

**Association of Heterodox Economics**  
**11<sup>th</sup> Annual Conference**  
**'Heterodox Economics and Sustainable Development, 20 years on'**  
**9-12 July, 2009**  
**Kingston University, London**

## **Heterodoxy of Islamic Economics and its Vision of Sustainable Development**

by

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### **1. Introduction**

Islam now remains perhaps the only religion of the world with a sizable number of its followers claiming a dominant role of their religion in social affairs including politics and the economy. They assert that Islam provides guidelines for all spheres of life that should (and could) be followed by Muslim communities at any time and anywhere. It is an assertion that receives skeptical to hostile comments from western people and scholars alike where a firm and universal decision was made long ago to keep any provisions of religion away from law, politics and economy of a country. In western secular societies religion has thus become a private matter and no sign of an effort by religious constituencies is seen to change this situation. In the twentieth century, the status of religion in communist countries was even lower or made to be non-existent altogether. It is not surprising then to note that the resentment of Islamic scholars towards all communist regimes always remained severer than their criticism of western secular democracies and their economic system based on capitalism. Why Islam still draws widespread following from Muslim masses as well as a sizable number of highly educated among them, mostly trained in the western academic institutions, is an important topic but somewhat unrelated to this paper.

Indeed there are many differences of opinion among Muslim scholars when it comes to defining the premises of an Islamic political or economic system in the contemporary world. One reason for these differences is that many (but not all) of them continue to depend on a methodology for Islamic studies that puts unreasonable emphasis on practices and juristic decisions of the past. The fact that many Muslims today regard themselves being followers of a particular school of thought and its contemporary (religious) leaders is a further source of continued differences.<sup>1</sup> Nevertheless, there are many issues on which there is unanimity or only minor differences. Furthermore, as

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<sup>1</sup> It could be argued that what is really required of Muslim scholars is to apply the incessant Islamic principles preferably derived directly from the *Qura'n* and deduce the rules, regulations and nomenclature of necessary institutions for contemporary world as was suggested by Ibn Rushd (Averroes) back in the thirteenth century. Any reference to the *Ahadith* (the narratives of the sayings and deeds of the Prophet) should take secondary position as they were compiled after the death of the Prophet and there is always a room for a human error or discrepancy between what was actually said and done and what was later narrated and recorded. Any *Hadith* contrary to the words and spirit of the *Qura'n* should not be given much importance.

progress is made in theory (and at a very limited level) practice of Islamic economics and finance, a number of contentious issues are expected to be settled.

Although, the concept of Islamic banking and finance, its growth and future potential are occasionally mentioned in western newspapers and financial magazines especially after the recent financial crisis, a significant literature on Islamic economics and finance has appeared during the last five decades. Many Islamic thinkers of the Middle Ages such as Ghazali (A.D 1058-1111), Ibne Taimiya (1263-1306) and Ibne Khaldun (1332 – 1406) had included economic issues in their discourses. The primary motivation for Islamic economics in recent times came from Islamic religious scholars after the Second World War that also saw the end of the colonial era of over two hundred years. They had fundamental disagreements with different models of command economies but were also dissatisfied with some aspects of the capitalist system. Later on, professional Muslim economists trained in western universities and other institutions took the lead. Several journals are now devoted for this subject and conferences on Islamic economics, banking and finance are regularly held throughout the Muslim world.

Like some other heterodox economics, it is clear from its name that Islamic Economics is primarily a normative discipline. It derives its ethical principles and guidance from teachings of Islam the main source being the holy book, *Qura'n*, the *Ahadith* or traditions of Prophet Muhammad and the vast literature on Islamic jurisprudence created by jurists of different schools of thought mostly during the early centuries of Islam. This paper is an attempt to briefly introduce Islamic economics to a wider audience. It first gives a very brief description of the journey to present orthodoxy in micro and macro economics. It then describes Islamic economics as a heterodox economics highlighting its points of disagreements (and of course, the agreements) with the orthodox neoclassical microeconomics and neoclassical-Keynesian macroeconomics. This discussion naturally leads to the claim that the concept of sustainable development is inherently embedded in an Islamic economic system.

It must be mentioned that the views on Islamic economics expressed here are based on author's personal opinions. Like any other heterodox economics, one can find differentiable strands in Islamic economics literature. Unlike those Muslim economists who have attempted to construct different aspects of an Islamic economic system with frequent reference to the Islamic juristic literature of the past, my approach is to first deduce the basic elements (essence) of an Islamic economic system from the basic Islamic sources, and then using the concepts and terminologies used by contemporary orthodox as well as heterodox economics present the structure of an Islamic economic system. It is hoped this would allow a better understanding of this research programme by proponents of other contemporary schools of economics and attract constructive criticism that could be helpful in the advancement of the discipline.

### **3. The Journey of Political Economy or Economics to Present Orthodoxy?**

The foundations of present orthodoxy of neoclassical economics were the culmination of a long tradition that had started from the Physiocratic school and the writings of Adam Smith and other members of the classical school. After receiving a tremendous technical boost from the marginalists it was then up to Marshal to synthesize all seemingly valid and defensible elements of the past theoretical work of that tradition to form the neoclassical school. It must be kept in mind, however, that the Physiocratic school of mid eighteenth century France was doctrinally in favour of a naturally free

economic order without making any reference to economic theory. It came after the Newtonian revolution in Physics that showed how natural gravitational forces could keep the universe in order and harmony. It was thought that the same must be true for the economy and the society and any intervention by government disturbing the natural order must be undesirable. The laissez faire argument made sense and got approval from the farmers in a political and social environment where the governments had long sided with rent seeking merchants, landlords and licensed private land-rent collectors.

A strong and persuasive theoretical framework for Physiocratic beliefs was provided by Adam Smith who shared their doctrinal thinking, through his most influential books *The Theory of Moral Sentiments* and *Wealth of Nations*. The natural gravitational forces among human beings were sympathy towards fellow human beings in non-economic matters and self interested behaviour in economic matters. It was argued that men and women *naturally* working in their own self interest in pursuit of wealth would not only enrich themselves but unintentionally benefit the society and increase the wealth of the nation. Furthermore, any excesses due to the egoistic human behaviour could be controlled *naturally* through competition among different factors of production.

Even if not clearly stated, the theories of value, rent, profit, wage and prices were developed by Smith, Ricardo and others under the premises of a completely free economy. John Neville Keynes in his book '*The Scope and Method of Political Economy*' published in 1890, admits this point and claimed that derivation of economic laws with the assumption of laissez faire was the easiest approach to start with as economic agents were allowed to deal with each other in a free and natural manner; the complexities of intervening forces could be addressed at the later stage. Keynes suggested distinguishing between laissez faire as an assumption of deductive method and using it as maxim of conduct. The use of laissez faire as a maxim of conduct has different meaning. It describes a preference for a system where individuals are given all kinds of liberty to make their own choices free from any intervention. Keynes admitted that the confusion was partly created by the fact that the economists who were busy in investigating the laws of positive science of political economy were also preaching the desirability of laissez faire as an ideal. In proof of his assertion, he gave several examples from *Wealth of Nations* how Adam Smith suggested a need for government intervention in the economy. How far the classical economists and their later followers were able to keep their preference for freedom of action not influencing the outcome of their positive economic analysis is an interesting area or research for students of history of economic thought.

It has been suggested that Adam Smith never celebrated the self interest behaviour of human beings, he only pointed out its unintentional positive effects on the economy. The issue has, however, remained unsettled. It is argued that Adam Smith somehow approved of self interested behaviour as an acceptable social behaviour apparently giving no regard to morality of some actions under such behaviour in different circumstances. I would come to this point again at a later stage in this paper.

The socialist writers using a historical approach (rather than the predominantly deductive approach of the classical school) questioned the harmony of interest thesis of a free market economy and argued in favour of varying degrees of control and intervention by the workers' supported governments for a desirable and justified distribution of income in the economy and freedom from the tyranny of the capitalists, industrialists and

land owners. For them, a capitalist system was inherently exploitative and source of conflicts. However, even if their support for an intervening government received widespread support among workers their theoretical work on theory of value was subject to severe criticism by a new group of laissez faire believers, the marginalists. This new group provided a much more sophisticated theory of value in support of their belief in the superiority of a freer economic system. In addition to self interested behaviour they promoted the notions of avoidance to work, impatient indulgence in present consumption (providing one of the basis and theoretical legitimacy for the payment of interest), capacity to take risk and hedonistic rationalism as *natural* human instincts that must enter in calculation of value of economic goods. They criticized both the classical economists and Marxists who based their theory of value on cost of production; labour being the main cost (or only cost for Marx) and hence major source (or only source for Marx) of value. Marginalists instead argued that the value of a good basically depends on demand that in turn depends on utility the good provides. They thus provided a new theoretical ground for a laissez faire economy advancing the case for free markets and the legitimacy of market determined prices of goods and factors of production. Marginalists kept their faith in classical notion of a free market economy always leading to full employment, the inability of money stock to affect any real variable in the economy and absence of monopoly.

It was finally left to Marshall to synthesize the classical and marginalist theories of value, bringing in both supply and demand, which provided the basic foundations of neoclassical microeconomics. Marshall and his contemporary neoclassicals remained loyal in supporting free market economic system and its ability to produce efficient allocation of resources, determine market clearing prices, distribute income and provide full employment to everyone who wanted to work.

It should be clear that the issue of morality was set aside by both the supporters and opponents of a free market capitalist system. The proponents of free market who were also advocating for a free society wanted freedom from government and religious regulations and pursued theoretical work in support of their ideals. The opponents supported a system that could bring freedom from the tyranny of the capitalists, landlords, industrialists, and of course from religion that was seen working in favour of these tyrants. None of the two groups were much interested in bringing moral issues into their arguments perhaps realizing that, as pointed out by Kant, any such attempt would eventually lead to religious edicts which were abhorrence to both.

John Maynard Keynes did not question Marshallian (neoclassical) micro economics and the ability of markets to allocate resources in the right directions. He only pointed out that the markets may not always create the volume of economic activity that would guarantee full employment although it may achieve the goal occasionally. He therefore developed a *General Theory* to show why government often needed to act through fiscal and monetary policies to avoid prolong recessions. Keynes did that by introducing his liquidity theory of interest and emphasizing the uncertain nature of future economic outcomes, the volatility of investment expenditures, the inflexibility of wages to move downward, and the inability of interest rate to equalize savings and investment. His views were eventually accepted by the main stream orthodoxy to what became a neoclassical–Keynesian thesis in macroeconomics. The governments were thus allowed, if not encouraged, to intervene to stabilize the economy towards full employment through

monetary and fiscal policies. The broad synthesis in macroeconomics has survived the onslaught coming from extreme proponents of free market proponents, first from monetarists and later by new classicals by restructuring its theoretical framework to accommodate their concerns for inflation and role of expectations. The synthesis has also survived the attacks coming from the left of the centre Post Keynesians who advocated for even larger intervention by the governments demanding an incomes policy for a better distribution of income.

While Keynesian revolution came in response to a theoretical challenge to neoclassical belief in a self (read *natural*) correcting economy producing full employment, the early institutionalists pointed their guns at the ability of the market to produce a desirable or justified pattern of distribution of income. They also questioned the behavioural assumptions of neoclassical school such as hedonism, and the presumed sovereignty of consumers. They recommended a closer look at existing institutions at a particular time in a particular place to understand how an economy works rather than looking for universal laws of economics. They supported reforms through democratic processes favouring the under privileged classes of the society.

At present, according to the orthodox economics, the goal of economics science is to allocate economic resources efficiently to produce highest possible volumes of goods and services in the society. The orthodox economics also claims that this goal could be best achieved through a free market system. I do not think any heterodox school of thought (holding the same world view and the same stand on morality, ethics and religion as held by the orthodoxy) would have any objection against this goal and the means to achieve it provided that it was sustainable; it did not lead to

- (a) an inequitable distribution of income in the economy
- (b) increasingly degradation of environment, and
- (c) frequent instability in the economy.

Indeed, Islamic economics shares all these three concerns of heterodox economics especially the first two as they come under its basic premises. However, as Islamic economic system bases itself on a different world view, it would also be concerned about the morality of different aspects of economic activities and economic institutions emerging from unbridled natural (but controllable) instincts of human beings. Mere maximization of material provisions thus does not form *the* goal of Islamic economics.

## **2. Premises of an Islamic Economic System**

As the name clearly suggests the heterodoxy of Islamic economics is inherently different from any other heterodox economics. Its goal is to construct (and reconstruct over time) an economic system for Muslim populations based on an Islamic world view and its principles of fairness and justice with such rules, regulations, institutions and organizations that are helpful in following Islamic injunctions both at individual as well as collective levels in order to succeed in this worldly life and hereafter. As the *Qura'n* generally gives broader principles rather than detail instructions, and the Prophet's verdicts were given in a less sophisticated economic environment, the objective of constructing an Islamic system in contemporary societies is far from a trivial job. The vast literature on Islamic jurisprudence mostly created between eighth and thirteenth

centuries could be helpful but not sufficient, and at times even problematic as different schools came up with conflicting solutions or verdicts.

The construction of economic systems for contemporary Muslim countries thus requires a sound methodology to start with deriving all sorts of insights not only from the vast literature on Islam but also from different schools of economic thought spurred in the west during the last two and a half centuries. More importantly, at the outset one has to be very clear about the basic differences between the orthodoxy of neoclassical economics, the nature and substance of criticism leveled against this orthodoxy by various strands of heterodox economics and the research programme of Islamic economists.

The basic difference between an Islamic system and any other economic system is that the former is based on a world view that is essentially very different; a belief of life after death. Any social system that takes out religion for any consideration must come up with its own understanding of

- (a) what is the position of human beings on this earth or universe
- (b) what are the things its people want to achieve through their individual and social activities and
- (c) what would be their standards for what is good or bad and desirable or undesirable individual and social behaviour.

For an Islamic community (and for other religious communities) the answers for these questions are provided by its religion. For b, Islam does provide an idea of what people would like to pursue due to their natural instincts; wealth, children, power, fame, respect, sex, etc. However, while it does not condemn any of them as they are supposed to be instincts put inside their nature by God, it does provide a guideline for achieving these desires with legitimate means providing them happiness in this world and the hereafter.

Primarily, Islam requires its followers to nurture their natural senses to control themselves and only use legitimate means as unrestrained and uninhibited pursuits of some human instincts would harm fellow human beings and themselves. It treats human beings differently from other animals that also have their natural instincts but little sense in their mind for justice, fairness and morality. Unlike other animals, human beings are provided with the faculty of judgment and ability to control some of their natural instincts. They are also provided the ability to build up a better character of them. The goal of the socioeconomic system of Islam is to provide an environment that helps individual Muslims in building such characters.

It is generally perceived by both Muslims and Islam's western critics that Islam puts restrictions on individual freedom. This is true if we compare the environment of an Islamic society with the contemporary western societies. But whether Islam puts unnecessary restrictions on individual freedom, this question should not be answered without considering the world view and the corresponding goals of an Islamic society. Unlike western secular democracies, Islam does not leave moral standards to be set by individual Muslims or the majority of the people in a Muslim society.

Throwing out religion from social, political and economic spheres of a community does not remove the necessity of having a set of moral standards. Kant, Adam

Smith and others, after setting aside moral values based on religion suggested their own methods to derive moral principles. Ironically, Kant had come to the conclusion that the issue of morality eventually falls down to religion. The western democratic societies eventually decided to settle all matters of morality at the social level through adopting or implementing the views of the majority of its people.

When Adam Smith pointed out the benefits of self interested behaviour in economic spheres of life for both the individuals and the society, he was not unaware of the possibility of excesses committed by individuals. However, he thought free competition among them would naturally control inconsiderate behaviour. He did not realize that the free market system he was advocating may lead to a situation where a government intervention may be required. One can argue that if he had lived long enough to see the excesses of free market system, he would have changed his mind.

According to the teachings of Islam, the earth and its surroundings carry provisions for the sustenance of human beings. The air, water, land, plants, animals, all matters ----- and their physical, chemical and biological properties are subservient to the needs and requirements of human beings in this universe. Islam does not asks its followers to necessarily live a detached and self inflicting life void of good food, clothing, shelter, health and education ----- but counsels against wastefulness and disregard for others and their own remaining worldly life and those of their children. Thus unrestricted pursuit of wealth and other worldly wants is supposed to be controlled both at the individual and the social level --- and thus the need for an economic system that provides assistance in controlling and / or guiding actions towards desirable directions at both levels.

Individual human activities to improve his / her conditions of living on earth are appreciated by Islam. It counsels its adherents to earn and be alms giver than end up being beggars. Unlike the doctrine of some other religions and Aristotle, it never regarded commercial or profit making activities a necessary imperfection of social life neither it ever ostracized people involved in such activities. Indeed it expects its followers to abide by permissible and recommended behaviour in their pursuit of wealth; at the same time it also asks its followers not to be jealous towards those who may possess more than themselves. Two quotes from the Qur'an are instructive:

"O You who have attained to faith! Do not devour one another's possessions wrongfully \_ *not even* (except) by way of trade based on mutual agreement \_ and do not destroy one another: for, behold, God is indeed a dispenser of grace unto you! "And as for him who does this with malicious intent and a will to do wrong \_ him shall We, in time, cause to endure [suffering through] fire: for this is indeed easy for God." (my Italic, and the word 'except' in the first parentheses) (4: 29-30)<sup>2</sup>

and

"Hence, do not covet the bounties which God has bestowed more abundantly on some of you than others. Men shall have a benefit from what they earn, and women shall have a

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<sup>2</sup> Asad, Muhammad, *The Message of The Qur'an*. It is important to note that in the translation of this verse, Asad has adopted the meaning of "illa" as *not even* instead of its usual meaning *except*. Please see his explanatory note # 38 of Chapter IV. However, for our current purpose any of these meaning is appropriate although the one adopted by Asad is more forceful. As I understand, it implies that economic or business transactions must be based on inherent justice and not only apparent agreement of the concerned parties.

benefit from what they earn. Ask, therefore, God [to give you] out of His bounty: behold God has indeed full knowledge of everything". (4:32)<sup>3</sup>

These and many other verses in the Qur'an are commands and advices given to individuals to follow. On the other hand there are general instructions given to both the rulers / managers of a Muslim society and the people. One of the most important verses is:

"Whatever [spoils taken] from the people of those villages God has turned over to his Apostle — [all of it] belongs to God and the Apostle, and the near of kin [of deceased believers], and the orphans, and the needy, and the wayfarer, so that it may not be [a benefit] going round and round among such of you as may [already] be rich. Hence, accept [willingly] whatever the Apostle gives you [thereof], and refrain from [demanding] anything that he *withholds* from you; and remain conscious of God: for, verily, God is severe in retribution." (59:7; my Italic)<sup>4</sup>

This verse provides one of the basic principles of Islamic economics i.e., the government of a Muslim country has an obligation to prevent the concentration of wealth in few hands *even if* the income or wealth could have been acquired through proper means. This provides a clear justification for the government to use tax and transfer policies after the production process and the corresponding distribution of income is completed to impede concentration of wealth. It is also important to note that individual Muslims are asked to willingly accept any government decision to take away some of their wealth that they have earned lawfully. However, what portion of the income should be taxed is not given in specific terms. For that a Muslim society has to make a decision based on not only the overall goals Islam sets for Muslim individuals and the community but also a consideration of human nature and the overall effect on the country. Any decision on matters such as rates of income tax then must be based on an intelligent and thorough analysis of the economy keeping both normative as well as positive aspects in mind. For example, the great Muslim historian of the fourteenth century Ibn Khaldun had concluded that cities and regions flourished economically and culturally that were subjected to relatively lower levels of income tax. He also observed that a very high level of tax would not necessarily maximize government's tax revenue. Similarly, any relief action of government that leads to avoidance to work and dependency among a section of people must be discouraged.

The above three verses give very basic principles for an Islamic economic system. The system must implement the direct commands given by the Creator, the distribution of income being the foremost concern. Furthermore, it has to provide an economic environment where following the precepts of Islam become easier for individual Muslims. For example, a fair distribution of income would subdue feeling of jealousy. Similarly, proper regulations to make sure that all economic transactions are carried out in a desirable way would put a restrain on men's natural instinct to get benefit even at the cost of others.

### ***The Role of Market and Permissibility of Private Ownership of Means of Production***

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<sup>3</sup> ibid, p. 109.

<sup>4</sup> (59:7), as translated by Muhammad Asad in the *Message Of The Qur'an*.



The Islamic injunction on the issue of private property and the role of markets on determining prices is also very clear. There is no controversy over the fact that an Islamic economic system would allow the markets to work freely to a large extent. Muslim societies have been practicing this since the time of the Prophet whose instruction clearly allowed prices to be determined through markets with the interaction of demand and supply. The Prophet and later Muslim scholars and rulers did emphasize to remove any unwanted and unfair means such as hoarding and other practices that could hinder the fair play of demand and supply. Similarly, throughout the Islamic history the sanctity of private property has remained non-controversial.

### ***Tackling Distribution of Income in an Islamic System***

It is clear from above deliberations that an equitable distribution of income becomes the primary goal of an Islamic economic system. The issue is how to achieve it? While government has been assigned the duty to make sure that wealth is not concentrated among a few, as a principle, individuals are allowed to pursue their material struggle without any limit. The government is supposed to devise tax and transfer policies as has been the practice in western capitalist countries that run under the orthodox economic doctrine. Such policies would also remain a part of an Islamic economic system.

However, some Muslim economists have emphasized the need to go beyond that and critically analyze neoclassical theories of wage, rent, and interest to see if alternative theories could warrant new policy rules and an agenda to reform existing economic institutions. In operationalizing Islamic economics, most Muslim economists have concentrated their efforts in providing the theoretical framework for the establishment of an Islamic banking system. However, a minority among them has also criticized neoclassical marginal productivity theory of wage and raised questions against the current treatment of capital gains and rent income accrued on different types of land.<sup>5</sup>

Siddiqui (1997-98) reviews the critique of neoclassical marginal productivity theory of wage determination. He mentions Paul Fabra (1991) who questions neoclassical notion that no profit is made when the last worker is hired at the margin. He also cites Stirati's (1994) claim that there is no functional relationship between demand for labour and wage and that the demand for labour rather depends on expected sales, clientele, availability of funds and technology. Siddiqui then presents a model to synthesize the neoclassical view with those of Stirati and shows the desirability and nature of government intervention needed for increasing level of employment as well as wages in different labour market situations.

On the other hand Siddiqui (1996) discusses the causes of increases in land rent and land prices and whether, under an Islamic economic system, the land owners (or the society as whole) are the rightful recipients of such increases. In this respect he mentions Henry George's idea of taxing all capital gains on land and that a single such tax would be sufficient for all government expenditures. He also discusses the need to look at the desirability of land reforms and regulation of share cropping institutions in different Muslim countries.

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<sup>5</sup> For example, see Siddiqui (1996).

The basic approach or methodology of Siddiqui is to investigate how changes made in existing economic institutions and making new rules, regulations and policies could lead to a better distribution of income among different factors of production without a direct involvement in production of goods and services of the government and an excessive reliance on taxes and transfers to achieve such equity.

Siddiqui (1996 & 2005) claims that Islamic economists have given little attention to entrepreneurship. He presents a sympathetic review of Austrian school's critique of neoclassical view that fails to assign adequate role to entrepreneurship. He then emphasizes the need for understanding of an even greater role of entrepreneurs in an Islamic economic and financial system. Notwithstanding a possible objection to the term Islamic entrepreneurs, in his opinion, there is a need and opportunity to nurture entrepreneurs that are properly trained and motivated to do business at different scales in an Islamically desirable way. Emphasizing the importance of entrepreneurs in general and for an Islamic economic and financial system in particular, he proposes that academic and professional training for different levels of managers should include all aspects of Islamic business ethics. The certification to do business could be awarded after taking a public oath to uphold the moral commitment required of them. After all, he questions, is it not the case that society expects a particular standard of morality from our doctors, teachers, preachers, etc., higher than ordinary citizens? Entrepreneurship is vital for any economy but for an Islamic economics system the promotion of morally upright entrepreneurs in large numbers is an extremely important matter.

The issue of capital and interest occupies a dominant place in Islamic economic literature. As interest also plays an important role in the financial sector of an economy, it will be discussed in greater detail in the following section.

#### **4. Premises of an Islamic Financial System**

In every economy almost all production and commercial units require financial resources which may not be readily available from their own (internal) sources. On the other hand many economic units (households and businesses) have surplus funds that they would like to invest for earning additional income. The financial system of an economy provides a framework of financial intermediation by different institutions to help these deficit and surplus economic units to meet their needs. Commercial and investment banks, markets for stocks and bonds, insurance companies, pension funds, etc., are financial intermediaries that constitute financial system of a capitalist economy. The performance of a financial system and its various components could be measured in terms of its relative efficiency, stability, its ability to solve problems of different groups involved in the system, fairness, and the nature of the attitudes it nurtures among different participants of the system. It may not be very difficult to observe that an economic doctrine that absolves itself from making any value judgments will naturally assign relatively lower importance to the last two measures just described.

Like other areas of social life, Islamic teachings require that transactions in trade, commerce, production of goods and services and financial intermediation should follow some basic principles. Some of these requirements are clearly understood and largely adhered by the faithful. For example, trade or financial dealings of forbidden goods and services (such as pork, pornography, gambling) is clearly prohibited and there is hardly any controversy about it. A clear understanding of some other requirements and their

implementation is, however, far from settled. The most important of them that is relevant for banking and finance is to refrain from *riba*, *gharar* and *mysir*.

### ***Avoidance of Riba, Gharar and Mysir***

Islamic scholars emphasize that *riba* (usury and/or interest), *gharar* (uncertain or unclear elements in business contracts) and *mysir* (transactions tantamount to be gambling) should be avoided in trade and financial dealings. The issue of *riba* is of paramount importance for Islamic banking and finance and will be discussed in some detail. In the context of financial transactions, *gharar* could be thought of as looseness of the underlying contract such that one or both parties are uncertain about possible outcomes or obligations. Alternatively, there could be an element of *gharar* if a contract could be read in a number of ways such that one party could deceive the other party.<sup>6</sup>

The issue of *gharar* in our time has been most frequently mentioned in the context of insurance. Many religious scholars (due to some misunderstanding) had initially claimed that dealings in conventional insurance involve *gharar*. They argued that it was not known in advance who would benefit from insurance claims in a particular period and what amount would be eventually paid in claim settlements. Furthermore, it was also contended that insurance seemed to have an element of *mysir* as it was possible for someone to claim a huge amount for which only a small premium was paid. A number of Muslim economists convincingly refuted both these claims.<sup>7</sup> However, one of the objections that has remained valid to this date with respect to conventional insurance is that most of the proceedings of insurance premiums are kept in interest bearing instruments.<sup>8</sup> The establishment of Islamic insurance companies commonly known as *Takaful*, is to make them conforming to the teachings of Islam.

The issue of *mysir* has been often referred in the context of the working of modern day stock markets, and markets for options, futures, etc. It is claimed that these markets are mired with excessive speculative activities. For example, in stocks markets people trade in stocks for making quick capital gains rather than focusing on dividend payments.<sup>9</sup> Apart from the issue of *mysir*, it could also be argued that the basic goal of a stock market is efficient financial intermediation, which can be better realized if dividend payments are directly made the focal point of the market.

The same may apply to forward and future markets for commodities where the primary rationale for their establishment was to reduce risk and uncertainty about future prices for both consumers and producers. It is questionable if these markets generally achieve this ultimate goal. Apparently they have become places for excessive speculation or *mysir* and need careful evaluation by Muslim economists and financial experts for their acceptability, or to come up with possible reforms to make them conform to Islamic teachings. Even if these markets do provide some useful services, their acceptance, it can be argued, should be linked with the acceptance of the general behavior it creates among

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<sup>6</sup> Bacha (1999).

<sup>7</sup> For an excellent discussion on this issue please see Siddiqi, M.N. (1985).

<sup>8</sup> It is also being argued that, instead of allowing some individuals or group to insure others, people facing similar calamities in future should somehow get together, form their own insurance companies and share the cost and benefits collectively. Please see Kahf (1994). Alternatively, an individual or group could offer to establish and run such companies / organizations on behalf of the subscribers who would be the actual owners of such companies.

<sup>9</sup> For a good discussion on this issue please see Tag-eldin (1998), Ackacem (1999) and Kia (2001).

the participants. One should also contemplate to see if the perceived benefits could also be achieved through other means. Some risks in investments and businesses are inherent. Providing opportunities to individual investors and businesses to reduce or avoid risk may appear sensible. However, it would be difficult to reduce the total inherent risk of a sector of the economy; one individual or business can only try to shift risk to other. The solution lies in a risk sharing mechanism that is efficient, achieves the underlying goals, avoids excess speculation tantamount to *mysir*, and is fair to all parties involved.

The primary reason for establishing Islamic banking was to avoid interest, the main apparatus of conventional commercial banking. Interest being one of the most important element of many financial dealings in the contemporary world, we now turn to have a deeper look into the issues related to Islamic banking and its *modus operandi* to avoid interest.

### 3.2 Rationale for Prohibition of Interest

The basic case against interest is drawn from the *Qur'anic* prohibition of *riba*. Indeed there are arguments against treating bank interest as *riba* that is prohibited by The *Qur'an*. Similarly, it is widely accepted view among contemporary Islamic scholars that charging a higher price for a deferred payment sale of a good is allowed in Islam. Shamim Siddiqui (2006, 2006b & 2007) has dealt with these arguments and views at length and concludes that not only bank interest does come under the definition of *riba*, but the non acceptability of higher price for deferred sale is essential to avoid any contradiction in this regard. One cannot go here into the detail arguments and counterarguments but some important points could be made.

It is reasonable and important to admit the fact that whenever a person gives any type of loan (*not charity*) to any one, it does have an element of sacrifice in the following three senses:

- (i) there is anxiety whether the loan would be paid back or not
- (ii) a possibility of missing a profitable opportunity during the loan period and
- (iii) the loaned amount may be needed for important and urgent personal consumption.<sup>10</sup>

However, in order to promote brotherhood and fraternity among human beings, Islam prohibits charging of any interest on consumption loan. But to deny the reality that, in general, there is some sacrifice made by the lender would be wrong. Muslims are asked to make that sacrifice. Although there could be many cases in which people do feel good after giving loans to friends and relatives or to fellow human beings in distress even when they understand that there is a possibility of default. Islam *encourages* giving *Qarde Hasanah* (loan without interest). It also asks Muslims to give more time to the borrowers in case he/she is having problem in paying back --- all to promote humanity and a reward in the here after. The least permissible thing for a Muslim, who has been approached by a fellow human being for consumption loan, is to make an excuse gently and politely. But to give consumption loan and then ask for an increment over the original is unquestionably prohibited.

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<sup>10</sup>This proposition is valid irrespective of whether people have a positive, zero or negative time preference.

A possible objection to this assertion could be the existence of inflation in a modern monetized economy. This raises several issues: Can there be inflation (sustained increase in general price level) without increasing the supply of money beyond certain limit? If no, should an Islamic economic and financial system then permit occurrence of inflation through its monetary policy (changes in stock of money)? If yes, then under what circumstances? Siddiqui (1994) addresses these issues and concludes that it is possible to avoid the occurrence of inflation under an Islamic economic system. However, even if one admits that some positive level of inflation is a common feature of any modern economic system (Islamic or otherwise) and that it is not purely a monetary phenomenon, it only allows a case for indexing consumption loans to make adjustment for inflation. The main problem with indexing even consumption loans is that it makes inflation acceptable and gives a freer hand to the government to create money. It encourages her to become prodigal and avoid taking politically harder decisions to generate financial resources from other sources (generally through taxes) or to reduce avoidable expenditures.

An Islamic economic and financial system, therefore, must follow a monetary policy that makes inflation targeting as its main goal. Recent international experience shows that for a credible central bank achieving short as well as long term price stability is not as difficult as once it was thought. As a corollary, very low levels of inflation could allow sale on deferred payment by incorporating the cost of inflation in uniform prices for cash and credit sale (same as uniform prices are charged for cash and credit card payments) provided that the time period is not too long.

In case of production loan, the lender is allowed to accept a fraction of the profit if he also agrees to share the losses. The rationale is again based on the notion of human fraternity and brotherhood. In Islamic system of humane relationship and social justice, it is unethical on part of some of the providers of the business funds to ask for fixed positive return irrespective of the outcome of the business. On the other hand, it would be unjust on part of fund users to pay only a predetermined (small) rate of interest even if he is able to make a big fortune out of the business. Similarly, it is unjust to pay the lender a nominal rate of fixed interest when the rate of inflation is higher than this rate and the borrower is able to make a substantial profit. This is the case in Pakistan and many other developing countries where borrowing from commercial banks has become a cruel source of exploitation of bank depositors.<sup>11</sup>

It could be admitted that some individuals in the society may not have any other resources to earn a living (an old or disabled person) but a small amount of savings which they would not want to put to risk. Some special arrangement could be made for those individuals such as creation of a welfare fund by each business using their savings in the production process, which can dispense necessary relief to them in case of a business loss. Alternatively, their savings could be put under some government department or prudent private agencies, indirectly controlled by the government, who can efficiently manage diversified portfolio even if that leads to a relatively low level of returns. But on the pretext of presence of such individuals (e.g., old or disabled persons), a general permissibility of

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<sup>11</sup> The above cannot, however, be an analogy for disapproving fixed payment to labor. It is not too difficult to see through the difference. Labor is generally paid wage as current income for current consumption for living. There is nothing wrong if a well to do labor risks all his labor for a share in profit, or some workers agree to link part of their income to uncertain performance of the business entity. But to expect that workers in general should agree to exchange their labor totally for an uncertain income will be unjust.

institution of business interest goes against the Islamic principles of social justice. Similarly, the need of financing of small business loans (and those consumer durables) is very important. However, the best way to tackle these financing in an Islamic society is to establish specialized financial institutions that give loans for genuine needs without interest.

Islamic economists have created a large literature proposing a profit and loss sharing Islamic banking (PALSIB) system. The salient features of that system are:

- Commercial banks making profit and loss sharing arrangements with both their funds providers as well as funds users.
- Commercial banks offering deposit accounts not paying any interest and charging a minimal fee for safe keeping and check clearance. Also, a 100% reserve requirements on such accounts abolishing their power to create endogenous money.
- Commercial banks are allowed to offer investment accounts of different maturities.
- The central banks also keeps multiple investment accounts in all PALSIB banks allowing it to hold a real stake in the banking system and remain the provider of funds (*not lender* !) of last resort. The central bank becomes the only entity to create and directly control money in the economy.
- Commercial banks combine share holders' and investment account holders' funds and invest with fund users on the basis of profit and loss sharing and other Islamically permissible modes of finance such as operational leasing. The banks then share the profits (and loss) at both tiers of transactions.

It must be mentioned here that this proposed banking system is yet to be implemented in any of the Muslim country. The existing Islamic banks are far from this proposed system and their products often mimic those of the conventional commercial banks. Siddiqui (2007) gives a detail overview of the need to establish PALSIB, describes the difficulties in its implementation, and presents a road map for its accomplishment. Fardmanesh and Siddiqui (1994) describe how the proposed PALSIB system would avoid the sources of instability inherent in the western capitalistic system. The current attempt of western governments to take equity stakes in commercial banks is compatible with the Islamic banking system.

### ***Financing of Consumer Durables and Micro or Medium Size Loans***

Commercial banks have been in the forefront in financing consumer loans specially those of automobiles and housing. Many of these loans are provided against expected stable stream of future income or collaterals and paid back in installments with accrued interest. There is no denial that such financing facilities do provide an important service to millions of people. However, if one accepts the notion that any amount of interest paid (that is over and above a compensation for inflation) is Islamically unacceptable, how would then proposed profit and loss sharing Islamic banks (PALSIBs) continue to provide loans for consumer durables?

It has been proposed that reasonable funds for consumer durables should be available through government resources. We should keep in mind that under an Islamic economic and financial system the commercial banks will not be allowed to create money

and hence an added room for (non inflationary) money creation will be available to the government. A part of this resource plus an appropriate amount from government tax revenue could be channeled for financing consumer durables including housing. The management of these funds could be given to specially created government institutions for these purposes. Alternatively, these entities could be allowed to be established in the private sector who would receive the required funds from the government along with a reasonable percentage as fees for their services. An added advantage of this arrangement will be that, through proper guidelines given to these institutions, the government should be able to curb the rampant consumerism currently seen in many Muslim countries.

Micro financing is a relatively new phenomenon. Its founder, Dr. Younus has clearly shown the world that through an appropriate approach loans could be given to the poorest of the poor without involving collateral. The key to his success was the way bank employees engaged themselves with their funds users. Some people have criticized his organization for charging a high rate of interest. However, one has to see the motive of his organization which was to help as many poor as possible through a sustainable non profit organization (interest was not charged to make money but to cover the cost of operation and expand the *helping the poor* activity (not making money through interest). Indeed if the government could provide funds, there would be no need to charge any interest at all. Also an appropriate structure of profit and loss sharing arrangement could also be developed to finance such loans with proper training and organizational set up.

Works on similar line have to be done to cater the needs of small and medium size enterprises. With the level of advancement in information technology and improvement and innovation in forensic accounting, the supervision and monitoring of even small business are not as difficult as it used to be.

### ***Rationale for Avoidance of gharar and mysir***

As mentioned above, *gharar* or uncertainty in business contracts and dealings could lead to exploitation of one or more parties involved. It may sow the seed of an opportunistic or selfish behaviour among some parties at the detriment of others. Avoidance of *gharar* achieves twin goals of protecting the just rights and interests of all parties involved in a business or financial transaction as well as reducing the chances of committing an Islamically undesirable act at individual level.

Similarly, avoidance of *mysir* or *qimar* in business and financial transaction would allow individual Muslims to refrain from gambling like acts that makes people believe they can earn large money quickly and without too much effort. It is being claimed by many observers, both Muslims and non Muslims, that the markets for shares and different kinds of derivatives are mired with excessive speculation that reaches the level of *mysir* prohibited in Islam. It is also being claimed that these markets allow the shrewder players to manipulate that causes harm to small ones.<sup>12</sup> While this may not be true any more as smaller traders have now option to invest through fund managers, the intense trading activities in these markets does create an atmosphere that unnecessarily keep people continuously thinking about the changing values of their wealth. After all, repeated and multiple buying and selling of shares throughout the day and week, hardly affect the performance of the companies or the overall profits of those companies. One can ask a very simple question as to what will be lost if trading in secondary markets is allowed only once a week or once a fortnight?

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<sup>12</sup> Please see Tag-eldin (1998).

One can make the argument that stock markets, even if they create unnecessary speculative activity under the current rules of the game, at least act as important financial inter-mediators in the economy by increasing the acceptability and sale of shares at the primary level. However, the desirability and importance of markets for futures and derivatives is much more questionable. Apparently they are seen beneficial as tools of risk management. However, from an Islamic point of view, the level of speculative activities generated by these markets make them questionable. Moreover, whether they really help in stabilizing prices over time and thus help economic agents better plan their future, is not very clear. One has to also see if the same perceived benefits could be achieved through different institutional arrangements. The agricultural support price system that helps both consumers and producers through stabilizing the prices over time is a good example.

## **5. Islamic Economic System is Inherently Sustainable**

There are many definitions of sustainable development but they all come down to two basic issues:

- (a) the development and growth of an economy should not lead to inequitable distribution of income creating tensions in different segments of the society, and
- (b) it should not lead to unacceptable environmental degradation that could harm the overall well being of present and future generations of human beings as well as other animals on the earth.

We have already seen how Islam gives a higher priority to distribution of income. Furthermore, maximization of material well being which basically means maximization of consumption is never the ultimate goal of the society or individual Muslims. In principle, in order to achieve a desirable distribution of income, if necessary, even some loss of efficiency could be tolerated. Similarly, the drive to realize higher and higher levels of GDP or consumption cannot be allowed at the cost of degradation of the environment. On one hand Islam discourages people to be misers but on the other it commands its followers to avoid waste and prodigality calling it a satanic act.

However, given the human instincts for wastefulness and inclination for achieving higher and higher levels of material comforts at the individual levels, it is the collective responsibility of the society that it empowers the government to take every possible action to assure that the natural balance of earth is not disturbed. It would be an important area of research in Islamic economics to help in formulating appropriate policies for the government.

## **6. Conclusions**

Islamic economics is based on Islam's world view that treats this worldly life a temporary phenomenon. An Islamic economic system recognizes human instincts for pursuit of material wealth but provides standards of moral behaviour to restrain such instincts for a harmonious society on this earthly life. An equitable distribution of income is important to help its people in following the precepts of Islam at the individual level. It directly commands the leaders of Muslim communities to shun concentration of wealth among few hands.



An Islamic economic system allows private property including means of production and encourages in letting the markets play their role in determining prices of goods and services. But again, it also supports government role in promulgating rules, regulations and establishing institutions for a desirable distribution of income among different factors of production. This requires a good understanding of the working of a modern economy with its existing institutions.

Even though Islam does not discourage to make efforts for a decent life on earth it advises its followers to take a middle path and avoid both miserliness and extravagant waste. Economic growth and corresponding higher level of overall consumption while not being discouraged, is not allowed at the cost of deteriorating income distribution pattern or environmental degradation. The notion of sustainable development is thus inherently embedded in an Islamic economic system.

It is expected that the points made in this paper will provide the basic idea of an Islamic economic system to the western audience.

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