

# 1. Wealth as understood in economics and finance

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The uniform, constant and uninterrupted effort of every man to better his condition is the principle from which public and national, as well as private opulence is originally derived, because from that principle comes the accumulation of capital.

Adam Smith (AD 1776)

## WEALTH AND CAPITAL

Contemporary economic thoughts equate capital, as mentioned in the above quote, to be wealth, which, as stated in the quote, is the accumulation of things of value from the continuous efforts of humans. Wealth is owned in different proportions by individuals, entities and the state. Wealth can be defined broadly as an item that has some economic substance, a value such that the wealth can be used for several intended purposes, in modern economics, for consumption as theoretically glorified by the Utility Maximization Theorem (Arrow-Debreu). As the great philosopher-economist Adam Smith said, wealth is from the efforts of humans to better the human condition, which then eventually leads to wealth as the capital accumulation owned by nations.

So in real terms, wealth can be anything from cash to real estate, which includes publicly owned public infrastructures to personal belongings such as a car, washing machine, and so on. It can also be referred to as the accumulation of all the savings and the investments by placing the savings transformed to investment in physical assets to create future wealth. Economic statistics suggest the world's savings are about 20 per cent of contemporary national income, which amount is then deployed as investments at large. But the cumulated wealth as a stock of value is much larger, as will be explained in the next chapter.

The Consumption Investment Tradeoff Theorem states that humans have a choice to consume all the wealth at a time, but choose to invest part

of it (say 20% in aggregate) in order to secure future streams of wealth for potential future consumption. Thus, wealth at a time point is either partly consumed with the other part of it becoming savings, which is then channelled into financial marketplaces to become investments in productive assets directed into real economically productive activities. This suggests that wealth is dynamic because wealth at a point of time is a stock, which then becomes consumption, while the savings in a period are put to work for our future wealth production.

## WEALTH IS NET WORTH

Wealth includes – if not translated to physical assets – even the money we spend on our education as an investment for increasing future wealth. This introduces the idea of human capital, which is largely unmeasured, and therefore left out from the definition of wealth. Wealth refers to the total value of someone's assets *less* liabilities. The total value is the gross wealth and net wealth refers to the gross value minus any liability such as debt or loans related to the holding of the wealth. Wealth necessarily must be the net wealth after all potential liabilities have been accounted for from total wealth, in a pure accounting sense. In finance, the households (even individuals in a household), corporations and governments have total wealth, which if reduced by their liabilities would give their respective net wealth. Net wealth or net worth may therefore be defined as:

$$\text{Net Worth} = \text{Total Assets} - \text{Total Liabilities}$$

Many a time, we use income and wealth interchangeably. However, there are certain differences between the two concepts. Income is a stream of cash flows over a period, usually measured over a month (or a year, mostly as convention requires) whereas wealth is surplus income at a future time when part or whole of the current income is spent on consumption so that the leftover is net wealth. In other words, income is what one generates periodically and wealth is the accumulation of whatever is left after the consumption (including consumption to build human capital) excluding any liabilities incurred in generating the total wealth. Thus, cumulated income over a measurement period less the consumption less the liabilities equals net wealth.

Wealth can be understood in many ways. As far as the term itself is concerned, it appeared repeatedly in the prominent work of Adam Smith. As Heilbroner (1987) argues, 'wealth is a fundamental concept in economics indeed, perhaps the conceptual starting point for the discipline. Despite

its centrality, however, the concept of wealth has never been a matter of general consensus.’

There are various reasons as to why there is such an interest in wealth. As stated above there are many ways to define the concept of wealth: from a doctrinaire point of view adherents to certain religions may define wealth very differently from secular persons. This book will explore the differences from one faith-based doctrine, namely from the perspective of permissible wealth as interpreted by researchers on how Islam looks at wealth. The concept of total wealth in the sense of total net worth should include both the human and the non-human capital. For lack of an objective measure of human capital as wealth, we normally do not measure the human capital portion of wealth by simply treating the money spent on building human capital as consumption expenditure (in firms, it is expended as training costs). However, in this chapter, the focus is on the material assets (at some past time exchanged for cash) that are in the form of property, accumulated savings and financial instruments as claims against assets created as investments. The concept of wealth as understood in mainstream economics is that of net worth which comprises the total value of material/non-human assets after adjusting for debts. In this sense,

$$\text{Net Wealth} = (\text{Properties} + \text{Accumulated Savings} + \text{Financial Assets}) - \text{Total Liabilities}$$

One of the major reasons for such a keen interest in wealth is that, as opposed to human capital, it can be traded readily as financial assets or accumulated savings or even as properties, which ultimately contributes to the betterment of human societies. This characteristic basically allows material/non-human wealth to be utilized to smooth out the irregularities between consumption and investment (as Consumption Investment Tradeoffs) where more consumption is required in the future or at special times. Special times may occur when the size of one’s family is increasing, when income decreases during the retirement stage or when there is a sudden shock to income (no work due to a recession or ineptitude of income earners) or unexpected expenses that eat away the accumulated savings or require the sale of financial assets or properties due to many reasons (maybe a fatal disease, due to the heavy medical bills). This *consumption smoothing* role is crucial especially when the capital markets are imperfect and people face borrowing constraints. Therefore, net wealth may at times reduce due to diminution of net worth for legitimate purposes as circumstances change when new income is unavailable or when there are unexpected large expenses. Net wealth therefore

may get smaller and smaller as it is spent when new income approaches zero.

Wealth can also be accumulated and acquired through inheritance. For a given wealth holder,

$$\text{Net Wealth} + \text{Inheritance} = \text{Enlarged Wealth}$$

Other reasons that may be non-economic but make it interesting to study wealth is the status of the wealth holder. Status may be due to power or social standing based on all or part of the net worth that is at the command of the individual or family or organizations or governments. One example of such status could be privately owned businesses, which are likely to provide streams of income to enlarge the future wealth of the business owners. Therefore, it is interesting to examine the pattern of holding wealth as assets across individuals, across firms in a given society and across governments. Wealth reflects the nature and kind of economies and societies that humans live in at a point in time.

Although the concept of wealth may look simple, the issue is whether we should include assets that are intangible – for example, the royalty income of McDonald's Corporation comes from the intangible trade mark, which is not strictly made of tangible or physical assets. Intangibles are difficult to measure or be separated from tangible assets of a corporation. The classification of intangible assets (therefore wealth) includes pension rights in the case of governments, life insurance claims of an insured, or the owner of trade rights, and so on. There are fundamental problems of how to value these rights and claims, so it is very difficult to quantify and incorporate these intangibles as net wealth.

A useful suggestion is to estimate the present value as the net worth of the future streams of income (say the royalty payments to McDonald's). Even in this case, to value these claims, the fundamental question is what discount rates to use, how to determine the flow of income and how certain or uncertain one is of the streams of income, which are difficulties that need to be taken into account to bring future wealth and intangibles into the simple idea of net worth. In the case of asset tangibility, there is no question of discounting the value! It requires a lot of time and work to estimate a 'probable' value of the net worth of an intangible asset. It is not surprising therefore to see most of the empirical literature on wealth-holdings is confined to tangible wealth. This is despite the fact, in modern economics, intangibles are increasingly becoming an important stock of wealth: Google's wealth is mostly intangible!

As per the conventional wisdom that is implied in this discussion up to this point, there are three central features of the wealth-to-asset idea (Bell, 2004):

- *The growth criterion:* Under this criterion, wealth/asset should have the ability to grow in terms of number, value or size for an indeterminate period.
- *The consumption criterion:* Under this criterion, wealth/asset must be able to generate consumption benefits to its owner.
- *The marginal value criterion:* Finally, wealth/asset must be scarce in its availability such that the marginal increase in its value adds to the overall utility of the wealth-owner.

As per the conventional wisdom, there are three important considerations in accumulating wealth: (a) consumption, (b) storing/saving and (c) investing. To illustrate these points, the example of a farmer will suffice. When a farmer harvests a crop (wealth), he has three options, that is, use it for current consumption purposes, store/save it for future consumption just as Robinson Crusoe planted some of the coconuts and tubers to yield future wealth of coconuts and tubers, and/or use the harvest for investment purposes by putting aside some seeds to grow another crop for the next season, which would earn a yield that will add to the current year's net worth as streams of income in the next year(s).

Driven by strong and healthy real estate prices and the bond and stock markets, the total household wealth of the world reached US\$ 263 trillion in 2014, which is a growth of over 8 per cent from the previous year. This is the net worth of the world. Year 2014 is also the first time the total household wealth has crossed the threshold of US\$ 250 trillion: see Figure 1.1 and Table 1.1. There are details on how this is distributed across the world. Two-thirds of the wealth is accounted for by two regions: North America and Europe which together account for an 11 per cent share of world population. One-third of the net wealth is owned by the remaining 89 per cent of the people in the world. Obviously as foretold by Adam Smith 240 years ago, 'where there is greater prosperity in the present world, there is great inequality'! This discussion on wealth would be incomplete without deliberating the works of Adam Smith. Two of his most celebrated works are *Wealth of Nations* and the *Theory of Moral Sentiments*. More famous by its short name, the full name of the first mentioned book is *An Inquiry into the Nature and Causes of the Wealth of Nations*. The book came out in 1776 and was very well received across all sectors be they in academia or industry. Originally, the book was actually a collection of six books.

Table 1.1 Change in household wealth 2013–14, by region

	Total wealth		Change in total wealth		Wealth per adult		Change in wealth per adult		Change in financial assets		Change in non-financial assets		Change in debts	
	2014 USD billion	2013–14 USD billion	2014 %	2013–14 %	2014 USD	2013–14 %	2014 %	2013–14 %	2013–14 USD billion	2013–14 %	2013–14 USD billion	2013–14 %	2013–14 USD billion	2013–14 %
Africa	2831	167	6.3	2.5	5080	2.5	106	7.5	74	4.9	8	4.3		
Asia Pacific	49 849	17 53	3.6	1.8	44 715	1.8	1 447	5.0	941	3.4	636	7.5		
China	21 404	715	3.5	2.3	21 330	2.3	443	4.1	502	4.5	229	16.7		
Europe	85 200	8 149	10.6	10.4	145 977	10.4	4 740	12.0	4 659	9.0	1 251	8.9		
India	3 604	-36	-1.0	-3.1	4 645	-3.1	3	0.6	-16	-0.5	23	10.4		
Latin America	9 113	-11	-0.1	-1.9	22 997	-1.9	-11	-0.3	39	0.6	39	3.3		
North America	91 240	9 370	11.4	10.2	340 340	10.2	6 615	9.9	3 174	10.5	417	2.7		
World	263 242	20 108	8.3	6.6	560 016	6.6	13 343	8.8	9 373	7.1	2 608	6.4		

Source: James Davies, Rodrigo Lluberas and Anthony Shorrocks, *Credit Suisse Global Wealth Databook* (2014).

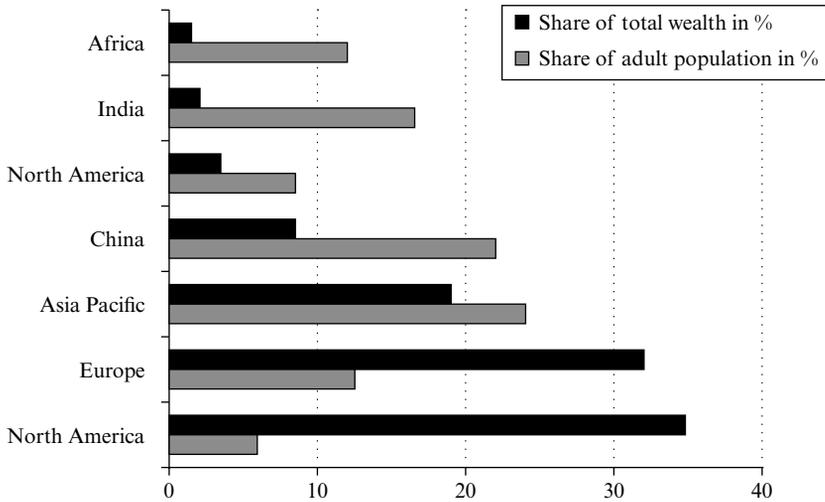


Figure 1.1 Wealth and population by region, 2014

## ADAM SMITH ON WEALTH

Although it is difficult to summarize this voluminous work, we briefly summarize the important concepts that are discussed in his book, concepts such as division of labour, productivity and free markets. In the *Wealth of Nations*, Adam Smith stresses the importance of efficiency and productivity, also how it can be achieved. Through an example of pin manufacturing, he presents this simple idea of division of labour that could be utilized to achieve maximum productivity from a given stock of resources. The process involves manufacturing pin heads and bodies and joining them. Therefore, he argued, if one person specializes in making the head, another the body and finally the last person joins them to make a pin, then the whole process would be much more efficient and can result in more production. Thus was born the idea of specialization, which signifies the human ingenuity at work.

The idea is very simple as to why division of labour can lead to more productivity and efficiency. First, the act of doing the same thing over and over again will make the maker more prolific in that particular skill category. Second, it saves time from adjusting oneself from one task to another both mentally as well as in the time taken from moving from one place to another.

His influential second idea is the freedom to trade: Smith argued for

a free exchange as both sides can benefit from such an arrangement. He argues logically that nobody would be willing to trade if they knew they would lose, and if both the parties benefit from the trade therefore it increases the overall wealth. So the wealth of a nation is not how much reserve one country has but its total production and trade. This is what is referred to in the literature in the modern economic parlance as gross national product.

Adam Smith defines wealth as 'the annual produce of the land and labour of the society'. Here the term 'produce' simply refers to something that fulfils one's needs/wants and therefore provides some utility, and does not extend for example to the idea of surplus over consumption making investment. That work was left to others more than a century later to develop the theory of time preference or consumption investment tradeoff (Coase, 1922).

The other book by Adam Smith, *The Theory of Moral Sentiments*, was actually published before the *Wealth of Nations*. It was published in 1759. It reflected the ideas of Smith about morality and its formulation, how do people make decisions that are moral, and so on. Briefly speaking, this work of Smith can be termed as moral philosophy. In fact one can trace the values and beliefs that he had laid down in this book, which eventually became the foundations for the theory of free market in his later work and for the need for morality-based economic activities that would promote greater utility.

He talks about the concepts of self interest (driving force behind the economy) and sympathy (that maintains morality) and explains how these concepts can still go hand in hand in these lines:

How selfish so ever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it. Of this kind is pity or compassion, the emotion which we feel for the misery of others, when we either see it, or are made to conceive it in a very lively manner. That we often derive sorrow from the sorrow of others, is a matter of fact too obvious to require any instances to prove it; for this sentiment, like all the other original passions of human nature, is by no means confined to the virtuous and humane, though they perhaps may feel it with the most exquisite sensibility. The greatest ruffian, the most hardened violator of the laws of society, is not altogether without it.

Wealth, especially concentration of wealth, is also a problem for the human society. It has been proven time and again in history that disparity of wealth led to revolution, and the confiscation of wealth (and lives) by the indigent poor. This is pointed out again in classic writing:

Wherever there is great property there is great inequality. For one very rich man there must be at least five hundred poor, and the affluence of the few supposes the indigence of the many. The affluence of the rich excites the indignation of the poor, who are often both driven by want, and prompted by envy, to invade his possessions. (Adam Smith, 1776)

One needs to therefore add a dimension – let us call it avoidance of wealth concentration – through morally mandated wealth distribution. This aspect forms a critical element of this book because Islamic wealth management has an embedded scheme to distribute part of the wealth each year, as will be explained in the appropriate chapter of this book.

This aspect has become more and more evident ever since Amartya Sen won the Economics Nobel accolade in 1998 for pointing out that income inequality is a source of friction for wealth creation in the long run. It is often pointed out in contemporary mainstream economics that the addition of welfare economics as propounded by Sen placed a soul into the erstwhile mainstream sterile economic thoughts that did not recognize the importance of the feedback from wealth distribution to create more wealth. Adam Smith had foreshadowed this idea in the quote given above, where he says that great prosperity coincides with great inequality, which excites the indigent poor to invade the wealth of the prosperous persons.

## CONCLUSION

To summarize, we see that the concept of wealth is well aligned with the moral and ethical values that must be observed in generating wealth, enabling others to have meaningful wealth (distribution), consuming the wealth, and saving for investments (later we will add making bequests of wealth). These ideas are not foreign to Islamic principles, as will be described in this book, so it provides an insight in consonance with the spirit of Islamic common law (*Shariah*) guidance in Islamic wealth management. From the Islamic perspective, the ownership of wealth (in any form) is with its creator, God. Humans are given the trust to own, create and manage this wealth with the objective of benefitting the human society, so wealth is not allowed to be concentrated in the hands of the few, which tends to lead to more inequality and injustice, thus wealth must flow among the society.

Calvin (1610) propounded the Christian idea that wealth is God's gift to man: an idea not far from what Islam has interpreted as owned by God. Further, this gift, if given to a person, under the *Shariah* guidelines, is to be put to use for its benefits to society at large. The *doctrine of greatest ease* in *Shariah* advocates that the wealth or any goods that are chosen to be

produced must benefit the most, not just the few who produce the wealth, highlighting the moral basis for wealth redistribution. This fundamental belief (that wealth is not to be concentrated, and that its production as well as its purpose must be to benefit the human society) will be further explained in this book.

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