A Comparative Study of Views and Role of Labor in Marxian, Mainstream and Islamic Economics

Presented at Islamic Economy Workshop (IEW) Conference in Istanbul, Turkey, 2015
Presentation Outline

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Introduction: Labor in Economic Literature

• In classical economics, labor theory of value was used as a framework to explain why prices of some goods were higher than others.

• If the production of a commodity requires more labor effort, the price of such commodities will be relatively higher.

• This theory remained in vogue in pre-industrial revolution era.

• Ibn-e-Khuldun also explained it much before Adam Smith, Ricardo and Marx used it to explain the production processes and determination of prices (Azid, 2010).

• Later on, this theory was replaced by marginalist revolution as foundation for demand and supply behavior in the marketplace.
Introduction: Labor in Economic Literature

• Another stream of literature in labor economics focuses on labor market itself and how wages are determined in the labor market.

• Frictionless labor market equilibrium is simple and a useful framework to analyze comparative static results of supply shocks and technological advancement on equilibrium wage and employment.

• However, the frictionless model is not able to explain the presence of unemployment and vacancies at the same time (Rogerson et al, 2005).
Introduction: Labor in Economic Literature

- Then, search models tried to fill the gap by adding frictions in the model to incorporate the empirical realities of the labor markets.

- Peter Diamond, Dale Mortensen and Christopher Pissarides are some of the prominent contributors in this strand of literature.

- Diamond (1982) and Mortensen and Pissarides (1994) explain wage determination in search models and how jobs are destroyed and created with frictions. This brand of literature is focused on positive explanation of empirical realities of the labor market dynamics.
Introduction: Labor in Economic Literature

- Another brand of literature in labor economics has tried to explain labor market rigidity, especially the wage rigidity to explain short run business cycle fluctuations.

- The wage rigidity is explained on the basis of differential work effort by the labor and tendency by firms to pay above-market clearing wages, i.e. efficiency wages to retain the talent pool and reduce tendency of labor shirking.

- New Kenysian and other economists have also focused on industrial organization and bring labor unions in the models to explain how insider-outsider relationships also result in wage rigidity.
Introduction: Labor in Economic Literature

• Still, another stream of literature has focused on explaining the micro foundations of labor supply and labor demand.

• To explain labor supply decisions at the micro level, mainstream microeconomic theory uses consumption-leisure framework for explaining the time allocation between leisure and working.

• Using this framework as a foundation, later studies have tried to explain the labor supply dynamics of immigrants, women, and minorities etc.
Scope of this Study

• To compare view and role of labor in mainstream and Islamic economics.

• To discuss how the frictions caused by the extractive institutions can be removed and hence how can we achieve circulation of capital and promote entrepreneurial culture for increased job creation.

• To analyze and suggest how labor exploitation can be removed without undermining innovation, private property rights and economic freedom.

• To explain how Islamic economics with its distinct worldview, work ethics and set of economic institutions solve these problems amicably in comparison to Marxian and mainstream economics.
A Critique of Marxian View of Labor

- In Marxian economics, it is argued that the labor creates surplus value in the production process and which the capitalists extract in an economic exchange.

- The surplus accumulates and this is exploitation of labor by the capitalists.

- However, upon closer inquiry, it is clear that the payoffs to the labor and the capitalists are different in the production process. Labor gets fixed wage; whereas, the capitalists earn random profit from the sale of a good or service in the production and exchange process.
A Critique of Marxian View of Labor

- Capitalists provide certain important functions to which Marx seemed to have given little importance. Capitalists provide employment to labor. Labor gets fixed wage irrespective of profit to the capitalists and which could be negative as well.

- Occurrence of losses at the height of industrial revolution was infrequent, but that did not suggest that profits are the necessary outcome of every production process for the capitalists.

- Capitalists compete among themselves and their competition in theory may bring prices down to the level of marginal cost. If there is allocative efficiency in the market, then the producer price is only as much as the cost of production which only includes the normal profit for the entrepreneur.
A Critique of Marxian View of Labor

- Furthermore, in the same countries where labor was exploited during the industrial revolution, the per capita incomes have increased manifold.

- We know by experience and data that most of the new startup firms fail and all capitalists are not always able to reap greater value than labor from the production process. Hence, capitalists take the risk of random profits, prices and sales fluctuations and they must have an incentive to take the risk.

- The incentive is in the ability to make profit from the sale of products. But, profits can be negative as well. As long as they are earning profits from the sale of goods (with intrinsic value) sold to willing buyers at competitively set market prices, it is not regarded as exploitation by Islam.
A Critique of Marxian View of Labor

• Also, social relations are not mutually exclusive these days. Employee stock ownership plans, general and limited partnership and joint stock companies have modified factor relations.

• In a joint stock company, there is no one big capitalist. There are small shareholders in large numbers. These shareholders are workers in other organizations.

• Now, scientists, programmers, and artists can have patents.
A Critique of Marxian View of Labor

• As per Marx, labor has only one thing which he can use to earn income, i.e. labor power. However, why does he not become a capitalist?

• It can be said that lack of seed capital acts as a constraint. But, in most developed countries, there is much less borrowing constraint. Then, why the majority of people do not become entrepreneurs by choice? If working class is always greater in number than the capitalists, then why most democracies do not overthrow market system?

• Markets create incentives, encourage competition and that allows capital accumulation, technological change, economic growth and transaction of wide range of goods as well as services.
A Critique of Marxian View of Labor

• The promise of equal wage and standard of living in communism is very attractive at its face value and especially to the masses that generally do not have highly employable and demanded skills, access to quality education and opportunistic circumstances.

• The argument that each person as a human being shall have equal rights and equal standard of living seems convincing.
A Critique of Marxian View of Labor

• However, it is a fact that people have different tolerance for risk, different innate abilities, different attitude towards progression in life and career, different levels of ambitions and as a result, they exert different levels of effort in acquiring education, skills set and as a result, their productivity levels are different.

• The difference in characteristics highlighted above may not necessarily be a result of discrimination. Most of these could be controlled and shaped by individuals and their intertemporal choices.

• Equating everyone’s compensation despite these facts would be unjustified.
Extractive Institutions in Capitalism Causing the Great Gap

• Nevertheless, there are two reasons why wealth inequality may still persist in a capitalist society: i.e. 1) interest bearing capital accumulation and 2) incapacitated wealth redistribution mechanisms.

• Both the absence of broad based wealth taxes and the legal decree of allowing compound interest on money capital are the prime sources of wealth concentration in a market economy.

• Das Capital, Volume III, Chapter 24 starts with this statement. 'The relations of capital assume their most externalized and most fetish-like form in interest-bearing capital.'
Extractive Institutions in Capitalism
Causing the Great Gap

• In an interest free economy, capitalists will not be able to systematically exploit in competitive markets. Competitive forces are also encouraged by egalitarian wealth and income distribution and wide circulation of capital rather than hoarding.

• 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. In an interest free framework, such debt servicing payments can be channeled into investment in human capital and public goods.
Extractive Institutions in Capitalism Causing the Great Gap

• The disincentive to enter in entrepreneurial pursuits because of lack of willingness of capitalists to risk capital while having the opportunity to earn fixed interest income reduces investment in the economy.

• Decline in the potential investment in productive pursuits reduces real sector economic growth, raise unemployment and it adds burden on fiscal position of the government to expend on transfer payments.

• Then, if more money is printed, it increases national indebtedness and which can eventually result in a country paying major portion of its gross national income every year in the form of interest.
Extractive Institutions in Capitalism Causing the Great Gap

• Islam removes the extractive institutions that perpetuate income and wealth inequality in an economy, especially the institution of interest and freedom to devise tax policy for elite interest groups in capitalistic democracies that put the welfare of future generations in jeopardy by excessive deficit financing and inflation tax.

• A uniform Zakat levy on wealth and produce can result in tax rate smoothing, automatic stabilization of business cycle and hence encourage long term investments and decision making without leaving the long term planner in the private sector to worry about fiscal policy reversals (i.e. Ricardian equivalence).
Differential Impact of Islamic Institutions on Labor Dynamics

- The principle of risk based productive enterprise can foster capital formation and entrepreneurship in an Islamic economy that disallows fixed return on money capital in the form of interest.

- Increase in investment through entrepreneurial activities will increase the labor demand and wages.

- Increase in wages will improve the standard of living of poor labor class and enable them to improve their productivity further. Productivity may also rise with the increase in capital per worker.
Differential Impact of Islamic Institutions on Labor Dynamics

• Islam has made it obligatory for every Muslim - men and women - to educate themselves and build their human capital and productivity to make effective use of resources.

• Islam has made it obligatory for Muslims to seek permissible source of income through entrepreneurship or offering their labor in productive enterprise.

• Hence, this will increase the effective and more productive labor supply and entrepreneurial capital at the same time.
Differential Impact of Islamic Institutions on Labor Dynamics

• Second, Islamic work ethics can resolve labor market imperfections, asymmetric information and conflicting incentives.

• Islamic work ethics stem not from the material incentive or legal requirement of engaging in righteous behavior, but from the concept of Tawheed and afterlife accountability and from which results a unique and distinct responsibility based concept of private property rights and socio-economic liberty within the bounds of responsibility set by Allah.

• Azid (2010) explains that the labor market in Islam is governed by the Islamic laws of fairness, justice and reward that is equivalent to the job done.
Differential Impact of Islamic Institutions on Labor Dynamics

• This set of beliefs give shape to the Islamic work ethics and which can have tremendous impact on the economic choices.

• For instance, in modern labor economics, it is suggested to pay premium wage to prevent people from shirking (underperformance).

• But, the belief of afterlife accountability will compel the person to use his skills in the just manner since if deliberate underperformance cannot be identified in this world, it will be brought for justice in afterlife.
Differential Impact of Islamic Institutions on Labor Dynamics

• Islam encourages people to avoid indebtedness and dependency. It has significant implication on labor supply. A Hadith says:

• “Narrated Hakim bin Hizam: The Prophet said,

“The upper hand is better than the lower hand (i.e. he who gives in charity is better than him who takes it). One should start giving first to his dependents. And the best object of charity is that which is given by a wealthy person (from the money which is left after his expenses). And whoever abstains from asking others for some financial help, Allah will give him and save him from asking others, Allah will make him self-sufficient.” (Sahih-Al-Bukhari: Book 24, No. 508)
Differential Impact of Islamic Institutions on Labor Dynamics

• Likewise, the Islamic concept of ‘brotherhood’ and ‘justice’ can help in avoiding the famous ‘insider-outsider’ problem in which the people already employed in the organization do not allow a change in policy which hurt their private incentive but which can bring a positive social change by increasing employment to the outsiders.

• Hence, the externalities are internalized in the decision making process by a person who believes in afterlife accountability and who regard his private property, social and professional authority and physical and mental faculties as a trust.
Differential Impact of Islamic Institutions on Labor Dynamics

• Islamic work ethics also affect the behavior of employer. Employers are directed to not overburden their employee, help them in work if necessary and pay them their due salaries without any delay.

• Imbued with values of Adl (justice) Ihsan (benevolence) and Ukhuwwah (brotherhood), the relationships between the employee and the employer will be congenial, peaceful and harmonious (Akhtar, 1992).
Differential Impact of Islamic Institutions on Labor Dynamics

- Prophet Muhammad (pbuh) said: “Give the labor his wage before his sweat dries”. [Ibn-e-Majah].

- In another Hadith, Prophet Muhammad (pbuh) said: “I will be foe to three persons on the Last Day: one of them being the one who, when he employs a person that has accomplished his duty, does not give him his due.” [Bukhari, No: 2109]
Differential Impact of Islamic Institutions on Labor Dynamics

- In another Hadith, employers are asked to treat their subordinates fairly and look after them.

- Prophet Muhammad (pbuh) said:

  “Those are your brothers [workers under you] who are around you; Allah has placed them under you. So, if anyone of you has someone under him, he should feed him out of what he himself eats, clothe him like what he himself puts on, and not put so much burden on him that he is not able to bear, [and if that be the case], then lend your help to him.” [Bukhari, No: 2359]
Achieving Egalitarian Income Distribution in an Islamic Economy

- Income function of an individual in Islamic economy can be represented by:
  \[ I_t = wL_t + E(\pi_t) + rA \]  
  --- (i)

- Where,

- ‘r’ is the rent on physical asset holdings ‘A’.
- Market wage is ‘w’
- Labor supply is \( L_t \).

- \( L_t \) is expected to be higher in an Islamic economy than in a capitalist economy. The reason is that the feasible income sources in an Islamic economy will not allow a perpetual income source which is a direct function of past accumulated wealth.
Achieving Egalitarian Income Distribution in an Islamic Economy

- $E(\pi_t)$ is income from direct and indirect participation in entrepreneurial activities for individual in time period ‘t’.

\[ E(\pi_t) = \sum_{j=1}^{k} p_j \pi_j \quad \text{--- (ii)} \]

- Provided that $0 < p_j < 1$.

- ‘$p_j$‘ is the profit sharing ratio in project ‘j’ agreed for time period ‘t’ at time period ‘t-1’.

- ‘$\pi_j$‘ is the profit in project ‘j’.

- If a person is the sole entrepreneur in some project ‘j’, then $p_j$ will be equal to unity.
Achieving Egalitarian Income Distribution in an Islamic Economy

- It can be seen that in an Islamic economy, there is no provision for risk-free income.

- The legitimate sources to earn include income from providing factor services like labor, land in ownership, possession and risk and any other income from entrepreneurial undertakings in investment opportunities in the real sector of the economy.
Achieving Egalitarian Income Distribution in an Islamic Economy

- If the average ex post realized return from investment opportunities is low, the household will have to increase labor supply to compensate for the lower income from entrepreneurial investments.

- Increase in labor supply will reduce wage bill for the production sector and hence it will increase the ex post realized rate of return from entrepreneurial investments.
Achieving Egalitarian Income Distribution in an Islamic Economy

• Hence, this adjustment process of capital mobility and labor market transitions will lead to an equilibrium state where the share in income of the workers and capitalists are closer to each other except for differences in risk tolerance, risk preference, effort and skills.
Labor Supply Choices & Market Equilibrium in an Islamic Economy

• In this section, we present a simple model that explains how the labor allocates time between leisure and working for generating enough income to purchase a given amount of consumption goods.

• Suppose a person wants to consume goods and services and he can generate purchasing power by earning labor and non-labor income.

• In a capitalist economy, the person can earn interest on accumulated wealth. In an Islamic economy, this source of non-labor income is not allowed.
Labor Supply Choices & Market Equilibrium in an Islamic Economy

• The total time can be spent on either working \((n)\) or in leisure \((l)\). Total time can be normalized to 1. So,

\[ n + l = 1 \quad \text{--- (iii)} \]

• Total income is given by the equation (iv):

\[ I = nW + rC \quad \text{--- (iv)} \]

• ‘\(I\)’ is total income.
• ‘\(C\)’ is accumulated wealth which can be invested to earn interest income.
• ‘\(r\)’ is the rate of interest offered in a conventional economy.
• ‘\(W\)’ is the nominal wage.
In an Islamic economy, ‘r’ will be zero and hence the second term in the income function will disappear.

For the purpose of highlighting the difference between interest free and capitalist economy, we ignore other legitimate means of earning non-labor income like rental income and profit on equity investments.
Labor Supply Choices & Market Equilibrium in an Islamic Economy

• The person can consume this income on buying consumption goods. Hence, the budget constraint is given in equation (v):

\[ Pc + Wl = nW + rC \quad \text{--- (v)} \]

• Where ‘P’ is the price of composite consumption good and ‘c’ is the consumption expenditure. The left hand is the expenditure and right hand side shows the income. Here, the cost of leisure is the nominal wage ‘W’ forgone.
Labor Supply Choices & Market Equilibrium in an Islamic Economy

• Solving (v) for ‘c’, we get equation (vi):

\[ c = \frac{(n-l)W}{p} + \frac{rC}{p} \]  --- (vi)

• The second term will disappear in an Islamic framework, so the person will have to either supply more labor or invest more capital in entrepreneurial investments either directly or through financial markets or intermediaries in order to achieve the same level of consumption.

• Both decisions will increase market employment with rightward shifts in labor supply and labor demand curves. Hence, in an Islamic economic framework, not only the employment opportunities increase, but there is also a simultaneous increase in self-employment and entrepreneurial pursuits (Khan, M. Faheem, 1992).
Labor Supply Choices & Market Equilibrium in an Islamic Economy

Next, we show the labor market equilibrium in an Islamic economy. Let the labor supply function be represented by equation (vii):

\[ NS = a_0 - NW + w - TR \quad --- (vii) \]

Where,

- ‘NS’ is the labor supply.
- ‘NW’ is the net wealth after Zakat payment.
- ‘w’ is the market wage per unit of labor employed.
- ‘TR’ is the transfer receipts.
- ‘a_0’ is the catch all term for all other variables.
Labor Supply Choices & Market Equilibrium in an Islamic Economy

• We can see that effect of rise in NW is negative on LS.

• With the institution of Zakat, NW will be decreasing function overtime.

• Hence, the labor supply is expected to be positively influenced by Zakat. Increase in labor force participation will also increase the total income accruing to laborers.
Labor Supply Choices & Market Equilibrium in an Islamic Economy

Let the labor demand function be represented by equation (viii):

\[ ND = a_1 - w \quad --- \text{(viii)} \]

Where,

- ‘ND’ is the labor demand.
- ‘w’ is the market wage per unit of labor employed.
- ‘a_1’ is the catch all term for all other variables like productivity, capital stock etc.
Labor Supply Choices & Market Equilibrium in an Islamic Economy

• In equilibrium, ND = NS.

\[ a_0 - NW + w - TR = a_1 - w \]
\[ 2w = a_1 - a_0 + NW + TR \]
\[ w = \frac{1}{2} \{a_1 - a_0 + NW + TR\} \]

• Equation for equilibrium employment is:

\[ N = a_1 - w \]
\[ N = a_1 - \frac{1}{2} \{a_1 - a_0 + NW + TR\} \]
\[ N = \frac{2a_1 - \{a_1 - a_0 + NW + TR\}}{2} \]
\[ N = \frac{a_1 + a_0 - NW - TR}{2} \]
Labor Supply Choices & Market Equilibrium in an Islamic Economy

- We can see that:
  \[
  \frac{\partial N}{\partial NW} < 0 \quad \frac{\partial N}{\partial a_1} > 0 \quad \frac{\partial w}{\partial a_1} > 0
  \]

- Hence, the Islamic economy will have the incentive in the form of higher wages for productivity enhancement from human capital development.

- Firms will also be encouraged in that system to invest in human capital because the barriers to entry in industries will be removed by disallowing fixed compensation to money capital.

- It will enhance the circulation of wealth and encourage widespread entrepreneurial culture. Hence, it will also increase the numbers of firms and boost competition.
Thank You

For any queries, feedback & suggestions

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