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Macroeconomic essence of Takaful: Exploring the significance and impact of Takaful in macroeconomic context

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ABSTRACT

Takaful is an Islamic concept of modern insurance. It is based on cooperation and mutual understanding. Takaful has a significant position in the financial market. Conventional insurance has also opened the window for takaful in the Middle East and African countries. Takaful is considered one of the lucrative industries in the financial market. Several aspects of Takaful were explained in various books and monographs. There are numerous benefits of Takaful studied in various research, but takaful has some significant aspects in Macroeconomics literature. It helps to grow the economy by enhancing the productivity and economic security. The paper aims to analyse theoretically the impact of Islamic insurance on production, consumption and investment to study the impact of Takaful on Gross Domestic Product of Economy.

1. Concept of Takaful

Takaful is an Islamic instrument for insurance. It is based on cooperation, donation and mutual understanding. The objective of Takaful is to diversify the risk among the members. In a practical sense, Takaful can be visualised as a method of joint guarantee among participants against loss and damage that may be inflicted upon any of them. The members of the group agree to guarantee jointly that should any of them suffer a catastrophe, they would receive a certain amount of money to meet the loss and damage.

Islam aims at establishing a peaceful society. Peace in the society can be ensured only when there is a guarantee against 'Risk' (subsistence) for all individuals constituting the fund-pooling Institute. In the absence of such a guarantee, everyone will suffer from the worries and anxieties. Insurance guarantee is

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similar to the Keynesian precautionary motive of demand for holding money in certain respects[†]. Sustenance of such a guarantee is possible when there are equity, justice and economics balance in society. "It is proper and in line with the Islamic principles that we should consider that mutual insuranceand cooperative insurance to solve the problem instead of finding the easy solution and grab the first thing that comes across in our way" (Rahman: 1979, p.217). However, the application of Takaful eradicates the custom of holding cash for a precautionary motive[‡] in society, and it may increase the circulation of money at certain extent in the economy. Circulation of money may increase the investment, employment, production, consumption and export in a cyclical way.

Insurance has a significant position in the economy and a strong foundation of the financial market. Arrow (1963) has netted the definition and significance of insurance in some beautiful words.

"*If insurance did not exist a large proportion of the rest of the economy would not exist either. Without a reliable mechanism for pooling and transferring risk, much economic activity simply would not take place. Along with banking and the joint-stock company, insurance is one of the three pillars on which modern commerce is based*" (Arrow: 1963).

2. Origin of Takaful

It is controversial to determine when the insurance was first introduced into Islamic civilisation as well as in the rest of the world. However, it is common thinking that insurance started in modern time from the 'Lloyds Coffee House' in Tower Street of London, where a person wants insurance covered to find an underwriter. The earliest form of insurance originated the idea of family insurance which was prevalent in Low Countries and Germany. Besides that, there is a variety of insurance which covers business, ship, building, fire, sinking of the ship in the sea, health, accident and family were invented. There is a lot of dispute in the origin and development of insurance, but it is a fact that the custom of modern insurance had begun in Europe and America with the era of industrialisation.

The Arab traders in the past felt the necessity of insurance too. In ancient times, they used to transport their cargoes in ships across the seas to other countries, and they would mutually arrange for safeguards against the risks of the sinking of the ship and their cargos. Likewise, all the traders will join to form a fund. They contribute little at a time and who ensures a loss draws the lot gets the full amount. This was a good example of savings. Whenever a trader would suffer an accident, then the unfortunate trader would be recompensed by this fund so that he could recoup his loss and find his bearings again and re-establish his business.

Some scholars relate the concept of insurance with the tradition Agila[§]. Al-Aqilah was a system in ancient Arabia which represents a joint guarantee by a group of people to help each other in the event of mishaps. This is in line with the Islamic principles of mutual help and cooperation in good and virtuous acts. The Prophet (PBUH) intended the Al-Aqilah concept, which has been known since the Jahiliya times,

[†] For more detail refer the chapter on Quantity theory of money in standard book on monetary economy or refer the Kaldor, Nicholas, and James Trevithick. "A Keynesian perspective on money." Lloyds Bank Review 139, no. 1 (1981): 1-19.

[‡] Precautionary Motive is a theory of holding cash for emergency expenses. It is a human nature that people keep some amount of unforeseen expenditure. This practice may freeze some amount of money which reduces the circulation of money in economy. Insurance for uncertainty may reduce the practice of holding money and increase the circulation of liquidity in the economy.

[§] Aqila is an arabic word. For details, see Billah, M. M. (1998). Islamic Insurance: its origins and development. *Arab Law Quarterly, 13*(4), 386-422.

to be an exception to the general rule because of the cooperation and benevolence contained in it as Allahcommanded. It signifies the legality of the cooperative principles such as of insurance that serves an important role in the social, psychological and economic welfare of individuals and societies. In the pre-Islamic period, different kinds of insurance were found in the Arab world. A few books were written on Arab Market before the advent of Islam reflects some facts concerning to insurance. Still, shariah scholars are discussing permissibility of insurance. Many kinds of insurance products are available in the market which is designed at different principles of Islamic jurisprudence like mudarba, wakalah and Ijarah.

3. Macroeconomic impact of Takaful

In present global economic scenario, Takaful has taken a well-known position in the financial market. Takaful offers important economic benefits where activities are seen as risky and risk control or transfer mechanism is needed. As a whole Takaful provides positive externalities regarding increased purchases, profit and employment both within and alongside the Takaful sector (Ward, 2000). In addition, Insurance (Takaful) facilitates innovation within an economy by offering to underwrite new risks. An active private Takaful can provide 'welfare benefit' which is more targeted at the needs of users, which can be administered at lower cost, than those provided by the state itself: witness the compulsory health and motor insurance in GCC region. Takaful effects economy from various sources but we will discuss only those aspects which are closely related to macroeconomic behaviour like investment, production, consumption, saving and national income.

Typically, Takaful comes under non-banking financial sectors. It is an intermediary, which has strong fund pooling capacity. Moreover, it is considered an active financial player, which creates confidence in the business environment and pools funds for productive activities. No financial institutions mobilise fund in the market as the insurance company does. It grew very dramatically. Conventional insurance started in eighteen centuries while Islamic Takaful has emerged just a few years before. It made significant holding in the market but very low base as the insurance industry. Takaful differs in certain dimensions from conventional insurance but in case of investment, production, and consumption; both industries have the same impact to a certain extent. However, Takaful is found to be very stabilised and productive due to its fiscal nature. Islamic Jurist does not allow the practice of interest in the business. They promote profit sharing (PS), profit loss sharing (PLS) and leasing type of business. Therefore, Islamic economists emphasise fiscal policy rather than monetary policy (Chapra,1991). Under Islamic State, the economy is controlled by non-interest fiscal policy. Consequently, it is expected that productivities would increase.

Retail banking and other financial institutions do not involve in long-term projects like venture capital and merchant banking. Their nature of intermediation is very short. However, as far as Takaful Institutions are concerned, they involve in both, long time as well as short time projects, providing funds to real estate, merchant banking, venture capital and stock market.

According to the standard formula of National Income propounded by Keynes (2016)[**], investment and consumption and government expenditure constitute the income of the economy. Investment, consumption, and production are the core of the measurement of national income. Every country adheres to use this

[**]JM Keynes is considered as a founder of modern macroeconomics, he wrote the book General theory of employment, interest and money in 1936. He introduced the formula of GDP=C+I+G(X-M) to measure the national income of a country. Atlantic Publishers & Dist. Republished this book in 2016.

formula for national Income measurement. Current formula of national income includes one more variable $(X - M)$ export minus import. It also supports investment and productivity of the economy. In brief, all variable of national income is interlinked to investment and consumption.

As per new approach, National Income is a function of investment, consumption, government expenditure, and export minus import. It can be seen numerically.

$$Y = f(I + C + G) + (X - M) \tag{1}$$

Where:
Y = National income
I = Investment (Autonomous investment + Indigenous investment)
C = Consumption
G = Government expenditure

The above standard formula is used for calculating the national income of a country. In Keynesian approach, investment determines the effective demand which creates supply and thereby regulates the entire economy. In a laissez-faire economy, Takaful can affect investment bilaterally. Initially, it gives peace of mind to insurance holder of any production unit. However, peace of mind is very important intangible capital. Secondly, it diversifies the risk, which can be considered as precious assets to entrepreneur. Thirdly, it indirectly induces investment via the stock market, merchant banking and real estate. In a nutshell, it induces an increase in national income. Likewise, it regulates the national income formula.

4. Islamic insurance and economic development

Arena (2008) observed that conventional insurance is one of the major factors which push economic growth and development in the economy thus it estimated that Islamic Insurance could also be a source of economic development. At low levels of economic development spending on Islamic Insurance would be low as low insurable wealth as well as limited financial awareness makes the opportunity of replacement of other assets high. As economies continue to grow and develop, a wealth of individual increases with financial awareness, allowing them to spend more on Islamic Insurance. Individual countries differ in their propensity to ensure as they progress through different stages of economic development. In fact, differences in demography, political, religious beliefs, and sociocultural environment make the growth of Islamic Insurance at a different pace in various countries. However, in general terms, the relationship between insurance spending and level of economic development can be measured by the following equation:

$$P = a + bG + cF + dI + eN + fM + gB + hDummy + Ui \tag{2}$$

Where:
P = Premium per head
G = GDP per capita
F = Financial development Index
I = Inflation Rate
N = Interest Rate
M = Mortality
B = Birth rate
Dummy for religious belief Islamic = 1 otherwise 0

A time series analysis can be conducted based on the above variables. It is expected that the overall growth of Islamic Insurance is much more in developed countries than in developing countries. These can be represented in regression analysis with expected strong positive signs with GDP per capita and financial development index. Other variables may also expect to provide reasonable relationship. A number of studies have estimated above relationship in case of conventional life and non-life insurance business. However, not much attention was given to Islamic Insurance.

5. Inflation and indexation

It is frequently argued that Islamic finance is incapable of tackling with contemporary issues in monetary management particularly as regard to inflation and indexation. Islamic economists rebut this argument with parallel Islamic finance tools except for the bank rate because of the prohibition of interest in the Islamic faith. The prohibition of interest would restrict the appetite for commercial lending as a source of financing and hence limit the volume of debt in the economy. Also, the supply of money in an Islamic financial system is tied to the supply of goods and services. Having said this, inflationary pressures cannot be excluded completely from an Islamic economy. Therefore, in order to hedge against inflation in an interest-free Islamic economy, the Islamic insurance tools can be used to ensure smooth supply of funds to business and encourage real productive investments. Similarly, the issue of indexation, that is to maintain the purchasing power of the local currency that deteriorated by inflation can be addressed by reducing uncertainties and bringing innovative Islamic insurance products to finance long-term industrial projects. It is noted that indexation in Islamic society is only allowed for real business transactions like wages but not for financial transactions that are mainly based on interest. So, Islamic insurance products can be instrumental in anchoring inflationary expectations as well as provide a yardstick to preserve the value of real assets.

6. Conclusion

Takaful is one of the biggest inventions in Islamic Financial Market. The entire world is benefiting from takaful. It has become one of the essential instruments in social and commercial life. Takaful operators numerate various individual and collective benefit of takaful. Numerous aspects of takaful were studied in various research conducted on takaful or Islamic Insurance, but there are some macroeconomic aspects of takaful which requires an empirical research by government and research agency. However, the nature of research requires a lot of resources, time and workforce to study the potential of takaful at a macroeconomic level which is not possible for an individual researcher. The paper economic essence of takaful is a theoretical model based on macroeconomic tools for measuring the National Income. Government estimates the national income every year. National income helps to study the level of growth and development in economy. Takaful plays a significant role in the enhancement of production, consumption, investment and business in the economy but hardly any Muslim economy tried to study the contribution of takaful at the macroeconomic level. This paper is a theoretical attempt to motivate government and policy maker to study this aspect further.

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