

A Comparative Study on Capital Formation in the Usury and Non-usury Economic Systems

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Abstract

The rule of ideologies which ban interest or usury which is earned through lending money has led to developing economic systems that differ from conventional economic systems in which interest has been entered. The presence of systems not relying on interest, in turn, has questioned the necessary motives in capital establishments through savings. In this paper, while defining the concepts of money, capital and attribution of interest to money and profit to capital, a comparative study has been carried out to study the characteristics of capital establishment in the usury and non-usury based economic systems. It has been shown how these two systems differ from each other in terms of production costs, amount of profit, risk acceptance, increased supply of goods and services and general level of prices. At the same time, the important issue of supplying financial provisions for non-investment projects and related indexes have been studied accordingly.

Keywords: Loan, usury, profit, capital, capital establishment, risk, hoarding, transaction value, financial supply.

1- Introduction

With the passing of several centuries in the Islamic world people, particularly Moslem economists have shown their intention and interest to determine the function of an Islamic economic system. Many books and papers have already been published in this respect. The effective elements in the function of economic system as considered by Moslems are compatible with conventional economic systems in some instances and contradict, or confront

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the said systems in other cases. This issue has led to many arguments and challenges which are both deep and important. One of the issues which has been raised on the non-usury economic system has been that, since receipt and payment of interest to money (usury)^[1] according to the Islamic codes^[2] is prohibited; thus, this economic system lacks the means to encourage and motivate its followers to save and ultimately, invest. In other words, the non-usury economic system does not lead to capital collection. And since, economic development and growth requires a considerable amount of capital, those systems which manage their economies with a usury banning ideology, due to not benefiting from a considerable saving suffer from problems caused by this economic behavior and accordingly, they are not placed in the growth path and ultimately, economic development. Since it seems raising such issues is mainly due to disregarding the differences in legal and economic issues, in this paper, while the type of legal relationship which provides means for interest or usury collection and showing this implication that there is the possibility to benefit from money in other methods for acquiring profit, this reality is proved that in the economic system of Islam there are other means and grounds to motivate people to have saving and provide necessary funds for investment in economic affairs. A comparison between the privileges and advantages of an economic system which is not based on interest over a usury-based economic system shows that Islam's thinking of the best interest in issuing economic instructions enjoys sufficient tools and means for being managed and accordingly, how they have manageable guarantees in this connection.

2- Money, Capital and Interest

In economics, "money" is defined with its tasks, and with respect to the fact that in different economic literature no difference has been made between "money" and "capital", as an introduction, the differences between the concept of "money" and concept of "capital" are pointed out:

One may well say that in addition to its three-fold duties, money has played roles in the economic life of human beings in various forms. It has "purchase power" and/or contains "exchange value" in such a way that its owner might think in the abstract and actually practice acquiring and obtaining parts of the goods and services he has in mind without considering personal concerns and relationship in this respect. This "purchase power" or "exchange value" despite changes in time and place and also, changes led to money attribution,

could always be accepted by people as well. In another words, any object or concept which is introduced as an unreal attribute of money, since it has “purchase power” and/or “exchange value” is desirable; however, the implications of “purchase power” and/or “exchange value” such as check or receipt, though being actual and real goods, dose not fit the concept of “money”; but, it merely represents money. At the same time, since “money” is not known as an actual good, it is different from “capital” which is an actual good and is the result of changes and possession of work force in nature. Capital or capital goods which are realized in form of buildings, constructions, machinery and stock and have share in establishing new physical values might take also the form of “money”. However, when it is capital goods; that is, when it is an actual good, it is not “money” any more, for the latter is an implication and secondary category and when it is changed into “money” it is not an actual good or “capital” anymore. Thus, “money” is different from “capital” and thus, care should be taken in its usage.

The important fact in the process of investment in banks or direct lending^[3] of “money” is the important point that a legal relationship is established between the lender (or vendor) and the borrower (or investor) through which, the lender puts the borrower in position of an owner of the former money for a certain time. The lender would be able to do any act with the said money and at the end of the period, the principal amount of money is then paid back to the lender along with a certain amount of money, as being specified in the beginning of this lending process. What Islam has banned is that in such a situation, the subject of money transaction is “ borrowing” or “loan” and receiving any excess than the principal money under terms such as interest or usury is not permitted. However this banning the use of “money” for its increase in form of “lend” does not prevent other methods of using the money and earning an extra amount^[4] of which procedure one may point out the method of converting money to capital or capital goods and sharing it in the work force is a factor. Another item that can lead to establishment of added value which probably might lead to “profit” after deducting production costs from the income, is a phenomena which is not only recognized by non-usury economic systems but is also emphasized. The important point is that, the amount of interest or usury should be specified in the course of concluding the contract for “lending” and has nothing to do with the method of using the loan, while in the course of activities which lead to profit, the economic effort along with the risk

taken is discussed. Although the share of investor might be specified in the beginning, the amount is not clear since it follows the economic conditions of the period of activity. Thus, profit is intrinsically different from interest or usury while profit is attributed to the capital and interest or usury is attributed to money. In the economic systems which are not based on interest, money- that could have probable income- might be converted into capital and after participating in goods production process or services, might earn profit. While in the economic systems which are based on interest, the money , without any risk, benefits from an interest with fixed and pre-determined rate in the course of “loan”.

3- Studying the Probability of Capital Formation

In the economic systems which are based on interest, the major motive to offer money in the monetary market is to earn interest and this category is prohibited in the systems which are based on banning interest receipt. In some instances, it has been argued that in non-usury (interest free) economies, essentially there is no motive to offer money in the market or save it to become grounds for capital establishment and subsequently, the possibility of capital collection is out of question. This expression comes from lack of attention to the difference between the nature of “money” and “capital” which was explained in aforementioned parts. However, in the usury systems, the point that acts as a strong motive for saving and investment is the “interest” while in the non-usury economic system, the “profit” earned by investment makes the motive. Thus, the course of receipt or acquiring the extra amount against working with money is present in both economic systems while in usury systems, the common procedure of loan or lending is to receive “money” and interest and in the non-usury systems, it is to convert the money into capital and make investment and receive profit.

Notwithstanding this case, it should be noted that although receiving interest against lending money in non-usury systems is banned- a factor that might seem to be an anti-motivation- since collecting treasures has been strongly criticized by the ideologies that support non-usury economic systems; for those who believe in religion, as paying and receiving interest is unacceptable, in the same token, putting money away from production process (treasure collection) is also an undesirable act and is subject to accepting due consequences. Thus, it is observed that along with the motive of acquiring profit, there is also another

institutionalized motive that prohibits idle treasure collection which reveals the stability of possibility of capital formation in non-usury economic systems.

4- Comparative Study

In order to have a comparison between characteristics of capital formation in usury and non-usury economic systems, the following cases should be studied.

4-1- Production Expense

In equal conditions at the input and product markets, the production cost (cost price) of the products in non-usury economics is less than production costs in the usury-based economic systems. The reason is that, in the non-usury systems no interest is paid to the capital or money factors and thus, in the costs function, there is no item titled as “interest” of money in the cost statements. As a result, the total amount of production in equal conditions, is less than cost price in the usury based economic system, for an amount equal to amount of interest which would have been exchanged if the system had been a usury economic one. If we go deep in to this subject in the form of a firm, like a bank, we see that while in interest- based banks, paying “interest” to the deposit holders is a part of bank expenses and receiving interest from “loan” recipients is a part of income of the bank, in the non-usury banks, since there is no interest to be paid to the account holder; there is no such expense for the bank in this respect. Also, due to banning any receipt of interest from capital receiving party (converting money to capital) no amount is registered as interest in the investor’s cost.

4-2- Profit

It is obvious that when the conditions of 4-1 is present, profit in the usury-based economic system is less than its amount in non-usury economic systems. This very factor is the most influential motives for investors’ and account holders’ efforts whose deposits are in the process of being converted into capital. Therefore, if the cost of lending money under the title of interest is α , the two sides of the following relations would be organized in such a way that in the first one, less profit is earned than the second one- which is a non-usury economic system.

$$\pi = TR - Tc$$

(Interest based economic system):

$$\pi_1 = P \cdot q - (w + \alpha + \dots) \quad (1)$$

(Non-interest based economic system): (Interest based economic system):

$$\pi_2 = P \cdot q - (w + \dots) \quad (2)$$

$$\text{So } \Rightarrow \pi_1 < \pi_2$$

4-3- Risk

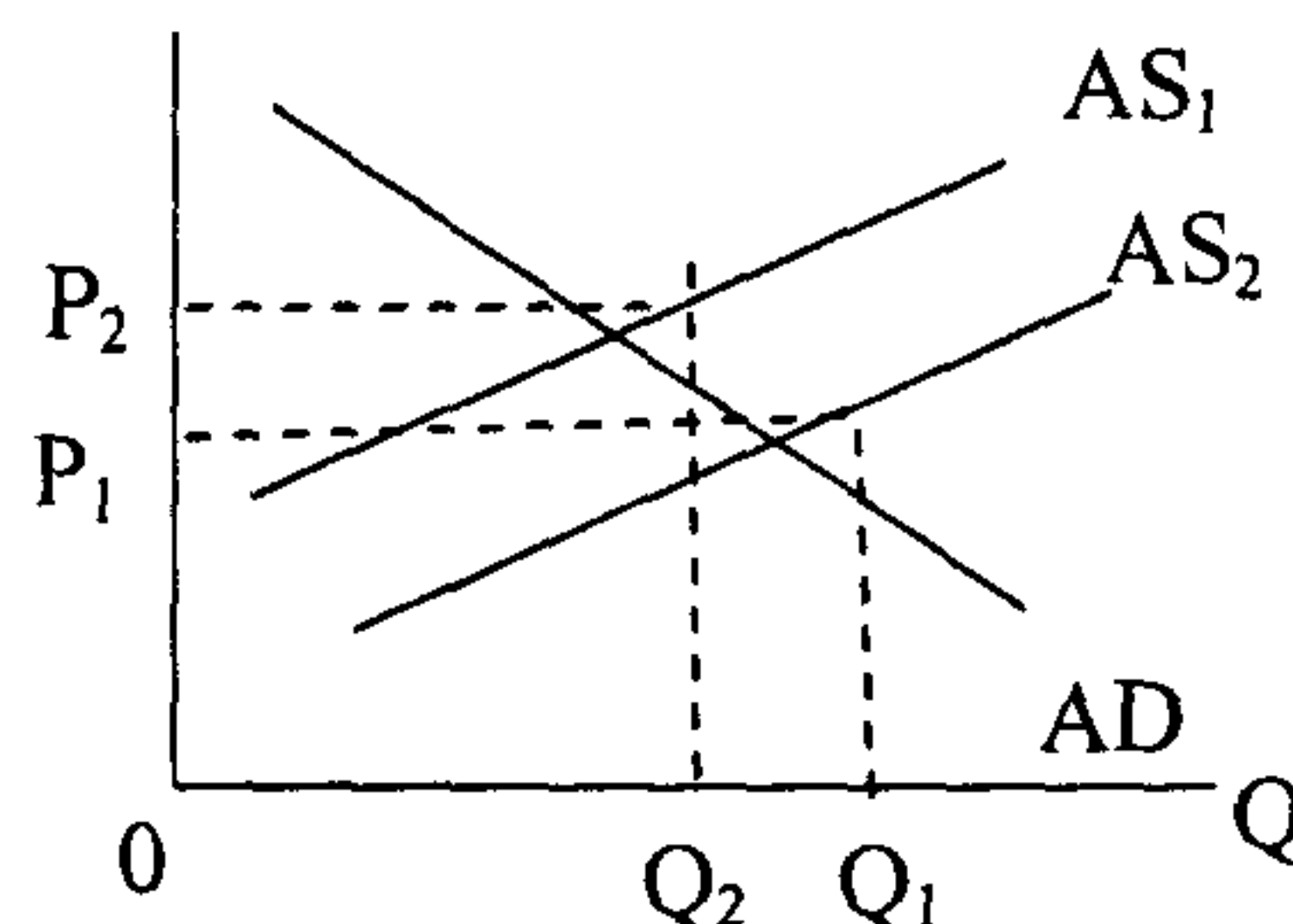
Of the most important characteristics of a non-usury economic system is risk taken by capital investors (vendors) or (deposit holders) whose money, on behalf of them, is converted into capital by a financial firm (that is, the investor experiences a less or more profit or probably a less or more loss in the investment process by being shared in the investment. The existence of such situation causes that maximum care would be made so that the capital owner would follow more success in the investment process and lower the risks in his investment through more care in appointing an experienced attorney and professional experts and ultimately, accept any probable loss as well. While in interest-based economic systems, the deposit owner who is lending his money would subsequently accept no risk since he is facing a fixed interest which rate has been already specified before transferring the money. This risk rejection is considered as a deposit holder's disregard to the production functions or speculation which is made in connection with money, since it makes no difference to him what is being done with his money, the only thing that matters is to ensure the interest flow to him.

4-4- Offering Goods and Services

Supposing an equal condition, it is obvious that in the non-usury economic system, at least for two reasons, the offering of goods and services which form the actual market of good are more than their counter case in usury economies. The first reason is lower production cost as pointed out before and the second reason is that, since money can not have any interest unless it is converted into capital and by being converted into capital it provides means for participation in production of goods and services in a more realistic form; thus, presenting goods and services is more probable than in the cases when there is no assurance of the entry of money in investment flow. As a result, even if general demand for goods market is equal in both usury and non-usury economic system, it might be

well expected to have lower price level in non-usury economic system since the total supply is higher.

In this diagram, AD is total demand and AS_1 is the total supply of goods and services in a usury system and AS_2 is the total supply of goods and services in a non-usury system where, we have $Q_1 > Q_2$ and $P_1 < P_2$



5- Criteria for Selection the Plans

One of the differences between interest based systems and non-usury systems is that, in the first type system, to invest in productive or substructure and social projects the comparison between local output rate of investment and interest rate is used; in this way, those projects are financed where their internal rate of investment output is more or equal interest rate and if this situation occurs by which, the internal rate of investment outputs of projects is less than interest rate, it is preferred to refrain from carrying out those projects since the money which is going to be used for those affairs could be used in other instances with more profit or at least profit equal to the interest rate. Thus, there are always some projects which are not executed for the reasons mentioned above and in this way, the supply of goods or services in the actual market of goods becomes a subject of decrease and does not increase. While in non-usury economic systems since there is no interest rate to feed the loan market, while the projects subject to investment have positive local output for investment they would maintain their executive capability in case of any capital, for there is no limiting factor for them, such as interest rate. The importance of this point lies in the fact that unused money and treasure collection is banned in the Divine Religions and the owners of money are not permitted to keep it idle and out of production process. Therefore, there would be no justification to refrain from investments in low output projects with the argument of a low internal return rate of investment and one should expect that in equal demand conditions, the price levels will be lower than similar cases in usury-based economies.

6- Conclusions

Although non-usury economic systems have not been actually realized in the economy, since in theoretical terms they have such a stability and strong foundation that offer a logical and compatible theory organization, in these systems, despite the common supposition, the motives to invest and save not only does not get weaker, but also through measures that are presented, those who believe in banning any receipt or giving usury against money lending would convert their money into capital and by receiving the profit of investment which, by chance- in equal conditions of variables- are more than usury-based systems, they would have highest motives. On the other hand, the unfavorable nature of treasure collection strengthens this issue. In non-usury economics, by capital formation they are able to lower the cost of producing goods and services and as a result, earn more profit for active firms in this respect. The investors in these systems are risk taking parties and participate in profit and probable loss of their investment since all their efforts are strengthen the actual market of goods and services and thus, they exhibit lower price levels than usury systems and in conclusion increase the welfare of the society. Also, the non-usury systems provide the possibility that all those productive, substructure and social projects which have positive internal output and have the means to be financed would become operational and bring along economic subsequences such as employment and production.

Footnotes

- 1- There might be some people who make a difference between “interest” and “usury” and so, find the orders governing usury as incompatible for “interest”. Without arguing this claim, we should remind that in this paper, interest and usury have come as equal terms.
- 2- Koran in verses 275 and 276 and also 278 and 279 states: Those who receive usury will not rise from graves in the judgment date unless like those who became made by Devil’s persuasion. These people commit the ugly deed of usury only for they do not differ trade and usury. You who have believed, be afraid of God and if you are true believers, do not take usury. Thus, if you do not reject usury, be aware that you have fought against God and his Prophet. If you become remorseful of this act, the principal amount (capital) belongs to you (not more) so, you have neither made cruelty nor receive cruelty.

- 3- Concept of lend and loan in Civil Law.
- 4- Verse 275 in Baghareh : Those who believed usury is like trade while God made trade acceptable and banned usury.
- 5- Verses 34 and 35 of Tobeh: Those who make treasures of gold and silver (currencies) and for world pleasure, warn them to the painful suffering- the day when they burn in hell. Their backs and forehead will be burned in the hell and this is the result of saving gold and silver (in world), now taste this suffering for the gold and silver you collected.

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