

## 1. INTRODUCTION

The Islamic financial system and its economic system have been under discussion for about two decades. Allocative efficiency has probably been the issue that has been most widely and most rigorously discussed. Such issues as stability and growth have also received substantial attention. Employment and human resources mobilization, however, is one aspect which, though it has been discussed in various forums, has not been discussed and controlled in a systematic manner. The purpose of this paper is to discuss the Islamic financial system in the context of human resources mobilization. The Islamic financial system emphasizes that the system has a more powerful built-in model of human resources mobilization than existing models of employment and human resources mobilization discussed in conventional economies.

# **HUMAN RESOURCES MOBILIZATION THROUGH THE PROFIT-LOSS SHARING BASED FINANCIAL SYSTEM**

**Mohammad Fahim Khan**

**ISLAMIC DEVELOPMENT BANK JEDDAH, SAUDI ARABIA**

**Courtesy of Islamic Research & Training Institute,  
Islamic Development Bank where this has been published  
as Research Paper No. 17**

# 1. INTRODUCTION

The Islamic financial system and its economics have been under discussion for about two decades. Allocative efficiency has probably been the issue that has been most widely and most rigorously discussed. Such issues as stability and growth have also received substantial attention. Employment and human resources mobilization, however, is one aspect which, though, recognized and referred to in literature as well as in seminars and conferences<sup>(1)</sup>, has not yet been subjected to rigorous discussion and formal presentation as an independent and important aspect of the Islamic financial system. This paper is an attempt to make a formal presentation on the employment and human resources mobilization aspect of the Islamic financial system emphasizing that the system has a more powerful built-in model of human resources mobilization than existing models of employment and human resources mobilization discussed in conventional economics.

Mohammad Fathur Rahman

ISLAMIC DEVELOPMENT BANK, JEDDAH, SAUDI ARABIA

Courtesy of Islamic Research & Training Institute

Islamic Development Bank where this has been published

as Research Paper No. 17

## 2. SIGNIFICANCE OF THE ISSUE

The human resources mobilization aspect of the Islamic financial system has significance from two perspectives. Firstly, the majority of Muslim countries are faced with low labour force participation, high (open and disguised) unemployment rates and extremely low wages and labour incomes. Despite more than four decades of trying different growth and employment strategies, most of these countries have failed to get out of the trap.

If the Islamic financial system offers hopes for the mobilizing of human resources and solving the problems of unemployment and the underutilization of human resources, then this is worth studying for the benefit of Muslim countries in order to point out to them the alternate strategies that are a part of their Islamic heritage.

Secondly, those Muslim countries which intend to Islamize their financial or economic systems are likely to face the problem of how to justify this on economic grounds. Although the theoretical discussions on the Islamic financial system have rigorously proved that in the long-run the Islamic financial system will make every-one better off, the conversion to the Islamic financial system may be a costly proposition, at least in the short run. This cost, of course, will have to be paid by the savers (by receiving lower returns) and by the investors (by paying the higher cost of capital).

The economic case for Islamizing the financial system of a Muslim economy can be made only if it can be linked to solving one of the immediate problems facing the economy. If the Islamic financial system can be shown to be conducive to human resources mobilization, then the policy of converting to the Islamic financial system can specifically be linked to the programs alleviating unemployment and poverty which even in the short-run, will make the conversion more acceptable and more fruitful. Linking the Islamic financial system with human resources mobilization will give a substantial edge to the argument for Islamizing the financial system and many Muslim countries faced with a reserve of unemployed and low paid human resources may find persuasive economic arguments for moving towards the Islamic financial system.

### 3. REVIEW OF EXISTING MODELS OF EMPLOYMENT

Before presenting the human resources mobilization aspect of the Islamic financial system, it may be instructive to review the existing models of employment and human resources mobilization particularly from the point of view of their relevance to existing financial systems.

Economic theory suggests various models that explain how the employment level is determined in the economy and what factors create a divergence between the supply and demand of labour, thus, creating unemployment (only major categories of models are reviewed below).

#### 3.1 CLASSICAL (COMPETITIVE FREE MARKET) MODEL

According to this model, the marginal productivity of labour determines the demand for labour at various levels of wages and the marginal utility of leisure determines the supply of labour to work at different wage rates. Supply and demand simultaneously determine the equilibrium level of employment.

According to the model, the mobilization of involuntarily unemployed resources would require an increase in the marginal productivity of labour, which would shift the demand curve upwards. The marginal productivity can be increased either by providing education and training to build up the human capital of labour or by raising the amount of physical capital per worker.

Although the option of raising the levels of education and training for the purpose of human resources mobilization has its own merits, its effectiveness in reducing the problem of unemployment is severely constrained, particularly for the developing world, for the following reasons:

- 1) Education and training involve heavy initial capital investment before they can bring about any significant increase in productivity. Developing countries facing an acute shortage of resources fail to give the necessary priority to the education sector in their investment plans. The lag in the investment in education and training and the realization in productivity increase may also result in a mismatch of supply and demand. Unemployment may persist for a considerable period of time.

- 2) Building up the human capital of labour in the economy may shift the supply curve as well, and despite the increase in productivity, the equilibrium level of employment may not significantly change.

The other option (raising the physical capital per worker) can be exercised in two ways: (1) by raising the capital of existing entrepreneurs/employers which in turn would generate a new demand for labour, or (2) by promoting new entrepreneurs out of labour which has no capital. The financial system of an economy plays an important role in this respect as it has to mobilize capital and distribute it in the economy in a way that not only improves the productivity of labour, but also motivates entrepreneurs to benefit from this productivity by increasing the demand for labour.

The capital and financial markets have to ensure that:

- (1) the system does not create a bias towards promoting capital intensive (labour saving) technology, and
- (2) the system does not discriminate against enterprises that create more employment.

The financial and capital markets in developing countries generally lack these features. These markets have developed in such a way that they concentrate on financing more capital intensive technologies in large enterprises which generally do not accelerate employment generation.

Besides, the model also fails to address itself to one very peculiar situation which generally prevails in several developing countries. This is the phenomenon of low labour force participation. The above mentioned model can suggest policies only for creating employment opportunities for those who are involuntarily unemployed, i.e., for those who are explicitly looking for work. The model makes no suggestions for those people of working age who are out of the labour force because they do not have economic opportunities of their own choice (or of the choice of their family) and at the place of their choice (or the choice of their family). Various moral and ethical considerations necessitate this behaviour in developing countries, in general, and in Muslim countries, in particular.

This stock of human resources is also required to be mobilized, firstly, because they are of working age and, secondly, because they have the willingness to contribute to their family income provided they get work that does not violate the social and ethical norms. The fact that there has been a willingness in this stock of human resources to enter into the labour market whenever suitable opportunities arise has been demonstrated, em-

pirically, in several countries. There are countries in Asia and Africa where the open unemployment rate has either remained at a very low level or has increased during the last 30 to 40 years despite the fact that job opportunities in those societies increased at a rate much higher than the growth rate of the population of working age. This merely suggests that the population previously reported out of the labour force is entering the labour force as soon as suitable opportunities arise<sup>(2)</sup>.

### **3.2 CLASSICAL (UNLIMITED SUPPLY OF LABOUR) MODEL**

The phenomenon referred to above is similar to what has been reported as the unlimited or perfectly elastic supply of labour by Arthur Lewis<sup>(21)</sup>.

The model suggests that the modern sector be pumped with capital so that the labour demand curve rapidly shifts upwards taking advantage of the minimum subsistence wage until the turning point is reached where further demand for labour comes with the increase in wages and the subsistence sector vanishes. Investment will continue to be needed in the modern sector until the sector absorbs all the stock of human resources.

The financial system is required to mobilize and channel necessary resources for investment into the modern sector. The modern sector has the credit worthiness to attract finances. The lure of jobs in the modern sector (accompanied by the temptations of the urban sector where the modern sector is located) mobilizes the human resources to demand these jobs even at a minimum subsistence wage. The modern sector, thus, is supposed to be a catalyst for mobilizing human resources. The success of the model greatly depends upon the investment decisions of the modern sector. The model suggests that minimum wages will generate higher profits for the modern sector to invest and this, along with other sources of finance, should accelerate investment and, hence, employment. But there is no compulsion in the system to induce the modern sector to reinvest the high profits or to allocate the finances acquired from other sources so as to accelerate employment generation<sup>(3)</sup>. "A great deal of documentation is now available to show that many countries so distorted incentives and signals in favour of capital that employment was heavily penalized"<sup>(4)</sup>.

The model suggests that minimum subsistence wages be maintained until the economy is developed enough so that all surplus labour is absorbed. This is bound to create class conflict. Empirical evidence from

several developing countries that worked on this model shows that serious political instability due to labour unrest arose as a result of the widening differentials in the income of labour and capital owners. This phenomenon is undesirable from an Islamic point of view as well.

Furthermore, this model, initially, envisages only a simple transfer of labour from the traditional sector to the modern sector without affecting the economic conditions of the labour class. It is only after all surplus labour is absorbed at subsistence wages that labour incomes start to increase (provided that the class conflicts and labour unrest do not put the model off the track before the turning point is reached). Although labour is mobilized in the sense that labour is moved from disguised unemployment to a more productive modern sector, this mobilization does not have much significance from the point of view of the economic conditions of labour itself.

Also this model does not take into account the fact that not all labour in the traditional sector in rural areas may be willing or be allowed to move to the modern sector which is mostly in urban areas. This will particularly be true for the female population and for younger and the older males.

### **3.3 NEO-CLASSICAL (PRICE-INCENTIVE) MODEL**

This is an extension of the classical (competitive free market) model discussed above. This model suggests that it is not absolute low wage levels that lead to employment expansion, but rather it is the reduction in the price of labour relative to the price of other factors of production, i.e., capital, that can generate more employment for unemployed human resources. According to the price theory, the reason for the low rate of utilization of labour force in developing countries, lies in a variety of structural, institutional and political factors that make the effective price of the utilization of human resources higher than the effective price of the utilization of capital, particularly that of financial capital. Some of the factors that are usually referred to in this respect include minimum wage laws, the role of trade unions, low or negative real rates of interest, protection on imported capital, etc.

The policy prescription of this model is : "set the prices right" so as to allow price incentive to work for better utilization of human resources.

Although, in principle, this policy makes sense, it fails to recognize several elements.

Firstly, in most developing countries, income inequalities are so high that further reductions in the relative price of labour will lead to serious political costs without achieving economic results.

Secondly, even a reduction in the relative price of labour may not bring the desired results in terms of employment expansion because the response to the reduced price will depend on the elasticity of the labour-capital substitution. Empirical studies<sup>(5)</sup> relating to the elasticity of substitution in the manufacturing sector place it between 0.5 to 1.0. This means a 10 per cent reduction in relative wages will lead to a 5 to 10 per cent increase in employment. Not only is this insufficient to solve the human resources mobilization problem, but it also leads to reducing the income of the labour class as a whole. In some developing countries, these elasticities may even be lower, reflecting an almost fixed co-efficient production function.

The model poses two dilemmas. Firstly, development requires accelerated investment, which in turn requires reducing the price of capital (including the price of financial capital). A downward pressure on the price of capital with an inability to reduce wages (being already at subsistence level) puts the price-incentive against employment expansion. Hence, the model has little to offer to developing countries which want to develop along with expanding employment.

Secondly, there is the question of how to define and then correct prices so as to use the price-incentive for promoting very small self employing enterprises in the so-called informal sector which can play a significant role in mobilizing human resources. All those who fail to get or do not want to get a wage-paying job have the option of doing their own work provided that they get the opportunity to do so. The bulk of human resources reported outside the labour force (particularly the female population) in several developing countries falls into this category. This option, however, cannot be exercised without some financial support. The financial system, therefore, has a significant role to play in mobilizing human resources to exercise this option.

Human resources intending to exercise the option of self-employment may not have the collateral to obtain the needed financial capital and even if they arrange the collateral, the repayment of capital with interest may be impossible if they are unable to earn a sufficient profit/income. Risk bearing is too costly for them. What does the price-incentive model suggest for this kind of employment? What correction in factor prices is needed



to promote self employment among those who fail to get a wage paid job? We need something more to add to this model in order to achieve the desired results with respect to human resources mobilization.

### **3.4 NEO-CLASSICAL THEORY FOR LOW PRODUCTIVITY AND SUBSISTENCE LIVING IN AGRICULTURE AND URBAN INFORMAL SECTOR**

The models discussed above deal with determining wage-paid employment in the modern sector. A major concern of the human resources mobilization program is the motivation of all labour employed in the rural sector and in the urban informal sector where productivity and incomes are extremely low. Efforts are required to improve their economic status and increase their productivity/income as part of any human resources mobilization program.

The rural agricultural sector provides a typical example of such resource mobilization where almost everyone is seemingly employed but their extremely low productivity, low income and subsistence living requires them to be mobilized to look for better economic status. Despite the need for a separate theory because of the peculiar nature of this sector, not much has been written on the subject. The neo-classical theories described earlier are generally assumed to cover the rural/agriculture sector as well.

The dilemma of the neo-classical theory, however, is that a decision to increase capital per worker should be the rational choice of the farmers/producers in the agriculture/ rural sector, but they do not choose this option despite the availability of capital. Indeed, they show resistance to such an option whenever it is offered to them. Lately, economists have suggested that the explanation of this dilemma lies in recognizing the fact that "subsistence agriculture is a highly risky and uncertain venture, because of its heavy dependance on nature. It is made even more risky by the fact that risk puts the lives of the farmer and his family at stake. In regions where farms are extremely small and cultivation is dependent on the uncertainties of a highly variable rainfall, the peasant and his family become exposed to the very real danger of starvation if they cannot get even a subsistence output from their farms. In such circumstances, the main motivating force in the peasants' life may be maximization, not of income, but rather of his family's chances of survival. Accordingly, when risks and uncertainties are very high, a small farmer may be very reluctant to shift from a traditional technology and crop pattern that over the years he has come to know and understand to a new one that promises higher yields but may entail greater risks of crop failure. When sheer survival is

at stake, it is more important to avoid a bad year than to maximize output in better years<sup>6</sup>.

In this entire argument, the financial system plays a key role. In fact, it is the nature of the financial system that makes the argument, as quoted above from Todaro, valid. Suppose a farmer is getting Y output from traditional methods (using his labour on fixed land). We can represent the production relation as

$$Y = F(L) = aL$$

Suppose he needs finances K to use a certain technology which will contribute an additional output

$$Z = F(K) = bK$$

and suppose the cost of capital is c per unit of capital. The net output of the farmer, with the use of new technology, after the payment of capital cost, will be

$$Q = Y + Z - (1+c)K = aL + bK - (1+c)K = aL + (b-c)K - K$$

If the farmer does not use the new technology, his net output is

$$Q = Y = aL$$

Now we introduce uncertainties. Suppose it is 50 per cent likely that weather will be good for the yield and 50 per cent likely that it may not be good. The expected net outputs thus would be :

$$\text{With new technology } EQ = 0.50(Y+Z) - (1+c)K$$

$$\text{Without new technology } EQ = 0.50 Y$$

It is clear that without technology, the farmer is getting something from tried methods (0.50 Y) which have at least been saving him from starving. But with technology he may not get anything at all. The amount 0.50 (Y + Z) may be less than the payments (1 + c) K, he has to make to repay capital and its cost and, hence, the farmer is risking starvation. The rational choice of the farmer, therefore, is not to use the new technology.

The financial system in which the farmer has to pay back the borrowed capital with fixed cost, irrespective of the outcome, defeats any attempt to induce the farmer to borrow money to use the new technology, improve his productivity and, hence, his income. The financial system will kill all the incentive and motivation for self-mobilization.

The same is true for the informal sector. Economic theory gives no specific model for mobilizing human resources in the urban informal sector with extremely low productivity/ income.