct features derived through Islamic economic teachings i.e. interest free economy, moral check on unbridled self-pursuit and provision of socio-economic justice to achieve the goals of Socialism as far as is naturally possible without denying individual freedom and incentives.

Another aspect of resource scarcity is completely psychological rather than physiological. Humans compare themselves relatively to their contemporary peers. Indeed, we, as individuals have much more facilities and better standard of living in material terms than even the kings of the past. But, even that does not satiate our hunger and sense of deprivation.

Religion provides such meaningful conditioning which makes us bring the right balance between our aspirations and physical limits. Religion also promises salvage from the limitedness of this worldly life in heaven which will be awarded to the most righteous people. This, in turn, provides a permanent incentive to choose righteous behavior as an end with the hope and fear of deterministic results in life hereafter.

Schematically, we present the two models below:

**<u>Capitalism Microeconomic Model</u>**

$$\text{Scarce Resources} \quad \frac{\text{Pursuing private benefit}}{\text{Indifferent between right \& wrong}} \quad \text{Unlimited Wants}$$

**<u>Islamic Microeconomic Model</u>**

$$\text{Scarce Resources} \quad \frac{\text{Seeking Allah's pleasure}}{\text{Differentiate between right and wrong}} \quad \text{Unlimited Wants}$$

## 8. Development from Islamic Perspective

In neoclassical growth theories, the emphasis is on increasing savings and technological progress which brings about increase in capital per worker and eventually output per worker and enables an economy to reach the steady state level of output. In 'endogenous growth theory' models, more sophisticated work has been done by endogenizing the technology, human capital and savings.

To summarize their findings, these theories and models help explain the differences in per capita across countries and conclude that countries with high savings and investment rate, having people spending more time in learning new skills and with better social infrastructure in the form of strong private property rights are able to have more per capita income than countries which lack in these characteristics.

Below, we try to analyze whether Islamic economic principles have the capacity to help build these elements for sustainable growth and development.

### 8.1. Boosting Investment in Islamic Economy

With a lenient rate of Income Zakat, the productive sector is provided with incentive to ensure achieving potential output with lenient fiscal levies and no scarcity of capital through prohibition of interest. This could itself bring about increase in output per person in economy and could bring stability in prices. Tax on cash and capital will force the people to invest their money in productive uses. With prohibition of interest, this money will only go in business either with the start of one's own business or equity participation in Mudarabah and stocks etc.

Besides this, a consistent and credible low tax rate policy with broader Zakat base ensures minimum distortions, boosts aggregate demand and encourages investment by decreasing costs of doing business and this could also simultaneously solve microeconomic problems of imperfection in markets by increasing competition and helping to reduce market power.

### 8.2. Improving Income Distribution in Islamic Economy

If we study the classical and neo-classical literature on growth and development, the theories and policies based on them have felt short to improve income distribution.

Islam economics has many non-state mechanisms to ensure income redistribution without interfering with individual freedom and market mechanism; we discuss three main mechanisms below:

**8.2.1. Prohibition of Interest** – Interest as a system of allocation of resources ensures a fixed return for one and variable and uncertain for another. In contrast, Islam encourages equity financing in which the loss/profit would be shared. This ensures better results from the perspective of redistribution and better co-operative behavior since payoffs for all parties are linked with productive sector of the economy. Consequently, markets will not have to produce speculative surplus output just to service exorbitant amount of debt and that could stabilize business cycles.

**8.2.2. Family System & Inheritance Distribution** – Family system of Islam brings social capital into existence. It ensures empathy and responsibility. It brings a very lasting and durable social safety net. Islamic injunctions about how to treat orphans and polygamy in special circumstances ensure social security for individuals with special circumstances. Furthermore, the inheritance laws ensure that the wealth of the deceased is distributed widely among the members of the family of the deceased and this permanently and systematically ensures doing away with the concentration of wealth in every generation.

**8.2.3. Zakat & Infaaq** – Zakat is a combination of wealth and income levy. It includes all heads of income and forms of wealth excluding only the means of production, items of personal use and value below Nisab. With a Wealth Zakat, redistribution objective is directly achieved. It reduces confinement of wealth in few hands. The flow (income) and the stock (wealth) both are taxed and hence it ensures appropriate transfer of wealth and transfer of asset ownership to the needy. If an economy is in disequilibrium and policies fail to immediately recover and boost incomes, wealth Zakat enables the distributive allocation that works independently of business cycles and help stabilize the extremes of business cycles.

### 8.3. Building Social Infrastructure in Islamic Economy

Islam does not disallow private property rights. On the other hand, Islam also educates people that they are not just responsible to fulfill duties set out in a legal framework in a society's legislature, but are also responsible to Allah. There are several such recommendations in Quran which are not binding in the legal sense of the word, but which educate the people of the desired behavior expected by their Creator.

Second, private property rights are safeguarded by the state after the provision of taxes. Beyond Zakah, Islam also does not give the government the right to fetch people's money and violate private property rights.

Third, rather than keeping other things as it is, Islam has a very clear view on certain institutions like 'interest based lending' which has been chiefly responsible for concentration of wealth, rising inequality and even poverty and is an exploitative form of earning money. Islam by disallowing interest based earnings, exploitative forms of trade and imposition of excessive taxes from the state beyond Zakah ensures individual freedom in a much wider sense.

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