Profit Maximisation: Secular Versus Islamic

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CHAPTER TWENTY

PROFIT MAXIMIZATION: SECULAR VERSUS ISLAMIC

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Introduction

The nature and content of economic theory has been much influenced over the years by the view that man is actuated only by self-interest.[1] One leading example of this influence is the proposition that profit maximization is invariably an epitome of business rationality.[2] The firm is rational only when it attempts at maximizing its profit irrespective of the market conditions under which it operates.[3]

Economists concede that the profit maximization hypothesis is inaccurate and ill-conceived. There has been some scathing criticism of this assumption in recent economic literature.[4] Yet textbook economics has not relented on the issue, save marginally,[5] for reasons we shall soon state.

The social order of the capitalistic structure accommodates many of the basic features of Islam, though in a distorted form. In fact, the evolution of these features of capitalism owes much to the Moorish Spain. In particular, Islam allows private ownership of property[6], grants freedom of enterprise[7], hails profit as a form of God's bounty[8], and permits a role for price mechanism in resource allocation and output distribution. One is, therefore, tempted to ask: Is there a need for retaining the profit maximizing hypothesis in an Islamic theory of the firm as well? This chapter seeks to provide an answer to this vital question.

However, it is not easy to answer the question. The pursuit of maximum profit is apparently avaricious and seems to conflict with the moral code of Islam. Still we shall venture the argument that the hypothesis is needed in Islamic economics as well. Secular economics has retained the profit maximization assumption despite its unrealistic and even misleading character primarily for two reasons. First, price theory, the core of economic science, cannot stand erect once the maximizing assumption is removed. Secondly, the critics of the tradition have not so far been able to propose an alternative behavioural rule which could have the same, if not superior, predictive value and lead to empirically testable conclusions. We, too, cannot throw away the baby with the bath water in Islamic economics. We need not, because the consequences of profit maximization can be shown in an Islamic model to be different from those in a secular frame.

Let us be clear that in profit maximization, *what* is maximized, *how*, and *for whom* are the real issues. The very concept of profit lies at the heart of this matter, and the vital factor is the paradigmatic frame of the economic system under consideration. To arrive at sensible conclusions, one must understand and compare the nature of profit and its maximization under the two systems — secular and Islamic.

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Production or output is the result of co-operation among some economic agents — capital (including land) and labour — that provide the required inputs. Therefore, each of the agents has a share in the product — the fruit of their combination. Justice demands, more so in Islam, that each factor gets as far as possible what it contributes to the value product of the firm.[9] We are not aware of any way that ensures in secular economics a just apportionment in the case of mass production. The division basis must not only be fair; it must also be acceptable to the contributing factors, for therein lies the clue for achieving peace and tranquility in today's turbulent industrial relations.

Secular economic theory adopts an essentially 'impersonal approach' to the issue of distribution. It relies primarily on the market forces as regulated by competition for achieving a 'just' division of the value product among the various input supplying agents. The share of the workers is separated through a market-determined wage and the residual goes as a matter of principle to the owners of capital, as profit, including interest. If the market-determined wages could be shown to be 'just' on the contribution basis, the division would obviously be just. However, no such demonstration has so far been convincing and conclusive.

In contrast, Islam uses an 'instructional approach' towards the distribution issue. We have presented a detailed argument on the subject elsewhere (Hasan, 1983). In essence we hold that Islam would prefer to treat the whole value product minus depreciation and a minimum maintenance wage as profit to be shared between labour and capital on some agreed equitable basis (Hasan, 1983). The scheme is seen as offering a greater chance to bring distribution closer to the stated norm of justice than the pure market arbitration.[10] Of course, interest has no place in this Islamic scheme.[11]

There has been some criticism of the above formulation of the Islamic viewpoint on profit. A major portion of the criticism we have already answered (Hasan, 1986) and some remaining points shall be examined in due course. Indeed, recent developments on this subject in secular theory (and practice) have only strengthened our argument for the sharing principle.

We shall take a rather broad view of the matter in the following discussion. The argument is essentially on an abstract plane involving only pure models for purposes of analysis and comparison. The environmental background is of the Third World economies as most of the present-day Muslim countries fall into this group, and the price mechanism is more impaired in performing its functions adequately in their case than elsewhere.

Secular Viewpoint: An Evaluation

In secular economics, profit maximization as a rationality condition is not concerned with individuals' welfare alone. The well-known Smithian dictum that the pursuit of self-interest automatically promotes the collective good[12] in a free enterprise system, is held as an article of faith for providing the hypothesis a sort of social respectability as well. The classical model of the system is not infrequently resuscitated to illustrate and reinforce the belief.

In this model, a large number of tiny single product firms run by the owner-managers, called the entrepreneurs, compete for private profit in a rather 'open' industry. Competition is perfect in the sense that the individual transactors have no pricing power in any market.

The model is claimed to have two important social welfare aspects. First, it allows the entrepreneurs a rate of profit on their capital which is no more than sufficient to give them an absolute income composed of (1) the interest on their investment at the rate available on the gilt-edged securities, (2) a wage for their services rendered to the firm for its management and measured by an opportunity cost, and (3) a premium for taking risk as determined by its actuarial valuation. In this sense, competitive pricing gives the entrepreneurs a 'normal' rate of profit which, it is claimed, is only the legitimate reward for their productive activities and must be treated as an element of production costs.[13] The maximum is the minimum required for survival.[14]

Secondly, the drive for self-enrichment disciplined by competition also maximizes the social product as plant utilization is optimal in each case. Furthermore, each factor can be shown to get what it contributes to the value product of a firm as returns to scale are by assumption constant. Society pays only what it must for the commodity-marginal cost equals its price. Thus seen, selfishness is a social virtue. The invisible hand of self-interest makes the free enterprise system both efficient and equitable as also promotive of growth.

The model is criticized as highly unrealistic. That is true but is only of secondary importance. Of real significance is the fact that the model tends to destroy itself even if the initial situation were the same as depicted, and that 'normal' profit need not remain innocuous in the process.

The argument of the model ignores an important feature of profit. It is that if the market price for the product of a firm is such that there is a margin, however small, over production costs (profit excluded), profit multiplies as more and more units of the product are sold.[15] And it is this profit multiplication process which must eventually hang perfect competition by the noose of its own making. It is easy to see how. Clearly the situation is such that 'each firm can increase its output without changing the price of the factor or the price of the product, or the marginal product of a unit of a factor. This means that if the firm is making any profit, it can increase this profit by increasing the scale of its activities. This would immediately make some of the firms large enough to be able to influence the price at which they sell the product or buy the factor.'[16] Thus, the process of profit multiplication must eventually transform the perfect competition model into that of monopolistic competition. Product differentiation in the widest sense of the term is now possible and only helps to hasten the process.

As the sales of a firm grow in the stated manner, its capital has to be increased (suppose) proportionately. The interest component of normal profit would increase in the same ratio. But managerial worries are expected to increase in a much lesser proportion than the firm's production activities. The risk of loss in fact tends to decrease as business becomes large and stabilized. Even if it increases, it is unlikely to increase in the same ratio as sales. Accordingly, the increase in the income of the entrepreneur with multiplication of sales, can rarely be only commensurate with the increase in risk-taking or managerial effort even though the rate of return on capital may still look 'normal'. Its excessive nature becomes all the more evident if one remembers that entrepreneurship, however conceived, is well recognized as a fixed and indivisible quantity relative to the size of a firm.[17]

Sales multiplication makes competition imperfect but that hardly explains the high drama of modern business. Of real importance is the theory that views, as stated earlier, profit as a surplus over cost (and taxes) to which the entrepreneurs are granted an exclusive and by implication a rightful claim. The concept has an in-built temptation for the entrepreneurs to pull as far apart as possible their sets of selling and buying prices to enlarge the difference for self-enrichment. The profit maximization hypothesis provides support and respectability to this temptation. Naturally, entrepreneurs initiate action in both the product and factor markets to overcome competition and create monopolistic (monopsonistic) shelters for increasing the size and continuity of their profits.[18]

The propensity to monopolize has certainly played a role in the great transformation — institutional and technological — market economies have undergone over the centuries. Two consequences of this transformation may be noted. One is the rise to dominance of large corporations which has disintegrated the personality of the classical entrepreneur beyond recognition through the separation of ownership from management and decentralization of the act of decision-making all along the hierarchy in the modern firms. Research and development have become team work. These changes have made profit essentially a non-functional surplus with the entrepreneurs — the 'control ownership' of the corporation.[19] Secondly, monopolistic market structures have become an integral part of free market economies. The case for free enterprise must, therefore, rest on the efficacy of such structures, not on the virtues of a non-existent type of competition.

Once competition is impaired, the logic of profit maximization tends to operate in the opposite direction. We may begin with the tangency equilibrium position of a firm under monopolistic competition (Figure 20.1). Here average revenue is equal to average cost (point P_0). Profit is but 'normal'. Again, the price of the commodity is more than the marginal cost of production $P_0q_0 > T_{q0}$. This implies that (1) the hired factors (workers) are not being paid the full value of their marginal physical product — they are being exploited;[20] (2) the consumers are denied the gain of a fall in price to equal the marginal cost at P_1 point, and their surplus is reduced; and (3) plant utilization is less than optimal — social product is not maximized ($Oq_0 < Oq_1$).

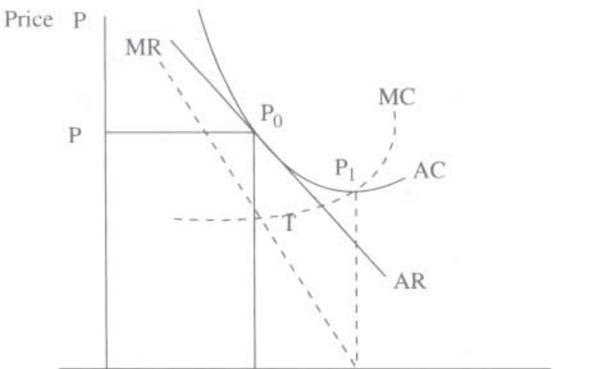

Figure 20.1 *Diagram Illustrating that the Concept of 'Normal' Profit Has No Ethical Import*

Thus the tangency equilibrium diagram of monopolistic competition looks paradoxical. Here the workers, the consumers, and the society at large all seem to suffer apparently to nobody's gain, for profit is just 'normal' and by implication reasonable. The diagram is meaningful only in the sense that it illuminates that the concept of 'normal' profit has no ethical import. Such profits may become exploitative through their multiplication process.[21] Under monopolistic competition, the exploitation of the workers and the consumers is vivid and tends to increase with the emergence and expansion of super 'normal' (economic) profits as the drive for their maximization is intensified.

If some economists — secular or Islamic — still insist that profit is a reward for entrepreneurship or that 'normal' profit carries a moral sanction, they only exhibit tainted thinking. We must state that the return to an entrepreneur *qua* entrepreneur can at best be a rent or wage, not profit. Once firms acquire pricing power, the free enterprise system can, under capitalism, hardly be shown as efficient or equitable on a priori reasoning. The pursuit of maximum profit is no longer a survival condition necessarily free from avarice. Individual selfishness need not remain promotive of the social good.

There is now a growing realization of these facts in the secular economic writings.[22] But since secular economics takes a segmental view of human existence and *laissez faire* remains its philosophical base, orthodoxy does not permit any external force to enter its paradigmatic frame for restoring the unity and equilibrium of the system. Instead, there is either insistence on maintaining competition as perfect as possible through public action, or there are ever-increasing assertions that modern business firms do not follow the profit maximization path because of (1) the separation of management from ownership, making the managers independent in decision-making, and (2) non-feasibility of maximization under uncertain conditions that characterize the business scene.

However, we have shown that competition (perfect) is inherently self-liquidating and must not be expected to achieve what it really cannot, more so in the developing economies where market distortions are relatively great and sticky. Also, the claim that modern firms shun profit maximization is in no way based on conclusive empirical evidence. Further, one is not sure about how real the difference between the interests of managers and the owners is with regard to profits, or how independent the managers in fact are to deviate from the traditional objective while setting the goals for their firms. Again, the micro models constructed on the basis of some supposedly alternative goals are highly situation-specific to permit meaningful generalisations.[23] In view of their insular nature, they cannot be integrated with the processes of arriving at the macro-level equilibrium in the economy.

Last but important, the feasibility question is in no way unique to profit maximization. In fact, the position, at times even the shape, of a curve cannot be fixed on an economic diagram if one is so mindful of uncertain conditions. Yet we do it with an air of authority. Uncertainty can make most sensible decisions look idiotic if expectations fail to materialize. But must that make trying to peep into the future insignificant? If the results of human effort, including the one for maximizing profit, were entirely and always at the mercy of chance, intelligence would hardly have any role in human life. Decision-making ability productive of results becomes scarce and hence valuable only under uncertain conditions.

Profit maximization as a business objective has a 'global' character and is for that reason more appropriate both for explanatory and predictive purposes in this area of human behaviour. However, the pursuit of this goal can be possible with a minimum of conflict between self-seeking and social good only if the concept of profit sheds its 'exclusive' income character and some sort of sharing becomes its institutional attribute. Secular economics may not allow such a change to become pervasive under the compulsions of its value frame, though there is of late some serious thinking in that direction.[24] In contrast, one finds support for the required modification in the Islamic injunctions and paradigm. For this reason, the results of profit maximization may be expected to be different in Islamic economics.

Islamic Position

Under dynamic uncertain conditions, profit maximization signifies the firm's endeavour to create, enlarge, and keep open as much as possible the profit-yielding space between the total revenue and total cost curves. To find the price–output combination for which the space would be the widest, through the equality of their slopes (MR = MC) on which secular economics seems to concentrate is a purely technical matter of secondary importance. To study the ramifications of profit maximization, one must analyse the factors that determine the relative levels of the revenue and cost curves.

In principle, there is usually a large number of feasible plans available to the firm to determine these levels and create 'profit-spaces'. But only one of the plans can be the best from the maximizing viewpoint. Evidently, the firm can rarely hope to arrive at this plan due to uncertainty. But unless it strives continually to move in that direction, it will certainly end up with a plan which is, in the matter of results, very far short of what others could achieve. Rational conduct, therefore, demands that maximizing plans are made and assessed on a comparable basis.

In Islam, such rational conduct is conditioned essentially by three factors: (1) the Islamic view of business; (2) the protection Islam provides to consumers; and, (3) the profit-sharing among factors which it seems to support.

Together they influence the levels of the revenue and cost curves to limit the 'profit space' such that the maximization effort does not violate the Islamic norms of behaviour. Rather, it tends to promote growth with equity and seeks to harmonize individual and social interests. Let us have a brief look at these factors.

Business: A Fard Kifayah

Of the various means of earning a living and acquiring wealth, Islam places business among the most beneficial and the noblest of vocations.[25] But on a more important side, it considers business as a social obligation of the individuals.

Islamic jurists classify business as a *fard kifayah*, i.e. a duty, the performance of which is obligatory on the general Muslim population but which when performed by one or a group of them absolves all others of their responsibility in the matter.[26] The requirements of the community like those for the services of the soldiers, doctors, teachers, jurists, administrators, etc., are some of the other examples of the same category of obligations.[27] The application of the principle in business implies the achievement of a self-reliant economy.

The level of specialization the world has reached, and the rate at which new occupations are multiplying, make people search for personal identification. Their loyalties are narrowed down to the subcults that specialization tends to breed. It results in the far finer fragmentations of the social order dominated by atomistic and rationalistic concepts which take a dichotomous view of man, placing him against the society.[28] The Islamic notion of *fard kifayah* seeks to keep the social obligation of professionalism in the forefront of human affairs.

One must enter business with a clear perception of social priorities. As a *fard kifayah*, business operations have to be geared to the broad ends of an Islamic social order. Business firms are not to be the mere wealth-acquiring instruments in the hands of the individuals or their small groups — the 'control ownership'. Notice that Islam praises not the trader but the honest,[29] not the unscrupulous but only the one who overpowers the temptation to follow the path seemingly more profitable but barred by the Shari'ah (Al-Qur'an, 5: 103). The restraint demanded is indeed among the most difficult ones to exercise. It demands piety of the highest order.[30]

The Shari'ah provides detailed instructions to the believers for conducting their business affairs in a way conducive to social well-being. The requirements broadly are:

1 All business transactions must be free as far as possible from traces of *riba*, speculation, *gharar*, and deceit.
2 Production relations are based on the principles of trust, mutual benefit, and co-operation. Temptations for exploitation or oppression must always be resisted.

The believers entering any branch of business are supposed to have prior knowledge of the instructions. Ignorance is no excuse for their violation.[31] Their details are available in all authentic books on Islamic jurisprudence that deal with the issues of buying and selling. Since these instructions are invariably explained and illustrated with reference to the small proprietary businesses engaged mainly in the marketing of local or imported products, they may not be readily applicable in the present-day economic setting of large-scale production using modern practices and organization structures. Presumably, one will have to work one's model of Islamic business more on the basis of the underlying spirit and implications than the literal form of these instructions. Non-emotive thorough discussions on matters of interpretation are required among the Islamic scholars to evolve broad agreements.

Consumer Protection

For protecting consumers from exploitation, the Shari'ah imposes a number of obligations on the sellers with regard to measurements, quality, prices, and information.[32]

Scales are the symbol of justice in Islam (Al-Qur'an, 27: 25). The traders are to keep proper weights and measures and use the same correctly.[33] It is better to give more of the measure while selling, and accept even less when purchasing, lest the other party is harmed.[34] Goods sold are to be of the declared quality or description. They must be suitable for the purpose stated by the buyer if he relies on the seller in the matter.

The price charged should not be more than what rules the market.[35] The Shari'ah condemns any attempt at raising prices by creating artificial scarcities, e.g. through withholding or cornering the available supplies.[36] If mark-ups are to be used, some jurists hold that the addition over costs should not be more than 33 per cent.[37] Others prefer to leave the margin to the sellers' discretion presumably because compulsion is not always the best way to make them charge reasonable prices. It is better to invoke in them an urge for compassion, for *ihsan* is an integral part of the Islamic ideology.[38]

Secular economies are certainly not devoid of business morality. But the point is that moral norms are not a part of the secular economic theory. Even on the ethical plane, one Islamic requirement seems to be a significant departure from the current business practice. Islam insists that not only should the seller desist from undue praise for his wares, he is under obligation to reveal to the prospective buyer defects latent or patent, if any, in the goods offered for sale.[39] From Ghazali's explanation of this provision, two inferences of major import follow.

First, the provision requires the producers to exercise strict control over the quality of their goods in the process of manufacture and urges the distributors to accept from the suppliers only such of the goods as are free from defects. Despite adequate care, if any of them — manufacturer or distributor — fails in the matter, he alone must bear the consequence in the form of, say, reduced price, or even loss.

Secondly, and more importantly, the provision sets some norms for advertising. Present-day advertising tends to become over-glamorous, diversionary, wasteful, and even aggressive. The Islamic norm seeks to keep advertising, indeed the entire selling effort, sublime, purposeful, supporting, and informative.[40] It helps resist the temptation to overpower consumers' discretion or distort their preferences for increasing profits.

The above-mentioned Islamic constraints that protect the consumers are expected to keep the revenue curves of the firm at a reasonable level from the social viewpoint in the context of profit maximization. Let us now turn to the issue of factor rewards.

Factor Rewards

Secular economic theory has met with one of its major failures in demonstrating as to how the value product of a firm can be apportioned among the participating factors in a just way. The marginal productivity theory, despite its heroic assumptions, runs into circular reasoning in its attempt to show that the marginal product and therefore the contribution of each productive factor is an objective, ascertainable quantity in the firm's value product. Even if one momentarily grants it as feasible, payments commensurate with marginal productivity need not be just on the contribution basis. It is not the contribution of a factor to output but its scarcity relative to other factors that would determine both its marginal product and reward.[41]

The matter becomes further complicated because the final outcome of business operations is characterized by a high degree of uncertainty. The forces of competition are blunted by obstacles to entry and the process of imputation is painfully slow. Since in real a dynamic situation there is no single unequivocal price system at which the various contributions and rewards are valued, marginal revenue product does not unambiguously determine either the contribution or the reward of the productive factors.

Still, some of the Islamic economists entertain the notion that the market-determined factor rewards are invariably just on the contribution basis and that if the employer pays such wages to the workers, he has fulfilled his responsibility, no matter if the payment made is not sufficient to meet even the minimum of their basic needs.[42] This view may have some relevance in cases of small proprietary business, but in modern mass production, the results of market arbitration may tend to be chaotic (Arrow and Hahn, 1971: vi–vii).

We are of the opinion that in mass production, labour participation in profits subject to a minimum wage constraint can alone bring us closer to a division of value product that may be just to both the workers and their employers.[43] The idea is in line with the content and spirit of the Islamic principles of unity, harmony, mutual trust, co-operation, and fair play. Participatory schemes are becoming increasingly popular even in leading capitalistic economies. 'Pressures of unemployment and foreign competition are beginning to make managements and unions willing to examine co-operation as a means of survival.'[44]

Profit-sharing between labour and capital may not entirely be a catalogue of virtues, but it is certainly going to be the dominant pattern of business organization in the coming century because of its tremendous potential for promoting efficiency, equity, stability, and growth. Economists have already started taking serious note of the impending change, even at the theoretical level.[45] It is up to Muslims whether they take to heart the message of their religion and put sharing into operation as leaders or just imitate the process (as they have often done) only when others have actualized the Islamic idea and demonstrated its utility.

From the Islamic viewpoint, we have to treat, as stated earlier, the entire net value product minus the minimum wage as profit resulting from the combinational productivity of labour and capital meant for sharing between them in priorly determined ratios.

This concept of profit is likely to free the cost curves of the firm from possible downward pressures the entrepreneurs may be tempted to exert for enlarging their profits even at the cost of the workers. It promises to make a more just and orderly apportioning of the value product between labour and capital than the impersonal market forces. This, combined with the observation of the Islamic norms of behaviour determining the level of the firm's revenue curves, must make the profit-space look reasonable. Thus, there is no reason why a firm in an Islamic system should not strive for maximization of the value product minus capital consumption and a minimum wage. Such an attempt would rarely need an apology or defence. Also, one will not be obliged to identify (or invent) the entrepreneur, whose functions and personality have long become obliterated beyond recognition in the modern gigantic corporations. Profit maximization would tend to be free of exploitation, discontentment, and strife, so characteristic of the industrial scene today, particularly in the developing economies. In general, it may be promotive of the urge for efficient and improved performance, for that alone can give more to each participant in the productive effort.

Thus seen, profit and its maximization would give, in an Islamic setting, a sense of participation to all the agents of production and would motivate them for mutual co-operation and hard work. It will tend to improve their X-efficiency.[46] The links between the equilibrium of the firm and industry would also remain unimpaired in matters of price formation and resource allocation.

Social Good and Profit Maximization

Under conditions of monopolistic competition, profit maximization may lead in an Islamic system to a lower commodity price, larger volume of output, and greater net profit, compared to that in a secular model of free enterprise. This we propose to demonstrate in this section.

In the secular system, let the price P of the commodity produced by a firm vary inversely with its output X such that,

$$P = a - bX, \qquad a/b > X$$

Likewise, let the average cost AC be an increasing function of output, i.e.

$$AC = cX$$

assuming for simplicity that all costs are variable. In the above expressions a, b, and c are some positive constants.

It is easy to specify the total cost (TC) and total revenue (TR) functions by multiplying the average in each case by output X. Using derivatives and solving, one would find that in equilibrium, the firm will have

$$\text{Output } x^* = \frac{1}{2}\left[\frac{a}{b+c}\right]$$

$$\text{Price } P^* = a\left[1 - \frac{1}{2}\left(\frac{b}{b+c}\right)\right]$$

$$\text{and Profit } \pi^* = \frac{1}{4}\left[\frac{a^2}{b+c}\right]$$

Now let us see what would have been the results had the firm decided to follow the Islamic path instead of the secular one, other things remaining the same.

Let W be the market wage, w, the minimum maintenance wage, and i the rate of interest, all the rates being per unit of output. We may put

$$(W - w + i) = y, \qquad y > 0$$

The Islamic total cost function can then be written as

$$TC' = cX^2 - yX, \qquad c > y$$

the total revenue function TR, remaining the same as before. The relevant values in equilibrium will now be

$$\text{Output } x^1 = \frac{1}{2}\left[\frac{a+y}{b+c}\right]$$

$$\text{Price } P^1 = a - \frac{b}{2}\left[\frac{a+y}{b+c}\right]$$

$$\text{and Profit } \pi^1 = \frac{1}{4}\left[\frac{a+y^2}{b+c}\right]$$

It is easy to see that in the Islamic system, the equilibrium output is greater, price lower, and profit (in its new version) larger than in the secular frame, for we find

$$x^1 - x^* = \frac{1}{2}\left[\frac{y}{a+b}\right]$$

$$p^1 - p^* = \frac{1}{2}\left[\frac{by}{b+c}\right]$$

$$\text{and } \pi^1 - \pi^* = \frac{y}{4}\left[\frac{y+2a}{b+c}\right]$$

One need not rush to the conclusion that the last result is merely the consequence of reducing TC by yX under the Islamic system. For it can be shown that the difference is larger than the reduction, i.e.

$$(\pi^1 - \pi^*) > yX^*$$

The differences noted above can further be explained with the help of a simple diagram, e.g. Figure 20.2, which is self-explanatory.

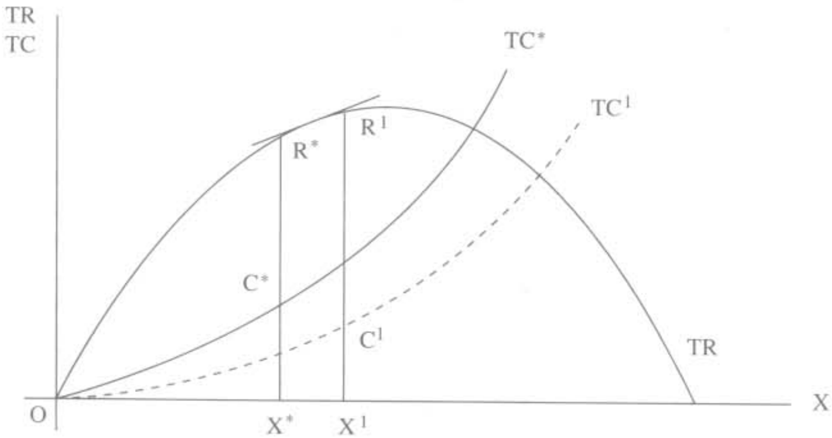

Figure 20.2 *Equilibrium Output, Price and Profit between the Islamic and Secular Firms*

Here $\pi^* = R^* C^*$, $\pi^1 = R^1 C^1$, $P^* = \dfrac{R^* X^*}{OX^*}$ and $P^1 \dfrac{R^1 C^1}{OX^1}$

The above noted improved results for the firm in the Islamic alternative follow from the non-fixity of returns to the productive agents which permits the firm to be more venturesome by ensuring a wider risk spread and more of work effort on the part of productive agents. Of course, increase in work effort is an additional factor not covered by the 'other things being equal' in our argument. It is mentioned here as a likely consequence of the Islamic reward scheme. Let us now return to the mainstream of our argument.

The debt–equity mix in the capital structure of a firm tends to enhance the rate of return for the equity holders through leverage.[47] However, 'trading on the equity' is not an unmixed blessing, for the equity capital has to bear more than its part of the risk.[48] In contrast, the abolition of interest and the provision of finance on a profit-sharing basis in Islam, tends to spread the risk on the entire investment equitably while still allowing some leverage benefit to the equity holders (Hasan, 1985: 24). This may create for the Islamic firm both incentive and feasibility for taking more risks compared to a secular firm under similar circumstances. We may use with necessary modifications, a diagram in Baumol (1970: 622) to explain the point.

Figure 20.3 depicts the relationship between risk and profit, net of interest payable on bonds in a secular firm by AA_1. This we may call, following Baumol, the risk–profit possibility curve. It shows optimal combination of risk and profit from which the firm may choose one according to its scale of preferences. The AA_1 curve is convex to the profit axis, implying that for any given increase in profit the firm may desire, the risk would increase at an increasing rate.

Likewise, we may draw for the firm a risk–profit indifference map consisting of curves such as I_1 and I_2 in Figure 20.3. These curves are inverted in shape because, other things being equal, we usually prefer lower levels of risk, i.e. points which are lower in the figure. The slope of the curves is positive because as risk increases, the firm requires a higher level of profit to remain indifferent (Baumol, 1970: 623).

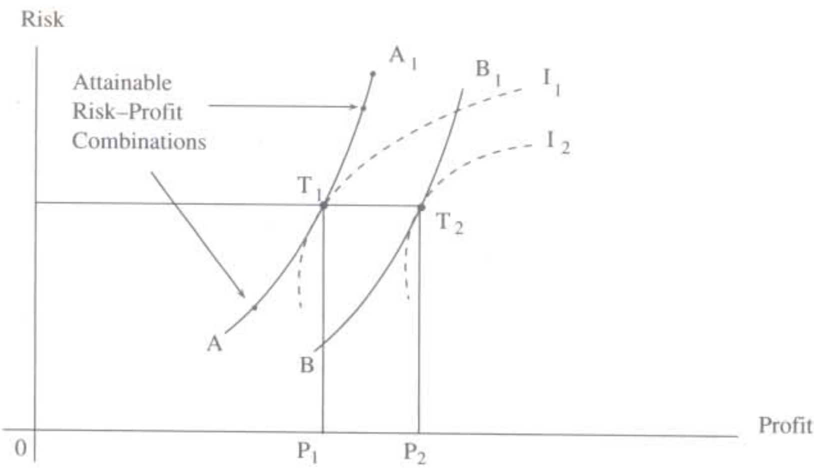

Figure 20.3 *Relationship between Risk and Profit (Net of Interest Payable on Bonds) in a Secular Firm*

For the secular firm, the optimal combination of risk and profit is given by T_1, the point of tangency between the possibility curve AA^1, and the indifference curve I^1. However, if the same firm adopts the Islamic way, the abolition of interest finance and its substitution by profit-sharing will tend to shift the possibility curve for the shareholders to the right to a position such as that of BB_1. The tendency will be further reinforced to the extent wages are also made to vary with profits as in our model. BB_1 is tangent to the indifference curve I_2 at point T_2. The implication is that Islamization may enable the firm to have (1) more profit for the same risk, or (2) same profit for a lower risk compared to a secular dispensation.

Conclusions

The object of this chapter was to investigate if profit maximization could be retained in Islamic economics as it has predictive value and leads to some verifiable conclusions, alternatives suggested to replace it being devoid of these features. We have argued that in secular economics, profit maximization tends to cause difficulties — social and economic — because profit is considered an 'exclusive' income category and reliance on market arbitration cannot ensure distributive justice. However, things are likely to be different in an Islamic system. Abolition of interest and profit-sharing with labour may lead to several consequences promotive of growth and distributive justice. The Shari'ah adequately hedges profit motive to make the maximizing effort socially conducive.

Islam is an ideology. It seeks to establish a social order operating primarily through voluntary restraints so as to keep the conduct of the believers in line with the spirit and content of the Shari'ah. It expects them to look at business as a *fard kifayah,* where social obligation has preference over self-enrichment. Once these norms are followed, there will in general be no need to curb the pursuit for maximum profit for it will tend to promote growth with equity.

Ghazali has made a very pertinent remark in this connection. He says: 'Profit cannot but be fair if business follows the instructions. But the trouble is that people do not remain content with relatively small (profit) and they cannot earn more without violating the injunctions.'[49] The mundane being in man tends to overpower his moral self, more so in business. The Shari'ah not only decries deviations from the chartered course, but also makes it obligatory for the state to regulate business conduct if the social environment provides clear signals that the drive for profit no longer cares for the legitimacy of means and the social obligation is suppressed by self-seeking. Some of the indicators of profit motive having gone berserk in modern societies — Muslim or non-Muslim — are created scarcities, allocative distortions, forced-up prices, development of black markets, race for monopolization, and glaring inequalities in the distribution of wealth and income. The Islamic social order cannot remain a silent spectator of such a scene.[50] Theoretical models such as the one presented in this chapter essentially depict the ideal; the extent of movement in that direction depends on socio-political awareness, will, and action.

NOTES

1 'This view of man has been a persistent one in economic models, and the nature of economic theory seems to have been much influenced by this basic premise.' Sen (1983: 84).

2 Indeed, profit maximization is one of the leading examples of the commitment of economic science to the postulate that the objective conditions of equilibrium can almost always be stated in terms of some extremum solutions (Samuelson, 1958: 5).

3 The conditions of business rationality are spelled out in terms of profit maximization in most of the textbooks on microeconomics. See, for example, Koutsoyannis (1980: 256, 263).

4 For a detailed bibliography containing the criticisms, see note 5 and for defence, note 6 in Hasan (1975: 59–60).

5 Mark the observation in Samuelson (1980: 478): 'As soon as the firm becomes of any considerable size and begins to enjoy some control over price, it can often afford to *relax a little* in its maximizing activities.' (*Emphasis* added.)

6 For example, the Holy Qur'an prescribes rules for inheritance (2: 180, 240; 4: 7–9, 19, 33, 176; 5: 109, 111), allows individuals the sale and purchase of goods (2: 188; 4: 29) and condemns hoarding of wealth (3: 180; 9: 34) and so on.

7 The Holy Qur'an permits legitimate trade even when on pilgrimage (2: 198). 'The merchant who is sincere and trustworthy will on the Day of Judgement be among the Prophets, the just, and the martyrs.' Tirmidhi, *Abwab al-Buyu*, quoted in Hifzur Rahman (1946).

8 Holy Qur'an (2: 198; 62: 10; 73: 20 and elsewhere). A tradition says: 'If you profit by doing what is prescribed, your deed is a *Jihad* (i.e. equivalent to fighting or any other vigorous effort in the service of God's Cause) . . . and truly a dirham lawfully gained from trade is worth more than ten dirham gained in any other way.' Quoted from Zaid Ibn Ali, *Corpus Juris*, ed. E. Grifini, Milan, 1919, n. 589. Also in Rodinson (1974: 16–17).

9 The Holy Qur'an says: 'God created the heaven and the earth for just ends in order that each soul may find the recompense of what it has earned' (88: 22). See also 2: 279; 4: 29-30; 11: 85; 26: 185.

10 For a detailed discussion of this view, see Hasan (1983: 7–15) and Hasan in Iqbal (1986: 37–43).

11 Holy Qur'an (2: 279; 3: 57; 3: 86; 4: 10).

12 'By pursuing his own interest, he (the individual) frequently promotes that of society more effectively than when he really intends to promote it.' See Smith (1961: 400).

13 On this, see Hasan (1972: 17–18).

14 'The whip hand of competition forces the policy of profit maximization upon every firm.' See Scitovsky (1983: 428).

15 This characteristic of profit has been particularly highlighted by Hawtrey (1951: 489–504). See also Hawtrey (1955: 21).

16 This is part of a lengthy explanation in Lerner (1960: 11).

17 Joan Robinson, A. P. Lerner, T. Scitovsky, and some other economists explicitly hold this view.

18 See Hasan (1975), Ch. IV, for a detailed discussion on the relationship between profit maximization in secular economics and propensity to monopolize.

19 This view has been elaborated in Hasan (1975) and appears in a summary form in Hasan, (1983: 6).

20 This is the view of exploitation taken by A.C. Pigou in *Economics of Welfare* London: Macmillan (1920: 540) and endorsed by Joan Robinson in her *Economics of Imperfect Competition*, London: Macmillan (1933 Ch. 25). In many textbooks on microeconomics, one may come across a diagrammatic explanation of this version of exploitation.

21 This is elaborated in Hasan (1972: 19).

22 For some of the important observations and details, see Arif (1987: 65). See also his note 40 for useful references.

23 For example, Baumol's theory of sales revenue maximization, Marris's model of managerial enterprise, Williamson's model of managerial discretion, and the behavioural model of Cyert and March deserve special mention and a useful discussion of these models appears in Koutsoyiannis (1980: Ch 15–18). See also Colander (1984).

24 Of significance in this connection is the contribution of Weitzman (1984). See also the review of his book by Saul Estrin; the contributions of Jones and Sveinger (1985) and Whyte (1990) also reflect the change very clearly.

25 Some of the reasons why Islam holds business — in its widest sense — in such high esteem are well stated in the instructions Harzrat 'Ali wrote to al-Ashtar at Nakai when he appointed the latter as Governor of Egypt at the time when the rule of Mohammad Ibn Abi Bakr was in turmoil. Hazrat 'Ali wrote: 'And all of these (soldiers, taxpayers, and Judges, administrators and secretaries) have no support but the merchants and the craftsmen through the goods which they bring together and the markets which they set up. These provide for the needs (of the first three classes) by acquiring with their own hands those (goods) to which the resources of others do not attain.' Again, Section 4 in the same part of instructions observes: 'Then make merchants and craftsmen . . . your own concern, and

urge others to do so, for they are the basis of benefits and the means of attaining convenience. They bring (benefits and conveniences) from remote and inaccessable places in land, sea, planes and mountains, and from places where men neither gather together nor dare to go. (The merchants and craftsmen) are a gentleness from which there is no fear of calamity and a pacifity from which there is no worry of disruption. Examine their affairs in your presence and in every corner of your land.' This letter of Hazrat 'Ali from *Nahj al-Balaghah* appears in *Tabatabai* (1982: 10, 14). See also note 7 above.

26 Prayer for and burial of the dead, for example.

27 Motahhari (1981: 65). See also Ghazali (1955: 100).

28 See, for example, Hasan, (1986: 36).

29 See notes 7 and 24 above.

30 'Because the person who seeks this world to facilitate himself in the hereafter will never exchange the gain of the latter for temporal benefits. This applies in equal measure to the conduct in the market, the mosque and the household. The only way to *escape punishment on the Day of Judgement is none but piety*.' Ghazali (1955: 103). (See also pp. 71–2, 99, 102).

31 Ghazali (1955: 75).

32 Ibid., pp. 77, 89.

33 Holy Qur'an (11: 84; 17: 35; 26: 181–3; 83: 1–4).

34 Presumably Ghazali derives this rule (1955: 93) from the Qur'anic verse that says 'Woe to those who deal in fraud, those who when they have to receive by measure from men take full measure but when they have to give by measure or weight to men give less than due' (83:1–3). They will be called to account (83: 4).

35 Ghazali (1955: 94–5). See also Maudoodi in Ahmad (1977: 412–15). Even when scarcity is believed to be artificial, he takes the stand that the state has no moral right to enforce price control unless it can arrange to make goods available to people at prices it may choose to fix. For the failure may result in the development of black markets and the state cannot demand that sellers and buyers stick to the prices it has fixed (p. 142). It follows that efficient rationing would be permissible in Islam.

36 Islam prohibits hoarding of goods with a view to raising prices and exploiting the consumers. Injunctions against the hoarding of food grains are clear but jurists invariably consider them illustrative of a general principle.

37 Ghazali (1955: 94–5).

38 Ibid., p. 95.

39 Ibid., pp. 82, 90.

40 On this, see, for example Mohammad Ariff (1982: 244, 294) and Hasan (1975: 82–3).

41 Robinson and Eatwell (1973: 88) have been very critical of the marginal productivity theory.

42 For these views, see Iqbal (1986: 18), for his comments on the author's paper. Even the staunchest supporter of *laissez faire* capitalism would perhaps hesitate today to make such observations, for these remarks imply that whatever the market does is always just and Islamic.

43 Put briefly, the argument is as follows: The outcome in mass production is characterized by a high degree of uncertainty. Therefore market forces are powerless to achieve the Islamic ends of justice in apportioning the value product among the participating factors. Prefixed factor rewards (in mass production) would presumably be distasteful to Islam.

The presumption finds support in that Islam abolishes interest; capital owners can participate in the productive effort only as sharers in profits accruing to them. Again, in the case of agricultural land, the dominant view seems to be that Islam would prefer its settlement between the landowner and tenant to be in the form of a reasonable proportion of the crop, in cash or kind.

This leaves us with labour and the issue of determining its reward in mass production. Prefixed wages may be defended on the grounds that the workers are human beings and have to be maintained in any case. But for this, workers may be paid a minimum maintenance wage during the production period. Such minimum wages are to be the component of cost in the same way as depreciation for maintaining capital. Beyond minumum wages, there is no valid reason why workers should not be allowed to share in profits. This may not be the only permissible arrangement. But at least there is no bar in Islam if society chooses to adopt sharing in view of its advantages, on a selective basis, to begin with. For details, refer to articles in n. 10 above. The author put forth this viewpoint for secular economics in 1975 and it now finds wide support. (See notes 22 and 24 for references).

44 See Burck (1983: 10) and Whyte (1990: 337, 342–3).

45 Weitzman (1984) is one significant example. The author has demonstrated with the help of diagrams the superiority of profit-sharing over interest finance in the capital structure of a firm.

46 On this important issue of efficiency of factors in use as opposed to efficiency in its allocation as a factor in economic development, see Leibestein's (1978) Introduction and Ch. 1.

47 For an explanation, see Baumol (1970: 626) and Hasan (1985: 23–4).

48 'In effect, bond holders absorb less than their share of the company risk passing it along to the stockholder. The more bonds are outstanding, the greater the danger to shareholders and the company.' See Baumol (1970: 626).

49 See Ghazali (1955: 92).

50 Hazrat 'Ali in the same instructions that we have referred to above, specifies the role of the state if businessmen do not observe the Islamic norms of behaviour and indulge in malpractices like hoarding, profiteering, etc. See Tabatabai (1982: 15).

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