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THEORY OF PROFIT IN SECULAR ECONOMICS LITERATURE AND ITS ISLAMIC FORMULATIONS: A COMPARISON OF THE VIEWS OF SELECTED THINKERS

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This is to certify that Bro./~~Sis~~ ABUBAKR ABDULLAH SOKOTO
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under my supervision. The relevant comments made on the paper during its presentation have been incorporated in the present version of the paper to my full satisfaction.

I have pleasure in recommending that the graduate committee may approve the paper in partial fulfilment of the requirements for the degree of Master of Economics.

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I. INTRODUCTION

Economists address the fundamental questions of determining conditions for efficient allocation of resources, the way of solving the under employment of resources and the task of understanding the principles governing economic development and distribution of output. With regards to distribution, there seems to be a general acceptance among economists on the the present theories of wages and rent. The difficult problem facing the western economists has been the lack of a clear understanding concerning the nature and source of profit.

Despite the claims that profit plays an important role in the workings of free enterprise capitalistic economies, the theoretical discussion on the subject happens to be one of the neglected areas in the Western economic literature. The few theoretical formulations, available on the subject, only contribute to the controversy regarding the justification or otherwise of the conventional assumption about the basis of factor relations in the capitalist mode of production.

The major difficulty for the western economists has been the lack of a clear understanding concerning the validity of the link between the entrepreneur and the emergence of profit. Entrepreneur is a term for which there is still no agreed definition. According to The New Palgrave's Dictionary of Economics, an entrepreneur is "someone who specializes in taking judgemental decisions about the allocation of scarce resources." [1] The term entrepreneur was first introduced into Economic theory by Cantillon (1755) and brought to prominence by Say (1803). Since then, the term was variously translated into English as 'Merchant', adventurer or 'employer'.[2] Although it is the entrepreneur who is the very soul of the business enterprise, the one who evaluates information and economic opportunities and brings together the necessary amount of land, labour and capital to engage in production, yet the entrepreneur is said "to be still an elusive character in the minds of economists."[3] This problem is apparent in the writings of Smith (1723-1790) and Say (1767-1832). While Smith treated the owner of capital and organizers of business enterprise as one and the same, it was the

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1 The New Palgrave Dictionary of Economics, The Macmillan Press Limited, London, 1987, p.151

2 Palgrave Dictionary, Ibid, p.151

3 Wu Shih-Yen, <u>Production, Entreprenuership and Profits</u> Oxford University Press, U.S.A, 1989, p.101

view of Say, that they have to be made distinct from each other if we are to better understand the distribution process.[4] Despite his efforts to tie profits to the entrepreneur, Say, treats entrepreneur sometimes as a capitalist and at other times as a labourer. He never clearly distinguished the entrepreneurial role from that of general labour.[5] Thus, since profit is widely attributed as a return to the entrepreneur, the confusion surrounding the concept of Profit in Western thought is related to this lack of a clear view of an entrepreneur.

Objective of the Study

This paper attempts to undertake a comparative study on Theory of Profit in secular economic literature and Islamic formulations on the subject. The focal point in our discussion of the Western thought would be the contributions of two major architects of the classical school; namely : Adam Smith (1723-1790) and David Ricardo (1772-1823). When discussing the Muslim formulations on the subject, we will focus on the thought of two prominent Muslim Thinkers of the thirteenth and fourteenth Centuries; namely: Ibn Taimiyyah (1263-1328 A.D) and Ibn Khaldun (1332-1406 A.D). In the Western thought we have chosen the classical thinkers, because in our view, it is classical thought that gave birth to most of the present western economic theory.

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4 McConnel, J.N, Ideas of the Great Economists, 2nd edition, Barnes and Noble Books, New York, 1980, p.160

5 Wu Shih-Yeh, p.234

This study is timely as it is a step in the direction of a larger project; namely a comparative understanding of Western and Muslim economic thought. It is hoped that more such studies would be undertaken in the future to contribute to this project.

As shown in this paper, the classical economists led by Smith and Ricardo (who are the subject of this study) "accept the legitimacy of profit as payment to the capitalist for what they referred to as performing a socially useful function of providing labour with the necessities of life and with materials and machinery for production."[6]

This paper also attempts to compare the above statement and the extent of its justification with the Islamic position on the subject. It should be noted that in this study, no reference would be made to the writings of Karl Marx on the concept of profit, as the discussion here solely focuses on the views of Smith and Ricardo and their impact on the secular theories of profit.

This study is motivated by a dissatisfaction with the theories of profit in secular economic literature.[7] In the absence of a clear concept of entrepreneurship in the Western economic thought, Economists have examined profits from two

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6 Harry Landreth and David C. Colander, History of Economic Theory, 2nd. edition, Houghton M. Company, U.S.A, 1989, p.72

7 See The New Palgrave. Op cit p 1020.

different angles: That is profit is either a payment to a factor of production (cost of production) or a surplus over costs (revenue minus costs). While the former posits a direct relationship between the profit Income and that factor's contribution to the production, the later denies a functional relationship between the contribution to production made by the factor which receives the profit income and the size of that income. (Wu, 1989 p 232) these two views seemed to be inconsistent.[8] Moreover, it is mentioned that the secular profit theories "have failed to distinguish consistently between profit and interest as categories of non-labour income; thus Theories for the existence of positive rate of interest are often thought of as theories of profit rate in Western economic thought. (The new palgrave, 1987 p 1014). Therefore, because of this inconsistency, neither view alone can be accepted as a valid explanation of profit. The paper tries to find an alternative understanding that will provide

8 The inconsistency arises because these two views are divergent.

a clear explanation of the concept of profit in economic theory. Such an alternative is a necessary prerequisite for any meaningful discussion on modern business organisations. It is hoped that the observations made and the conclusions drawn in this study would contribute to further discussion on the concept of profit in the literature.

SCHEME OF THE PAPER:

The paper is divided into Five sections. Section I is the Introduction. Section II elaborates on the Theory of Profit in the Western economic thought with emphasis on Adam Smith and David Ricardo. Section III discusses the Islamic formulations on profit with emphasis on the works of Ibn Taimiyyah and Ibn Khaldun on the concept of Profit. Section IV is the general comparison between the Western thought and Islamic formulations on Profit. This section also includes specific comparison among the scholars under study. And section V consists of the conclusion.

II. THEORY OF PROFIT IN SECULAR ECONOMIC LITERATURE:

A SURVEY OF THE CLASSICAL PERIOD (1776-1870S).

It is interesting to observe that the historians of Western economic thought do not have a clear-cut answer to the question of who are the classical economists.[9] But to most economists, the classical school is said to have been inaugurated

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9 See Dasgupta A.K, Epocs of Economic Theory, Oxford, U.K, 1985, p.96

with the publication of the wealth of Nations by Adam Smith in 1776, and it became so influential that by 1870s it was completely dominating the western economic thought. The most important characteristic of classical scholars is their emphasis on the primacy of capital accumulation which resolves itself into investment that keeps the economy moving. The economic analysis of classical writers always relates to the progress of the aggregate wealth of nations. Another important feature of classical thinkers is that, they always acknowledge the existence of classes in a society since the difficult task of explaining how the aggregate output is distributed to these classes is considered to be the purpose of classical theory of distibution (Dasgupta, 1986, p.18)

The classical economists proposed many theories of profit. These theories comprised the labour Theory of Value - which naturally views profit as a surplus, and the cost theory of value which treats profit as a return to a distinct factor of production.[10] The labour theory of value as explained by Smith has it that in the "early and rude state of society which precedes both accumulation of stock and the appropriation of land, the proportion between the quantities of labour necessary for acquiring different objects be the only circumstance which can afford any rule for exchanging them for one another. In this state of things, the whole produce of labour belongs to the labourer; and the quantity of labour which it ought commonly to

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10 This means that profit consists of interest since capital could be borrowed

purchase, command or exchange for."[11] It was because of accumulation of capital stock which allows its owner to employ people that make the value which the workers add to the materials. The problem of Smith's Labour Cost Theory is the difficulty of measuring the quantity of labour required to produce a given commodity.

Ricardo's Labour Cost Theory of value is considered by (Oser 1988, p.93) as one of the most difficult to comprehend in all of economics. But he has tried to simplify all the probable difficulties that must be faced by anyone trying to understand labour theory of value (Oser 1988, p.93)., These are:

i. To measure the quantity of labour,

ii. To reflect the fact that labour has differing skills,

iii. To account for capital goods as a factor influencing prices,

iv. To account for land in price determination and

v. To account for profits in price determination

The main aim of classical economists was to investigate the source of nation's wealth and analyse the consequences of economic development especially its effect on Society's welfare. This emphasis later shifted to the associated concepts of value and distribution. It is here that the classicals laid the foundation of an important issue which shows their concern regarding the problem of exchange value and the role of price mechanism in allocating labour and other resources among

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11 Smith Won, p.51, quoted by Dobb, M. Theories of value and distribution since Adam Smith, Cambridge University Press 1975 p 45.

the various sectors of the economy.

According to Wu (1989) up to the end of the classical period around 1870 'a coherent theory of distribution and profit did not exist.[12] The whole concept of market mechanism is also said to be not clear - "The classical economists were unable to reach a consensus on whether self-adjusting market is capable of promoting harmony or whether it leads only to concflict of interest among members of the various social classes."[13]

After providing a brief overview of the classical school and their major contributions to the concept of profit, we now focus on the thought of - Smith and Ricardo on the subject. Though they provide almost similar explanations of their concepts of profit, it is appropriate to have a brief discussion on their respective views on the concept of profit.

SMITH ON THE THEORY OF PROFIT:

Adam Smith (1723-1790) provided a brief explanation of the concept of profit but it is considered inadequate by the historians of economic thought. Infact it was this inadequacy coupled with his refusal to make explicit remarks as to why must profit and rents be subtracted from the output of labour, that made him prone to severe criticism by those opposed to

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12 Wu Shih-Yen, Production, Entrepreneurship and Profits, Oxford University Press, U.S.A, 1989, p.236

13 Wu Shih-Yen, Ibid, p.22

private property based capitalist economy.[14] Through his framework of the exchange economy, Smith explained the apparent inter-dependence of incomes and prices with an explicit realism. According to Smith "Wages, profits and rents are the three original sources of all revenue as well as of all exchangeable value, all other revenue is ultimately derived from one or the other of these."[15]

According to Landreth and colander (1989) Smith was interested in changes in the rate of profit over time. They give mechanisms, which according to Smith, will make the rate of profit decline over time. These reasons in principle boil down to the idea of competition in the labor, commodity and the investment markets.[16]

Pribram (1983), mentions that Smith tends to include profits and interest on capital among the costs of production. While sometimes Smith refers to profit as an increment over and above the exchange value created by labour, on the other occassions he characterises profits as deductions from such exchange values.[17] The first statement (i.e increment over exchange

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14 As this becomes the basis of the exploitation theory of profit advocated by Karl Marx

15 Smith, A, The Wealth of Nations, New York Modern library, 1937, p.248, cited in E.K. Hunt, History of Economic Thought, A Critical Perspective, Wadsworth Publishing Company, U.S.A, 1979, p.41

16 Due to competition prices whillfall and hence profits

17 See Pribram K; History of Economic reasoning. John Hopkins University Press, USA 1983 p 159.

value) challenges those advocating the labour cost theory with the task of explaining the reasons that make capital create exchange value in excess of value produced by labour in the previous and present production proceses. The second alternative (i.e deductions from exchange value) dismisses capital as an original source of exchange value and income and at the same time raises the question of why owners of capital could claim a portion of exchange value created by labour. It is interesting to note that in both cases, Smith was reluctant to provide any comprehensive answer. The only justification he gave, as described by Landreth and Colander (1989), is that labour permits the deductions of profits from its output because it has no material to work with and no independent means of support.[18] Smith believed that market mechanism establishes a wage for labour below the value of labour's output so that a margin was made available to the capitalist, he says "The value which the workmen add to the materials resolves itself into two parts of which the one pays their wages and the other the profit of the employer.[19] This illustrates that Smith, like his colleagues in the classical period, is of the view that the origin of profit is in the diversion of some part of the value created by the working members of society into the hands of dominant class. This shows a resemblance with the neo-classical explanation of Profit which advocates the right of the capitalist to

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18 Here profit is composed of two parts: a pure interest return and a return for risk, see Landreth and Colander, opcit p 72.

19 Smith A., Wealth of nations opcit, p. 66.

appropriate any residual after he has paid out all wages and costs of production. The only significant difference between Smith's view and that of the neo-classical economics is that while Smith locates the original source of profit in the normal appropriation by capitalists of a share of the value of the product of labour, the neo-classical economics has no way of explaining why the appropriation of residual should be persistent.[20]

DAVID RICARDO ON THE THEORY OF PROFIT:

David Ricardo (1772-1823), like the rest of the classical writers also believed that, it is the expectation of profit which motivates accumulation of capital and stimulates economic growth. His main concern is with the question as to how the produce of the earth is divided among the proprietors of land, owners of capital and the labour. The original preface of Ricardo's 'Principles of Political Economy and Taxation,' according to Dean (1980), stated categorically that the principal unsolved problem of political economy was to determine the laws which regulate the distribution of the national product between rent, profit and wages.[21]

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20 This is because of the basic assumption that competition prevents capitalists from economy wide conspiracy.

21 Dean P. <u>Evolution of Economic Ideas</u>, Cambridge, London, 1980, p. 60.

Although, like Smith, Ricardo is also said to be not very clear on the meaning of profit, his surplus theory is more clearly expressed than Smith's deduction theory. Ricardo's theory was to the effect that profits depend upon the difference between the product of Labour at the margin of cultivation and the subsistance of that labour; both being expressed in corn to be precise.

Dobb, (1975) summarizes Ricardo's profit theory in the following words "The rate of profit and interest must depend on the proportion of production to consumption necessary to such production".[22] Profit was thus expressed as a product-ratio to wages: The ratio is automatically reduced as the margin of cultivation was extended coupled with the decline of product of day's labor. In the 'Essay on Profit' (1815), Ricardo is of the view that, the general profit of capital stock depends wholly on the profits of last portion of capital employed on the land. His most important proposition is that profit in agriculture determines profits in the economy in general,[23] thereby introducing the fact that profits are determined by the relation between output and wages at the margin in agriculture. Thus, for Ricardo, profits decline only because of the inability to procure

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22 Dobb, M., Theories of Value and Distribution since Adam Smith, Cambridge University Press, U.K. 1975, p.70.

23 Although he later modified this proposition in the light of Intense attack by Thomas malthus. The modification went to the extent of allowing for the fact that labourer did not only consume corn but consumed some manufactured goods as well.

new land. Dobb (1975) goes on to provide a clear picture on the issue by saying that as a result of diminishing productivity of labour at the margin, as cultivation is extended, profits tend to fall as capital accumulation and population grow with it. This to some extent provides the missing link (explanation) in Smith's theory of tendency to falling profit.

COMPARISON BETWEEN SMITH AND RICARDO:

Adam Smith's greatest contribution to economic analysis is his explanation of self-interested economic agents operating under the framework of competition in the society. This proposition, coupled with his attack on the then prevailing view that the pursuit of self-interest by individuals is anti-social greatly helped in building the framework of market mechanism. The average level of profits on capital according to Smith depends on the accumulation of capital. According to Smith, "increases in capital stock are generally associated with falling profits as well as rising wage rates, for as mutual competition in the same trade will reduce the rate of return."[24] Since all capital is the result of savings, so, Smith thought that an increase in stock is the source of additions to the wage fund. What determines the demand for labour is the size of the wage fund. Given the wage fund, the size of the labouring population, determines whether the average level of wages will rise or fall. Both Smith and Ricardo are of the view that profit from different

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[24] Smith. A, The Wealth of Nations, Vol. 1, p.78, cited in Rima, I.H., Development of Economic Analysis, 4th edition, Richard D. Irwin, U.S.A, 1986, p.90

employments of Capital always tends towards equality. Both of them also believe that profits and wages always have an inverse relationship with one another. Because of the risk associated with every investment, Smith explained that the lowest rate of profit must be high enough to compensate for such losses and still leave a surplus for the entrepreneur.[25]

While Smith thought that the rate of profit would decline due to intense competition among entrepreneurs, Ricardo, thought that the rate of profit would decline because of the increasing difficulty in cultivation to feed the growing population.

NEO-CLASSICAL VIEW OF PROFIT: A GLIMPSE

Modern theories of profit in secular Economic literature mostly assume that firms are profit maximisers. They also believe that profits are an index of efficiency leading to movement of capital from one line of production to the other. It is interesting to note that the empirical investigation on current economic realities in the World clearly illustrates that these propositions are questionable and far removed from reality. The study by Burham (1941)[26] raised serious doubts about whether

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25 Oser, J., and Brue, S.L., The Evolution of Economic Thought, 4th edition, Harcourt Brace Javanovich Publishers, Florida, U.S.A, 1988, p.77.

26 See Burham J, The Managerial Revolution, Cambridge University Press, New York, 1941.

firms are solely motivated by profit maximization due to changes in their institutional character.

Also regarding the unrealistic nature of profit maximising assumption of the western economics, we can say that the secular economics has retained the assumption due to the lack of any viable alternative to sustain its own structure. In this regard (Hasan, 1992) elaborates the situation with the following statements - 'Secular economics has retained the profit maximisation assumption despite its unrealistic and even misleading character primarily for two reasons. First, price theory, the core of economics science cannot stand erect once the profit maximising 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.'[27]

Although our focus is on the two scholars of the classical period, it should be noted that both the physiocrats and merchantalists generally failed to note any difference between interest and profit.[28] The widespread and established feeling in the west that seeking of profit is in some way immoral started

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27 Hasan, Z, Profit Maximization; Secular versus Islamic, in Sayyid Tahir (ed) <u>Readings in Microecnomics</u>, An Islamic Perspective, Longman, Malaysia, 1992, p.239

28 See John, M., <u>Ideas of the Great Economists, 2nd edition</u> Barner and Noble Books, New York, 1980 p. 76.

from the time of the Medieval Christian doctrines of the just price.[29] This negative view was changed only when the sixteenth century Protestant reformers Martin Luther (1483-1546) and John Calvin (1509-1564) reinterpreted the Christian beliefs and provided a healthy perception of profit as a virtue.[30]

With the beginning of the twentieth century, Alfred Marshall and J.B Clark presented their own explanations on the components that constitute profit.

While the classical economists tried in vain to find the profit factor (the productive factor that generates profit), the neoclassical economists completely do away with the profit factor in their framework.[31] The non availability of profit factor in the neoclassical economic theory is due to the lack of any impact of uncertainty in the formal analysis. Then we have the profit theories of Knight and Schumpeter.

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29 See Shand H.A, <u>The Capitalist Alternative:</u> An Introduction to the Neo Austrian Economy, Wheatsheaf Books, U.K, 1984, p.119

30 Muhammad Arif, "Towards Establishing the Microfoundations of Islamic Economics: The Basis of the Basics", The Islamic Quarterly (London) Vol. XXVII No. 2, Second Quarter 1984, pp.61-72

31 Wu Shih Yen, Opcit p. 236.

Knight[32] and Schumpeter[33] tried to provide a concrete foundation for a meaningful profit theory. This, they do by the inclusion of uncertainty in their theoretical framework. Knight regards the bearing of uncertainty in the economy as the factor which gives rise to profits. To Knight, the presence of uncertainty prevents the resource owners from agreeing on a joint production policy through the market and thus destroys the markets ability to coordinate production. This situation, according to him would result in the emergence of the capitalist entrepreneur, who uses his own expectations and judgement to set production policy.

But in a situation of uncertainty, the market fails to reward factors of production equal to their actual contribution to the total output based on their marginal productivity. This is because "Input is demanded based on the expectations of future outcome instead of the future outcome itself" (Hasan Z. 1975 p.26).

In Knight's profit theory, the entrepreneur is identified with the capitalist. This necessarily confounded profit with interest. On this he said, 'It is useful however to distinguish between the return actually realised by an entrepreneur and the competitive rate of interest on high class edge securities where

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[32] Knight F.H.; <u>Risk uncertainty and profit</u>, New York University of Chicago, 1921.

[33] Schumpeter J.A. The Theory of Economic Development Cambridge, New York, 1934.

the risk and responsibility factor is negligible. However, it would not be fruitful to attempt an accurate separation of profit from interest.[34] Commenting on the analaysis of phenomenal profit by Knight, Hasan (1975) tries to explain that it is not consistent and is so broad in analysis for any serious study - According to him, Knights' analysis of phenomenal profit "lacks precision, suffers form internal inconsistensies and tends to lead economic discussion into the barren and conflicting interpretations of the probability theory.[35]

Schumpeter (1942) tries to explain the basic elements of the dynamics in the process of economic change. He regards the role of an entrepreneur as an innovator and profit as the reward for his innovation. He regards profit and interest as interchangeable and they all reduce to nothing as the nation's economy moves towards a static position. Economic development according to him, results from innovation. It is innovators supported by entrepreneurs who turn the economy into action. By encouraging prospective lenders to anticipate a high rate of return, thereby he makes innovations as a purely internal affair and an important investment for economic development. Though Schumpter's anlaysis has some useful ideas for constructing a new profit theory, yet his profit theory "leaves outside the city wall a large and important part of the city already in existence"

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[34] Knight F, opcit,p. 304

[35] Hasan, Z., <u>Theory of Profit</u>, vikas publishing House, New Delhi, 1975 p. 36.