Brief Comparison between Cost of Capital in Capitalistic and Islamic Systems (1988)

By: Iraj Toutounchian, Ph.D.
Professor of Economics
Islamic Money and Banking

Interest and profits are returns to money and capital, respectively. In Capitalistic system, cost of capital has correctly been proved to be the rate of interest. This paper argues that in the justification of the opportunity cost, one crucial element is missing; that is, the independence of the rate of interest from that rate of profit (in fact, internal rate of return). In other words, return to event B is the opportunity cost of the return to event A only if A and B are independent(i.e., mutually exclusive). Hence, in a pure Islamic state where interest has no place whatsoever, the cost of capital is zero.

Since investment projects can no longer be assumed to be independent from one another and each project competes with others. Therefore, in deciding which project to be undertaken in an Islamic state, a lower rate-of-return project plays the cut-off-rate role without it being cost of capital for the project of a higher rate of return.

An important conclusion is that these two concepts, i.e. cost of capital and cut-off rate, are not the same (however, rate of interest plays the cut-off rate role, as well); hence different implications. The most important implication is greater investment in an Islamic state and welfare improvement due to bigger consumption basket enjoyed by Muslim consumers than otherwise.