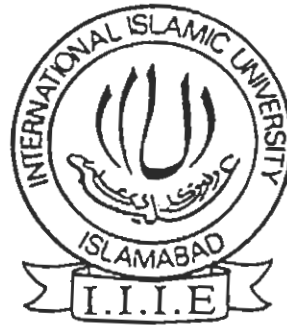


**RIBA VERSUS PROFIT-SHARING:
THEORETICAL FOUNDATIONS AND POLICY IMPLICATIONS
IN ISLAMIC PERSPECTIVES**

BY

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ABSTRACT

The central theme of this study is to exhibit the economic rationale and the legal wisdom of fundamental parameters of Islamic economic system. The essential features of the system such as, its pragmatic nature and market oriented mechanisms would be critically investigated. As the market economy primarily consists of a set of economic factors; institutions that would help voluntary cooperation and mutual exchanges among individuals' economic resources, the main factors may generally include, the legal tenets, ethical framework, the economic patterns of social interactions and operational processes. Islamic financial principles emphasize the significant role of the market in the economy, to such an extent, the assessment of economic parameters is determined by natural market operations. That is, rejecting *riba* and *gharar* on one hand and permitting the pursue of profit on the other. However, these elementary principles that make up the foundations of Islamic financial system have not been substantially elaborated in consistent and coherent fashion. As a result the role of the market operations in Islamic economics and its inherent features of simplistic, realistic and natural manifestations has not yet been rigorously explored.

This work may be attributed to the reinterpretation of the *riba* doctrine and reconsideration of profit theory in Islamic perspective. It aims at discovering their neglected aspect to provide them with stronger theoretical justifications in both economic rationale and legal consistence. The approach adopted for this research, is to display relatively easy and perhaps a proper way of identifying the inherent distinctive features between the basic terms of *riba* and profit than their present situations. Although both of these elements establish the components of the theory of excess value, if we examine them in the context of exchange economy, the point of divergence between them would emerge as a natural phenomenon. In the sense, that *riba* precisely falls in the context of exchange in identical goods or services, while profit entirely falls in the area of trading dissimilar ones. Probably the economic relations of goods and services constitute the central point of the theory of excess value, which, perhaps, make up the core of Islamic price theory. Therefore, the difference has essentially economic bearing and legal perspective. In economic bearings, the *riba*-based activity has no benefit or no economic gain is expected to the participants as a whole, but, it leads to a general want and scarcity. However, profit represents; the values added, welfare and increase in utility through trade to both participating parties or at least in Parieto

inefficiency condition, at least either party would be better off without making anybody else worse off. In legal perspective, since *riba* stands for a kind of squandering and devouring the property of others in vanity and faulty way, profit stands for natural growth which is permitted in Islam provided the exchange to take place in mutual willingness.

These two dimensions of the subject determine the origin and eligibility of excess value in Islamic perspective. The elaborations of these aspects require a serious attempt and rigorous logical integration of Islamic teachings with the basic economic theories, in order to reformulate the microeconomic foundations for Islamic financial system. However, achieving this desired objective confronts a great challenge from two perplexing perspectives. Firstly, the complexity of underlying conventional theory of capital in the context of which the identifications and rationale of even the elementary parameters, i.e., profit, interest and rent seem to be highly ambiguous and subject of ever lasting controversies among conventional economists. Secondly, the obscurity of *riba* doctrine and the existence of diverse juristic interpretations of its conceptual and practical implications is historical fact. The fiqh scholars have been debating over centuries on the nature and legal implications of primary attributes of *riba*. In an attempt of building a theory of excess value (profit and *riba*) from the basics, the incorporation of these challenging perspectives is necessary adventure.

Departing from the predominant view of the contemporary studies, the research intends to coin a consolidated notion and integrated concept of *riba*. In such a manner the term *riba* would cover both the *riba* of sale and that in loan transactions. The derivation is based on the synthesis of the available authentic Islamic injunctions and classical juristic explanations. It would establish a comprehensive view and generic meaning of the term *riba* in Islam which would be the key and foundational ground for the rest of the analysis. In this connection the study is designed to address primarily the need of the common Muslims by enabling them easily to comprehend the real nature of *riba* stained economic operations, in order to, avoid this economic evil and immoral activity. Secondly, it is to prepare a ground for solid economic theory and finance in Islam and for further research works of the development of this new economic system.

Basically, this study is devised to be generally constructive, but, a systematic critique of the mainstream view of Muslim scholars may be noted. In the sense, we have come up with the

conclusion that the fixity and variability of the rate of return, or the association of the natural phenomenon of uncertainty and risk bearing to economic activities have nothing to do with the origin and eligibility of both *riba* and profit terms. In this postulation, the factors which relate to profit sharing or entitlement to business outcomes are considered as a separate issue from those originate the profit or determine its permission. This implies that the factors that determine the sharing ratios should be distinguished from those generate the profit itself or govern its legal position. The underlying economic activity of financial modes, i.e., Mudaraba and Musharaka according to this study are related only with distributional aspect, depending on the level and nature of the participation. On the other hand, the fixity or predetermination assumption of the rate return is unable to convert what economically and legally is recognized as a justified profit into prohibited *riba*. As a result, the predetermination of the rate of profit, even though it may accompany certain degree of *gharar* (risk and uncertainty which are tolerable to some extent in Islamic jurisprudence), there is no evidence to justify its equivalence with *riba*. Therefore, reshaping the PLS system in the light of these findings, there is a large possibility of improving the theoretical basis of profit-sharing system and enhancing the feasibility and operational conditions of the Islamic financial system than its predominantly envisaged state.

CHAPTER I

INTRODUCTION

The elimination of *riba* is one of the basic requirements for the establishment of an Islamic economic system. Hence a correct understanding of *riba* is a prerequisite for appreciating what needs to be avoided and adopting an appropriate policies for its elimination. In recent years a good deal of attention has been paid by Muslim experts in economics, banking and finance to find ways and means of doing away with *riba*. A tremendous efforts and intensive work have been directed to dig out the conceptual meaning and practical implications of the term. A series of conferences, seminars and symposium are held in Muslim World. And numerous of *fatwa* rulings has been issued on its prohibition at individual, institution and government levels. Despite, all these efforts the issue of the elimination of *riba* and implementation of full-fledged model of a profit-sharing as the sole natural substitute of a *riba* element seems to be hardly realized and dimly theorized. Given this reality, the present study devoted to enlighten the major issues and mostly overlooked underlying problems of this intricate subject. This introductory chapter outlines the issue at hand as the central problem of the matter which this research is intending to address. It makes the reader to comprehend the nature of the research synopsis; for instance the significance of the topic as the basic motivation of conducting this study, objectives and the methodology followed. It summarizes the structure of the study and its contents in a chapter wise structure.

1.1 THE ISSUE AT HAND

As we mentioned above, in spite of, extensive efforts directed towards the eliminations of *riba* from the economy at institutional and national level the desired objectives have not yet been attained in substantial. Perhaps the reason lies with the interpretations and the adopted methodology inconsistency between *Fiqh* position and contemporary approaches. Surveying the existing literature of classical *Fiqh* interpretations and contemporary studies on the subject of *riba* and profit, we see two main approaches, juristic approach and modern Islamic economic approach, each one of these two trends is facing certain kinds of conceptual difficulties. These difficulties perhaps raise the most challenging questions of this field in the modern time. The nature and rationale of profit-sharing system are generally based on its essential features of total rejection of *riba* and establishing a financial alternative system free

from this element. However, the whole theory of Islamic financial system is founded squarely on the assumption that *riba* is essentially risk free and fixed rates of return. While, PLS in opposite allows for the participants to share risks. And the fixed nature of the rate of return on capital is considered the unique characteristic of interest as believed by most of the contemporary Muslim economists, on the view that *riba* in Islam is absolutely equal to the conventional interest. Thus, PLS principle (*Mudaraba* and *Musharaka*) is the necessary substitute, which is based on the variable rate of return. However, the emergence of Islamic financial institutions has practically demonstrated a contrary reality. They are almost dependent in their financial operations on *Murabaha* or short-term trade-based system known as mark up and leasing techniques of financing. As these modes would provide a relatively risk-free and predetermined income, while, the profit sharing as it is visualized in the contemporary Islamic literature, is the least popular and practically negligible part in the volume of business operations of Islamic financial institutions. As a result the Islamic financial institutions practically have shown that they cannot run on the basis of PLS principle because they are too risk-prone while this system in its present form is too risk-oriented nature. It is strongly argued that the ordinary financier is not entitled to a return on his savings unless he puts them at risk, on the basis of the maxim '*al-ghunm bi al-ghurm*' interpreted as - no gain without risk taking.

1.1.1 Methodological Problem

The contemporary studies apparently show a methodological inconsistency with how the earlier jurists approached to the explanation of *riba*. The early *Fiqh* scholars reduced its scope entirely into the context of an exchange contract and accordingly examined in depth its essential features such as: the intrinsic characteristics of exchange items, a standard unit of estimating, and the conditions and features of the nature of a contract. The contemporary Islamic economic literature on this subject is continuously presenting the subject on the basis of conventional assumptions such as; Consumer Time Preference, uncertainty or risk-bearing or risk and return sharing ratios, to distinguish between and separately define what is the justified profit and prohibited *riba* in Islam. There is no feasible correlation between the above *Fiqh* methodology and contemporary studies. It seems that the Muslim economic experts have not substantially incorporated in their researches the juristic considerations or they have not independently worked to trace out the underlying principles of the classical *Fiqh* discussions

in order to formulate a workable Islamic economic model and logically meaningful conceptualization.

1.1.2 Unresolved Fiqh Considerations.

No doubt that there is a complete agreement among Muslim jurists that *riba* is strictly prohibited by Qur'an and Sunna in clear and unambiguous words but despite this fact, the issue of *riba* in Shariah, as far as its identification and rationale is concerned, has been one of the most complex and challenging issues tackled by the Muslim scholars, since, the time of early Islamic jurists. There are number of fundamental issues related to the very nature of the term *riba* which have not been yet resolved in the *Fiqh* literature. The main points of contention between classical *Fiqh* scholars and their modern interpretations have been identified as; Firstly the obscurity of the technical connotation of *riba*, where although the literal interpretation of the term is very clear and obvious, the intended meaning of the term *riba* by Shariah was subject to recurring disputes. Whether the word *riba* is a generic term as may be understood from its linguistic usage or it is undeveloped word that has an inchoate meaning like prayer and *Zakah* has been the question worked out by the early Maliki and Hanafi schools of jurists respectively. As a result of this traditional debate most of the Islamic economic writers in the modern time feel uncomfortable with referring the term to its dictionary meaning, instead they rely on the objectives and the central purpose of its message. Secondly, the significant dimension of the problem arises from the ambiguity around the effective cause (*illat*) of *riba*, its well familiar among *Fiqh* scholars that there is general disagreement among juristic presentations about the underlying rationale of the prohibition *riba* and its "illat" or effective cause. Although the majority of *Fiqh* scholars are of the view that *riba al fadl* is extendable to all goods rather than confining it to only the six items mentioned by the Prophet (saw) in his famous hadith, but, there is no agreed effective cause or illat that exclusively determines the existence of *riba* in transaction. All the approaches worked out by the *Fiqh* scholars for this extension of *ribawi* goods have been subject to critical, and serious reservations, since the early *Fiqh* scholars. Thirdly overlooking the qualitative aspect of exchange items is another crucial matter. The general view of the *Fiqh* scholars totally disregards the concept of quality difference in the context of exchange of identical items. The conceptual difficult of this point are widely noted and it is considered as an unjustified assumption which is contrary to the common sense and objectives of Shariah.

Generally *Fiqh* scholars emphasize only the quantitative difference of the two items irrespective of their quality standard. The rationale of selling superior property for inferior one of equal quantity is subject to logical question and serious conceptual criticism in contemporary treatments. Fourthly, Perhaps apparently the serious theoretical inconsistency of time valuation is not rigorously investigated. However it is noted that there is a double consideration in the notion of time value, where on one hand we see a complete rejection of time difference in exchange of two homogeneous articles or *ribawi* objects for this will amount to *riba nasia'* or *riba al-yad*, on the other hand the permission of a price increase on credit sale is categorically considered as a permission to time value. Further more a time lag is allowed in a loan contract and it should not get any compensation otherwise it would be clearly *riba nasia*. It is hardly to be overemphasized the significance of resolving these conceptual *Fiqh* questions for Islamic financial system. They are in fact the integral and central point of the problem or present paradoxical situation faced by Islamic economic theory.

1.1.3 Present Paradox

Contemporary studies as it is noted above, show certain features of conceptual inconsistencies and theoretical difficulties that may put in doubt the rationale and logical conclusions of the subject. Majority of Muslim writers are repeatedly focusing on an equality assumption, that is, one to one correspondence of *riba* and interest relationship. The current Islamic economic studies concentrate almost on justifying the above presumed equality on the basis of that *riba* is a fixed rate of return on money capital. However, the main arguments of this justification are built around certain features attributed to this conventional term of interest rate, such as: its time framed and risk-free nature, in other words the certainty/predetermination of its rate as well as its time dimension. Despite the conventional roots of these characteristics of interest, the modern Islamic economic studies accepted them as the principal elements which establish the effective underpinning reasons of the prohibition of *riba* in Islam. Unlike the rent the *Fiqh* books have not shown any substantial elaboration of the concept of profit. Despite the fact of its immediate concern not only for its role on economic efficiency, resource allocation and being the sole known substitution of *riba* in Islam, no precise interpretation of the word profit and its originating factor has yet been worked out Akram (1993). The current studies instead of developing this raw concept of profit they relied on the conventional literature, which bears a lot of ambiguities and placing in doubt even its basic existence.

Profit in contrary to interest is determined through counter rationale of an interest rate. for uncertainty and risk bearing determine the existence or permissibility of profit. The contemporary Islamic scholars have built their theory of profit on Knight's all embracing eclectic theory, and they strongly asserted that profit by definition to be the reward for risk-bearing on the basis of juristic principle *al-ghunm bil-ghurm* which interpreted as no risk and no return. Hence, any risk-free return is considered as *riba*. As a result of this view, it is concluded that risk-bearing to be a necessary condition for the legitimacy of the rate of return. This perception of assuming the existence of the risk element as the sole difference between profit and *riba* has led a large number of the Muslim economists to a paradoxical correlation between profit and *riba* where profit is equivalent to a pure interest rate plus a risk premium or total sum of profit plus interest in capitalist economy, was regarded to amount to profit in Islam Chapra (1983). Naqvi (1983), Choudhary (1992).

Despite the theoretical claims that in Islamic frame work *Mudaraba* and *Musharaka* will be better modes for utilizing resources in the financial sector, in practice, the Islamic banks and financial institutions are very reluctant to adopt it. Perhaps they are afraid of the dishonesty of their clients or the cost of monitoring. On the other hand the traditional *Mudaraba* applications in the modern banking finance have been found to have inherent limitations by some Muslim scholars, i.e., Hamoud (1985) and Bacha (1995). Hamoud has shown certain reservations on the applications of traditional *Mudaraba* in the modern financial system on several grounds namely: Firstly the bilateral nature of the classical *Mudaraba* principle may not satisfy the needs of financial intermediation, secondly, the bilateral *Mudaraba* practice show profit distribution after every transaction while in the modern profit sharing is largely different. Thirdly, *Mudaraba* in its traditional form is incapable of providing finance durable and non-durable consumer goods.

Therefore, the Islamic banks have found certain trade-based and leasing modes financing, i.e., *Murabaha* and *Ijara* to be the most suitable operations for their practical business. Despite all the rationalizations, Islamic economists have been unable so far to convince the common man about the Islamicity of these alternatives. Following the public opinion of rejecting two of the major financial modes of financing without giving convincing justifications makes the entire program of Islamization of economics doubtful by increasing

the opinion diversifications without concrete logic and authentic legal ground. While, Shariah objectives are addressing the immediate problems which humanity might face as a whole, the contemporary studies have not focused sufficiently the points of contention on the light of the revealed texts. To explain this practical diversion of financial institutions from the theorized ones Islamic economists have presented different opinions which may not yet address the core of the subject matter. Waqar Masud argued that it is due to the informational asymmetry related to the nature of PLS principle, Bacha also explained this reality using a series of theoretical model came up with the conclusion that *Mudaraba* is susceptible to acute agency problems where it contains certain features of both debt and equity finance, because, the proprietor should not have any interference in the operations of the business at the same time liable to all the losses. Fahim Khan explained it in the context of existing financial and fiscal structure, and with the availability of cheap modes of finance, according to the rule of bad products drives out the good products. However, the important questions yet unanswered arise from here, such as: Does Islam glorify risk to such an extent that any legitimate gain is determined by it? And to what extent the Islamic bankers argue that they cannot do without it? . Do any predetermined and risk-free return necessarily mean *riba*? On the other hand, does any uncertain and highly risk return implies profit? If it is so, what is the role of *gharar* in business activities? . On the other hand the logical conclusions of the current literature have not given a clear answer to the following important questions such as. whether PLS is a specific mode of finance or simply the distribution of outcomes among participants? Whether its operation is absolutely free from *riba* in other words, whether it has internally built-in factors or safety which may keep the system in *riba* free? Do we say the organizational form of *Mudaraba*, *Musharaka* or even their proposed combination of common joint stock and corporation is necessary and sufficient condition for *riba* elimination? Or does the process of *riba* elimination require certain other conditions?

1.2 THE NATURE OF THE RESEARCH

This apparent inconsistency and present paradoxical situation of Islamic financial agenda necessitate further research and fresh examination of the fundamental concepts of the issue. The problem seemingly starts not with the fixity and the variability of the rate return. But, with the absence of precise and exclusive definitions of profit and *riba*, the ambiguity about these two terms is perhaps the main source of recurring confusions and present irreconcilable

disparity between the theory and practical reality. This unfortunate situation of theoretical crises in this vital issue serves primarily, the motivating factor for the present research.

1.2.1 Importance and Motivation of the Study

The importance of the subject cannot be exaggerated as it addresses the heart-center of Islamic financial system, and I am optimistic about that this study may pinpoint the major factors of the problem and present the modest attempt to build a consistent view and theoretical process that may reactivate Muslim intellectuals towards bridging the gap between *Fiqh* teachings and modern economic analysis. That is to synthesize the existing diverse scholastic views on the subject of *riba* and profit. Needless to emphasize, if this conceptual and communication deadlock is worked out that it will have practically and theoretically a far reaching socioeconomic implications. Ironically, the issue of the topic is considered beyond any individual effort, it is pointed out that it requires for a collective work of *Ijtihad* to be made by Shariah scholars and economic experts. It is so, because, on one hand, the explanation and determination of profit and interest still give rise to more disagreement among conventional economists than any other branch of general economic theory, on the other hand the concept of *riba* in Islam is considered the most ambiguous and debatable area in the *Fiqh* literature. Incorporating these obscurely correlated parameters together in one issue is, in fact, extremely difficult and a dangerous task. Keeping in mind with this reality, we would make adventure, and try to examine the basic ingredients of profit-sharing doctrine in Islam with cautious. If we safely and successfully go through it is with the help of Allah (swt) and any mistake that may occur is from me no options except to ask Allah the almighty for pardon and the perfection is for Him (swt) alone.

1.2.2 Objectives of the Study

Precisely, the research is designed to address the following issues:

- i. It is to demonstrate a simple integrated concept of *riba* unifying its divisions (*riba al fadl* *riba nasia* and according to some of the jurists *riba al yad*) and applicable to all its designated individual elements on the basis of the literal usage of the term *riba* in the Qur'an and in the Sunna of the Prophet(saw). Precisely, we would try to present a synthesis of the interpretations and widely diverse views of the Islamic jurists on the rationale, source, scope and practical implications of *riba* in order to make the common man easily understand

where the problem of *riba* falls on.

ii. To draw a clear separation and illustrate the distinctive nature of *riba* and profit concepts in the context of pure exchange, inter-temporal choice and uncertainty assumptions, and try to shed the light on some conceptual ambiguities and apparently naive justifications' presented by the modern Islamic economic literature as the rational principles behind the prohibition of *riba* and permission of the profit in Islam.

iii. To study the implications of the research's findings for Islamic financial system and try to search for an economically viable and Islamically acceptable method of capital valuation in order to build a theoretical foundation for exclusively profit based financial system on the framework of *Mudaraba* and *Musharaka*. According to this study the applicability of Islamic financial operations based on profit-sharing and participatory financing might be largely improved demonstrating that this system is comparatively superior to the conventional interest-based system on purely economic ground.

1.2.3 Hypothesis and Methodology

Al though, the illustrative mathematical models and sophisticated form of some journal articles are the preferred means of scientific communications, the nature of the present study is a desk of an audit tool of research work based on critical analysis and conceptual formulations, with the belief that unless the fundamental issues are resolved and some clear grounds are prepared any well articulated model and empirical studies are most likely liable to miss the mark. In our general impression on the existing literature on *riba* and profit is that it is facing theoretically a highly unsettled state, which necessitates the reexamination of their fundamental concepts. In general, the present work is based on library work of a secondary source. We used the existing text books, research publications and works of classical *Fiqh* scholars or original sources of Islamic law. And incorporating with the basic tools of modern economic techniques, we seriously tried that the gist of Islamic financial features may be brought into the light.

The research is trying to formulate a microeconomic-foundation for the concepts of *riba* and profit. This research, perhaps, seems to be a deliberate diversion from the dominant

view and mainstream's methodology of Islamic economists that maintains to concentrate on an equivalence approach by equating first the conventional term interest to the concept of *riba* in Islam and drawing from their common features, the rationale of their prohibition. Thus, consequently they try to conclude the justifications of profit as a contrary result. Instead, this study focuses on a separation approach between *riba* and profit, that is demonstrating the essence and origin of each and illustrating their individual distinctive nature as well as their justifying factors, based on the authentic Shariah injunctions and their literal interpretations. Although both terms of *riba* and profit in Islam are increase, and excess values which are basically exchange phenomena. Nevertheless, unlike interest which is inherently subject to so many ambiguities and controversies, the two terms have exclusively separate roots and separate natural origins. Profit arises from trade in two different goods / utilities. While, *riba* in contrast, arises from the exchange of two identical utilities contained by the same kind of a good, this interpretation applies to both kinds of *riba al-fadl* and *riba al-nasia*. Profit-oriented activity is beneficial to all parties while *riba* shows a zero sum game operation as the gain of either party is a loss to the other. Moreover, while, in this context *riba* is clear quantifiable with complete certainty, the advance determinations or distribution of profit may associate with uncertainty and *gharar*. In these postulation factors which relate to profit sharing or distributions are considered separate issue from those originate it or determine its permission. In order to illustrate the essence of the matter we will apply certain elementary principles of the modern economics and generally accepted basic laws of utility and trade theories. In our exposition of Shariah principles related to the subject we should consult the authentic works of classical jurists, concentrating upon such views and interpretations which establishes a conceptual unanimity and meaningful comprehension. Some times we may not follow the view of the majority instead we may choose an opinion of minority if it is consistent with the general objectives of Shariah and clearly relevant to the immediate requirements of the concerned issue.

1.3 THE RESEARCH STRUCTURE

This study contains three parts divided in ten chapters including the introduction, and the final conclusions. The first part consists of chapter 2 and 3 and addresses the theoretical background of the research. It is intended to demonstrate a comprehensive literature review about the nature, source and implications of mostly confused concepts, such as: *riba*, profit,

and rent according to the contemporary Islamic economic writers and classical *Fiqh* literature. Chapter two exclusively exposes the concept of *riba* in Islam and its contemporary interpretations concentrating its linguistic meaning and logical consequences of *Fiqh* injunctions according to the *Fiqh* scholars. Chapter three demonstrates the theoretical review of profit, rent and interest. It examines the modern interpretations of these terms on the light of the economic state of arts. This study discloses that they are in the most ambiguous and obscure state as we find that there is no agreement among economists about the fundamental nature and origin of these three terms. In this chapter we devote to critically assess the main theoretical inconsistencies that associate with these elementary concepts. Section 3.1 will highlight the nature of profit and its sources in mainstream perspectives and confusion associates in the usage of profit and interest. It would draw to the attention the influence of the said confusion on Islamic economic literature. Section 3.2 would look into the concept of profit in Islamic perspectives and examine the nature and source of profit in *Fiqh* perspective as well as in the contemporary Islamic studies. Section 3.3 reviews certain theoretical apprehension associates with the nature of renting in conventional economics, it highlights the conceptual ambiguities in lending and leasing. Comparatively, on the other hand it discusses in section 3.4 the nature of renting (*Ijara*) according to Islamic jurists and current Islamic economic literature. It will briefly elaborate the modern applications of leasing mode of finance.

The second part which covers next four chapters establishes the central theoretical arguments of the study and aims at formulating a consistent integrated picture of the subject. Perhaps chapter four establishes the cornerstone and the solid foundations for almost all subsequent discussions. In this chapter we would like reconstructing an integrated view of *riba* (excess value) derived from the basic message of Shariah principles. This is a serious attempt of building a consistent theory of *riba* doctrine in Islam. That is *riba* in Qur'an together with *riba* in the Sunna of the Prophet (saw) constitute a single generic notion in Islam. The chapter is focusing on several fundamental issues and basic arguments that may run as follows: Section 4.1 presents a brief outline of the juristic treatment of traditional conclusions, unresolved problems and conceptual difficulties. In section 4.2 we examine the basic ingredients and textual analysis of the subject, in order to substantiate this postulation we try to decompose the central message of the Prophet (saw) into certain manageable principles or axioms. Section 4.3 is to elaborate the nature of loan transactions and its nebulous contours, loanable

goods, repayment conditions. Section 4.4 formulates an integrated concept of *riba* by constructing the common characteristics and essential features of sale and loan transactions in the context of exchange in homogeneous things and from these findings it examined the basic effective reason or *illat* of *riba*. Section 4.5 devotes to the third principle related to the concept of hand to hand. It examines the role and economic implications of this ascertaining principle and its broad applications in financial transactions to take care of *riba* as well as *gharar* elements.

In an attempt of formulating microeconomic foundations for some logical separations of the concepts of *riba* and profits we illustrate the underpinning logical principles of the prohibition of *riba* and the permission of the profit in the context of exchange theory. We would like to examine the concept incremental value exclusively in pure exchange economy. The arguments in this chapter would run as follows; Section 5.1 highlights the nature, scope and importance of the exchange economy. It explores the underpinning philosophical comprehension of the subject. Section 5.2 presents classifications of transactions, providing certain economic assessments on the incremental value and the concept of counter value in juristic as well as economic perspectives. Sect.5.3 is a logical investigation of the economic rationale of *riba* and profit in consumer perspectives employing generally accepted microeconomic laws of utility theory. Section.5.4 investigates the problem from the perspective of trade theory and in this context argues that profit may be realized in the form of cost reduction in production activity and in terms of gain from trade. Section 5.5 outlines the Islamic point's of view in pursue of profit and presents certain ethical principles governing the market operations.

Chapter six concentrates the concept of time value in conventional as well as Islamic perspectives. It is the matter of fact that the concept of time is strongly related to the fundamental issues of Islamic financial system the nucleus of the issue lies with the Qur'anic principle of the permitting the sale and rejecting the concept of *riba*. The permitted sales include all kinds of credit/deferred transactions, whereas the Islamic jurists are in a consensus that the price of a sale contract may be increased in case of deferred payment, but, any increase of the borrowed principal is completely ruled out. The rationale of this apparent duality is yet unresolved issues which represent the crux of the confusion in the minds of the contemporary Islamic scholars. Given these apparently conflicting considerations we examine,

in section 6.1 the nature of time element and time value. Sect.6.2 presents debates on Consumer Time Preference in which we may discuss the conventional theories underlying this assumption the views of contemporary Islamic economic writers on the basis of their subsequent discounting postulations. In section. 6.3, we will present the critiques and alternative considerations of Consumer Time Preference in both conventional literature and contemporary Islamic economic teachings. In this connection we will examine the production preference, saving behavior, liquidity preference theory as the main evidence of the weaknesses of Consumer Time Preference. Sec.6.4 critically analysis deferred sale and time factor in Islamic perspectives reviewing the existing conflicting thoughts about the subject. It formulates a synthesizing view in its entirety. Sec. 6.5 looks the nature of a loan in Islamic points of view and it examines the role of loan transaction in Islam. Finally we come to the concluding remarks of over all discussions in the chapter.

The profit theory propounded by the Muslim economists is built entirely in the context of uncertainty and risk bearing assumption. In this chapter we would like to probe into the theoretical foundations of this dominant view in the contemporary literature of Islamic financial system on one hand and the practical viability of its operational reality. We shall examine two basic aspects of the Islamicity of the existing system of Islamic banking. First we would critically investigate the nature of risk and uncertainty in Islam. Secondly the role of risk bearing on the nature and existence of the rate of return. The main arguments of this chapter may be formatted as follows: In section 7.1 the first we would critically investigate the nature of risk and uncertainty in Islam. The section 7.2 would address the role of risk bearing on the origin and legitimacy of the rate of return, the relationship between risk and return, between risk and the element of interest and acknowledging that uncertainty as a part of human ignorance it comes to the conclusion that the monopolistic nature of risk determines the magnitude of the return. Section 7.3 investigates the risk and the legitimacy of the return on the base of the dominant view which asserts that without risk there is no profit, and dissent opinion which holds that profit is earned by ownership. In this context we would critically review the interpretations of Shariah axiom *al-Kharaj bil-al-thamman* or *al-ghurm bil-ghunni*. Section 7.4 will expose the general Islamic point of view about risk and uncertainty or *gharar*, it furnishes the scope of *gharar* in *Fiqh* injunctions, the nature of effective *gharar* and its implications and concludes with the fact that *gharar* in Shariah relates to profit not to *riba*. Lastly the section 7.5 focuses on risk management and implications of the predetermination

on the following dimensions such as risk shifting or risk transferring, risk averting on the basis of contract, risk distribution or risk sharing mechanism, risk reduction or risk minimizing, dealing with risk in Islamic perspectives, and finally the operational practices of Islamic banks

The third part contains the last two chapters and the final conclusion and it is related to the policy and economic implications based on the above theoretical findings. Profit-sharing system may be generally referred as a method of participatory engagement in business activities and sharing the resulting outcome according to pre agreed proportions. Given the contemporary apparent inconsistency of theoretical concepts of profit-sharing system and its practical application by Islamic financial institutions, the arguments in this chapter are organized as follows: section 8.1 briefly summarizes the kinds and forms of business organizations in contemporary Islamic financing and possibility of the conversion of *Musharak* and *Mudaraba*. Section 8.2 discusses the general *Fiqh* principles of joint enterprise governing the determination of profit and its distribution among partners, liability of the worker or partners for capital loss and lastly the rights and responsibilities of partners. Section 8.3 demonstrates the scope of profit sharing. It is to determine the position of profit sharing in economic sectors and financial modes. Section 8.4 critically reviews the current contentions between theoretical presentations and practical applications. It argues that the problem results mainly from conceptual misgivings and practical misuses of modes of financing under profit sharing. Section 8.5 reconsiders the nature of profit sharing in its present application by synthesizing the traditional profit-sharing techniques with modern requirements of collective business enterprises such as managerial freedom, liability for loss, profit distribution with predetermined rates.

Chapter nine presents the economic implications of the theory of excess value which have presented in earlier chapters how these interpretations of *riba* and profit are applied in economic policies what kind of application can be concluded in the context of efficiency & resource allocation, Equity & income distribution and stability as well as measures for restraining inflationary pressures and preserving monetary values consistent with the prohibition of *riba*. We will comparatively study the impacts of a conventional term of interest, profit and profit-sharing and the prohibited *riba* in Islam. The main points of the arguments in this chapter may be formatted in the following manner. Section 9.1 outlines the

implications of *riba* on the economic efficiency and resource allocations, trying to remove some of the apparent contention points between conventional perceptions and contemporary Islamic economic conceptualizations. Section 9.2 outlines the equity and income distribution on the light of this discourse and its implied measures. Section 9.3 elaborates some of the inherent causes of economic instability and alternatively Islamic precautionary measures. Section 9.4 presents the inflationary problems and current thinking. It will briefly review the major sources of inflation and the present paradoxical situation of restraining it. Although there is almost general agreement on the demand management policies being the significant cause of inflation, the proposed general indexation schemes. Section 9.5 examines the nature and conceived legal impediments against indexation. It aims to resolve the present conceptual deadlock arises from the inconsistency between the demand for indexation in order to maintain the original value of loan contracts and the prohibition of *riba* in Islam.

PART ONE

THEORETICAL BACK GROUND

CHAPTER 2

REVIEW OF LITERATURE ON RIBA TRADITIONAL TREATMENT

Riba is prohibited in clear terms in the Qur'an and the Sunnah of the Prophet (saw). Despite a consensus on this prohibition, the issue of *riba* and its practical implications have been among the most contentious issues in the Islamic jurisprudence since the very beginning of Islamic history. This chapter looks at the different views of the prominent early Islamic jurists on the nature of *riba*. In this chapter we briefly outline the traditional approach of the interpretations of *riba*. It is exclusively review of the nature or common apprehension of the concept of *riba* in Islamic literature. Section 2.1 looks into the usage of the term "*riba*," its literal meaning and essential features on the basis of how the revealed injunctions employed it or applied it and in the light of the Qur'anic commentators. It examines the linguistic meaning of the term in Qur'an Sunnah and practices in the pre-Islamic era. Section 2.2 summarizes the juristic studies of the subject. It takes a look at the technical usage and juristic interpretations of the term *riba*, scope and classifications, effective causes and underlying rationale (*illat*) of *riba*, the juristic view of the similarity concept and lastly the views of modern *Fiqh* scholars. Section 2.3 reviews the interpretations of contemporary Islamic economics on *riba*. It briefly outlines the main views and various trends of Islamic economists about the subject. Section 2.4 sums up the main findings of this literature review highlighting the unresolved issues and shortcomings of the literature reviewed.

2.1 THE NATURE AND THE PROHIBITION OF RIBA

Riba is a Qur'anic term. Both the Qur'an and the Traditions of the Prophet(saw) have repeatedly used this word in its literal context. The commonly believed perception of *riba* regards it as the increment or increase over the principal in return for nothing. In this chapter we elaborate the essence of "*riba*" in original revelations. The argument runs as follows. Firstly, we present the literal interpretations of the term *riba* as the Qur'an used it, according to the Qur'anic commentators. Secondly, we explain the prohibition of *riba* in the Qur'an in the chronological order. In each stage of the prohibition we highlight the textual meaning of the *ayat* in the light of explanations given by the Qur'anic commentators and in the context of the practical usage of the term by pre-Islamic Arabs.

2.1.1 Riba in its Linguistic Usage

Usually, in understanding about the essence of any conceptual subject the study starts with the exposition of linguistic usage and identifying the basic terminology applied to the subject. A clear comprehension about subject matter of *riba* depends on its literal interpretation far more than it is presently envisaged explanation. Referring to its linguistic usage, *riba* means increase, growth, addition, expansion or augmentation.

It means an increase over its origin according to *Lisanul Arab* the root of it is the increase of *al-mal* (a financial asset) where it grows¹." Al- Imam Al-Wahidi mentioned that: "Linguistically *riba* is an increase²." It might be according to the purely linguistic usage of the term an increase to the thing itself or a growth stems from comparison or differential between two things in respect of quantity as well as the quality. ³ Al-Imam Wahidi has elaborated these two cases and stated that both above cases we find these examples from the Qur'an. Allah (swt) says;

"Would not you see the lifeless land but when we make water fall on it, it shakes and grows." (Al Hajj :5). In another verse "Allah shall strip *riba* of all the blessings and increase the alms (charity)"(2:276).

In the first verse the meaning of the word "*rabat*" means expands when rain fall on it and gets wet, and it increases on its own accord. In the second verse, while what is given for charity gets increase by the will of Allah(swt), *riba* gets ever decrease. This meaning is also used by the Prophet (saw) in his sayings: "It does never grow a flesh feed by "*suht*" (unlawful)."⁴ Some companions reported that the prophet (saw) invited them for a meal and while they were eating they observed an increase of the food itself. One of them pointed out that "whatever be taken out (of the food) its replacement grows from below" using the term "*raba*."⁵ it is growth from itself, where the same food gets an increase from within.

¹ Ibn Mansur, *Lisanul Arab* vol.19. Term *Riba*.

² M. Al Sharaf Al-Nawawi, *al-Tahzib Al Asthma Wallughat*, Section 2, vol.1. p.118.

³ Sami H. Hamoud. (1985) *Islamic Banking*. Arabian Information, London, p.67

⁴ Sunan Al-Tarmidi, p.79

⁵ Al Bukhari, *Muwaqit* p.79

In the second case Wahidi noted that the growth results from a relative increase in two parts of the same thing. This meaning is mentioned also in the Qur'an. Allah (swt) has stated that. "One nation to be more in number (stronger) than another" As the word "*arba*" implies more numerous, greater or stronger which implies superiority or having a margin by one nation in any respect of the above aspects comparatively over another. This profound understanding of Imam Wahidi can be explained in the light of our modern state of arts. The comparison of two nations as the above verse used the term *arba* can be in terms of number but what is important as we see today may not be the mere quantitative magnitude, it could be in terms of quality of the people and how well they are equipped in training and technology. This may confirm the essence of Arabs saying '*fulan arba ala fulan*' that Mr so and so is superior to Mr. so and so

In another place the Qur'an used the term *riba* in the meaning of power and strength and mentioned "He (Allah, swt.) has taken him (pharaoh) with a strong, terrible grip" (al-Haqq:10). The word "*rabiah*" in this context shows the meaning of extra power and strength or increase in its terrible effect, comparing to the degree used for other disbelievers⁶. Al-Tabari has mentioned that "*rabia*" was (hill) thus, called because it is greater in height than others, and over looks the level of the area around it.⁷ The Prophet (saw) also mentioned that "*al-firdowsa*" is "*al rabwah*" the highest and the best in the middle of the paradise, in other words this term indicate that "*al-firdowsa*" is comparatively the best and highest place of the paradise. In all these meanings we may find that *riba* is an increase but, particular increase. its peculiar features may be derived from the way it is used literally, that is an increase from the same thing, growth within or increase of the thing on its own accord. In this connection one may conclude that *riba* peculiarly has a feature of automatic growth. From the above linguistic interpretations one may deduce that the type of an increase that associates with the term *riba*, is substantially related to the quality dimension in addition to the quantity consideration. These peculiar characteristics of *riba* would perhaps expose the real nature and essential characteristics of the concept.

Referring the matter to its practical applications the earlier Islamic jurists had faced

⁶ Al-Haq, Verse.10. Al-Tabari, vol.12, p.34

⁷ Ibid.

certain challenging difficulties. Although the Qur'an used the word *riba* and its grammatical derivatives in the pure linguistic sense which can give us a ground to believe that Allah(swt) has used the same word as would be comprehended in its literal meaning and linguistic usage. But, this pure lateral implications apparently had been seen to be different and incompatible with the meaning intended restrictively in the applications of the term during the pre-Islamic and early Islamic era (the era of ignorance). The pre-Islamic Arabs knew for the word *riba* what they used to deal in, on the basis of an increase of money in consideration of the term of maturity or from the actual date of the debt. The following quotations illustrate the practical use of the term during the era of ignorance. Al- Tabari quoted Mujahid: "A man borrowed a sum of money from another and pledged himself to return it with an excess amount, if the lender gives him a certain grace period⁸." Qortubi also reported that *riba* in the period of ignorance had the form that: A man was to sell a thing to another and after certain period of time if the payment was not made at its maturity the buyer asked for extension with the increase of the principal. Numerous reports from the prevailing practices of *riba* transaction before Islam prohibited, show that the dealings with *riba* transactions were very common in the early Islamic period. The most well known transactions were that a loan was advanced to a person on the payment of monthly *riba* over and above its principal. This kind of transaction was widely used among Arabs in those days. They were advancing loans for a fixed term and when its maturity lapsed, the creditor demanded repayment of his dues from the debtor. If the debtor was not able to pay it, an easing time was granted to him on consideration of an additional sum of money.⁹

Similarly al-Imam ar-Razi noted the dealing on *riba* that the Arabs used to pay the money on loans and receive a certain sum of payment each month leaving the principal sum intact, when the debt matures the owner of the principal receives it back from the borrower. If it is not possible on the part of the debtor to pay it, they used to increase the principal sum and extend the time. This was the *riba* which was prevailing in business dealings of pre-Islamic days¹⁰. Among usurious classes of Arabia Banu Mughira were the prominent users of *riba* dealings after the victory of Makkah. The Prophet abolished all *riba* which the people owed to them. He issued a strong and final verdict, according to which if they persisted in

⁸ Ibid.

⁹ Anwar J. Qureshi, (1946) *Islam & Theory of Interest*, p.65.

¹⁰ Al-Fakhru Din Al-Razi, *Al-Tafsir Al Kabir*, vol.7, 1st ed., p..91.

demanding for *riba*, war should be declared on them. Hence, the pre-Islamic usage of the term conveys the meaning of increase or growth of the same principal amount of money after certain period of time. So, although, the people see only that certain kind of transaction, such as; loan or credit transaction, takes place, but, the resulting fact is the incremental growth of the original financial amount over time, by comparing the initial amount to the final repayment, it shows quantitative increase. But the existence of an increase does not negate to be justification for the presumed growth in value or claim on the base of quality for the time difference, irrespective of its existence. In this perspective, there may not be any difference between the linguistic usage of the term in Qur'an and how practically was employed during the pre-Islamic and even very early period of Islam. In order to, find out the crux of the matter and the exact nature of the subject, we have to refer it to the Shariah injunctions related to the prohibition of *riba*. This may enable us to pinpoint the essence of the subject and illustrate the scope of prohibited *riba* and its implications. We would examine the concept in three levels, in the context of Qur'anic verses, the authentic traditions of the Prophet (saw) and the views or interpretations of Islamic jurists.

2.1.2 The Prohibition of Riba in the Qur'an

The Qur'an contains clear revelations which gradually have absolutely forbidden the entire concept of *riba* that may arise in the financial transactions. The Qur'an has prohibited charging of *riba* repeatedly, in four different revelations using all the times the grammatical derivations of the term *riba*. The first stage of *riba* concept in the Qur'an is in *Surah ar-Rūm* which was revealed in Makkah. The second stage is mentioned in *Surah al-Nissa'* in the form of reminding the Muslims about the banishment deserved by Jewish people as consequence of their *riba* practice. The third stage occurs in *Surah al-Imran* with stronger tone, while the last decree on *riba* was revealed in *Surah al-Baqarah* as the final *ayat* of the Qur'an. In the following paragraphs we elaborate the different stages that the prohibition of *riba* has taken place referring to the prominent commentators of the Qur'an and their interpretations.

The first stage of the prohibition of *riba* occurs in *suret ar-Rum* of the Qur'an and this *suret* was revealed in the early period of Islam when the Prophet (saw) was in Makkah. It implicitly shows the undesirability of *riba*. Allah (swt) has said;

"That which you give as an *riba*, to increase the peoples' wealth, increases not with Allah. But that which you give in charity seeking the good will of Allah, multiplies manifold" (30:39).

It is considered the first verse has dealt matter by intimation with *riba*, declaring that *riba* will never derive a credit with Allah, while, alms and Zakah grow and multiply. Fakhru-ddin al-Razi commented on this verse saying that "this verse carries the meaning of inciting" which may be inferred to imply that "you do not get credit with Allah(swt) through *riba*, where if asked, you respond and give one for two"¹¹. Al-Allusi also pointed out "*riba* in this verse meant the well-known kind of dealing which were banned by Shariah."¹² Late Sayyed Qutob expressed also that "Allah(swt) is clearly declaring that this *riba* can never be a means of growing wealth. Then Allah(swt) has shown/them the way the wealth can increase in real terms¹³." Al Qasimi added that "this verse means that Allah will give not blessing (to *riba* transaction) and it has no increase at all¹⁴." It is also mentioned this verse covers some existing practices in pre-Islamic Era that people to extend a gift to another with intention of getting from him more gift as a reward or return. Ibn Kathir went on the view that this (gift) practice is not *haram* itself but the way of conducting it, is analogous to that of *riba*, and accordingly the Prophet (saw) has prohibited it following the order of Allah (swt) "give not asking for more¹⁵." Al-Tabari commented on the meaning of this verse saying that it implies "What you give (you) people among yourself of gifts and donations by intention of increase and more return within the other people's wealth will increase not with Allah (swt) for it was not intended for getting reward from Allah. But what is given for charity or Zakah for the sake of Allah they will receive multiplied reward and handsome credit."¹⁶

The second stage of the prohibition of *riba* can be referred to the wrong doings of Jewish people including their *riba* practice, which was prohibited by Allah (swt) from them. The verses are reminding the Muslims what was the consequence of these peoples' bad deeds. Allah (swt) said;

¹¹ Ibid., vol.6, p.529.

¹² Sharafuddin Al-Alusi, vol.21 p.45-7

¹³ Syed Qutob, *fi Thilal Al Quran*, vol.6, p.460

¹⁴ M. Jamaludin Al Qasimi, *Tafsir Al Qasim: Mawadin At Ta'wil Allama*, vol.2. p.221

¹⁵ ,Qur'an, Verse 4:159-161, See Ibn Katheer

¹⁶ Ibn Jarir Al-Tabari, *Jami ul Bayan fi Tafseer al-Qur'an*, vol.10, part.20, p.20, Darul Fikr, 1988/1408

"And for their taking *riba* even though it was forbidden . . . We have prepared for those among them who rejects faith a previous punishment"(4:159-161)¹⁷.

These verses are strongly stating the penalty deserved by Jewish people for their abnormal economic dealings. Comparatively stronger words are chosen for this expression. The verse unveils the fact that Jews did manipulate the situation and some of them imagined that usury is permissible if it charged to a gentile (Bible: verse 23/19)¹⁸. Ibn Katheer noted the conformity of this *riba* mentioned in the bible with the familiar *riba*. But some difficulties of understanding its meaning is noted as it appears in *surat Al Baqara* (278).

The Jews using various kinds of tricks raised suspicions on the issue and justified their taking *riba*, though, Allah (swt) banned from them in committing it¹⁹." Al Qurtobi in his interpretation said that: "Allah did not intend (the usage of the word *riba* in these verse) to be the *riba* of the Shariah which was banned from us, but the intention was directed to the illegitimacy of eating properties of the people in *batil* (wrong way). Hence, *riba* implies here, all *haram* earnings covering any illegal acquisition of property, i.e., "They (like to) listen to a falsehood and to devour any thing forbidden, and their devouring of men's properties wrongfully"²⁰. However, Majority of commentators indicated the similarity of the case. Al-Tabari has considered the ban on *riba* taking by Jews something which makes it nearer to pre-Islamic *riba* according to him "the intention is their taking of surplus to the sum of their capitals in consideration for extension of the term of maturity."²¹ He considered that "the matter as long as it relates to the Heaven's Shariah is one, and of the same; that *riba* which was banned to the Jews is the same *riba* which is banned to the people of Islam: that the heavenly laws confirm to one another as each of them originates from Allah (swt). It is pertinent to mention in this context certain quotation the scriptures of their book we may find how they misinterpreted them:

"If you lend money to any of my people who are poor do not act like a money lender

¹⁷ An Nisa, Verses,160-62

¹⁸ Bible (verse: 23/19)

¹⁹ Ibn Katheer, *Tafseer al Qur'an al-Azeem*, vol.4, p.584.

²⁰ M. Bin Ahmed Al-Qurtobi, *Jamil Al-Ahkam Al-Quran*, vol.3, p.348.

²¹ AL-Tabari. *Ibid.*, vol.9, p.391.

and require him to pay interest". {Ex 22 v.25}. Do not charge him any interest but fear God and let your fellow Israelite live near you. Do not make them pay interest on the money you lend him" {Led 25 v:35-7}.

The Jews have definitely modified the scripture granting themselves license to practice usury, which is completely contrary to the divine justice and harmony inherent in the scriptures and actions of the prophets' (saw). Perhaps this is a manipulated version of the above scriptures "When you lend money or food or any thing else to a fellow Israelite, do not charge him interest you may charge interest on what you lend to a foreigner, but not on what you lend to a fellow Israelite". (Devt. 23, v. 19-20)

The third stage of the prohibition directly addresses the Muslim believers and prescribes with more clear and stronger way not to eat *riba* that multiplies. Allah (swt) said:

"Oh ye who believe; Eat not *riba* (usury) which is doubles and Multiplies and fear Allah that may you be successful.(3:180)²².

The commentators are on the agreement that the phrase of "doubles and multiply" is not meant by specification or fixing the nature of the prohibition to this particular aspect, but it is meant by illustrating its practical dealings which was prevailing in the early period of Islam and pre-Islamic Arabs. Sayyed Qutob commented on this, saying that "It is not only a historical example in the past or not a condition for its legal position but it is an attribute of the prevailing reality" In another place he pointed out "this phenomenon is the real nature of any *riba*-based system²³." Al-Qasim wrote that the verse is meant by repetitive increase (of a *riba* contract) not to confine and limit the scope of the prohibition by linking to this specific nature (of *riba*)."²⁴ Shallut responding to the argument that this verse banned only excessive *riba* said this statement is null and void. Allah (swt) does mean by "doubles and multiples" to remind them what they were actually doing and strongly condemned their evil doings²⁵." This verse was revealed at the wake of the "Battle of *Uhud*." Thus, for construction and

²² Ala Imran, verse: 180.

²³ Sayyed Qutob, Ibid., vol.4, p.74.

²⁴ Al-Qasimi, Ibid.

²⁵ Sheikh Mohamed Shallut, cited by Hamoud, Ibid. p.87

internal preparation of the society was needed on this occasion so, the order of banning the eating of *riba* and to obey Allah (swt) and His Messenger (saw) came in the purpose of a total ban on all kinds of *riba* which were known and understood by the Arabic speaking people while the phrase "doubles and multiples" were their customary and popular terms in business conducts of those days before its prohibition.²⁶

The fourth and last stage of the prohibition of *riba* is placed in suret al-Baqara. Allah (swt) stated that: "Those who benefit from *riba* shall be raised like those who have been driven to madness by the touch of the devil; this is because they say "Trade is like *riba*" while Allah has permitted trade and forbidden *riba*. Hence those who have received the admonition from their Lord and desist may have what has already passed, their case being entrusted to Allah; but those who revert shall be the inhabitants of the fire and abide there in forever. Allah deprives *riba* from all blessings and blesses charity; He loves not the ungrateful sinner. O' ye believers, fear Allah and give up the *riba* that remains outstanding if you are believers. If you do not do so, then, be sure of being at war with Allah and His messenger. But, if you repent you can have your principal neither should you commit injustice nor should you be made injustice" (2:273-279)²⁷.

In these verses of the Qur'an the ban of *riba* is concluded in the shape of the ultimate verdict. The prohibition on the practices of *riba* is established beyond any doubt without carrying any confusion not containing any loop holds which can permit the penetration of inclination. The verses are also demonstrating the impact of *riba* on its users. Al-Qasim reported from al-Baqai saying that "we had never seen and never heard on user of *riba* speaking of wisdom or familiar with dignity they were of the most inferior and wicked people²⁸." Al Tabari commenting on arguments of unbelievers of *riba* users that "Trade is like *riba*. And Allah has permitted trade and forbidden *riba*." He said "the *riba* users were saying no matter if we increase the price in the beginning or at its maturity in this way they claimed (the above equality). And Allah (swt) has declared that Allah (swt) has permitted profit out of trade in selling and purchase and prohibited *riba* out of extending in maturity." And the two increases one is from trade (bay') and the other from the increase of the principal along with

²⁶ Saffer Rena Naqvi, (1993) History of Banking & Islamic Laws, p.42

²⁷ Al Baqara verses 275-280.

²⁸ Al- Qasim Ibid, vol:2

the extension of its maturity which are not the same."²⁹ And its payment follows with the ability to pay. But, you will get your own principal sum without increase or decrease³⁰." In general the Quranic commentators are on the view that the definitive term used in it such as: *riba* indicates its reference to the kind of transactions familiar in early Islamic history. Al-Jassass pointed out that it was a common fact that *riba aljahiliya* was stipulated increase only on loans in a fixed term.

2.1.3 Prohibition of *Riba* in the *Hadith*

A large part of the *riba* discussions and perhaps the most contentious portion of its literature related to the explanations and interpretations of the textual message of the *ahadith* of the Prophet(saw). In other words, throughout the history of Islamic jurisprudence, the Shariah scholars concentrated their deliberations on *riba al-fadl* which is known as *riba* in *hadith*. Although, the Prophet (saw) has condemned *riba* dealings in the most unambiguous words, and elaborated the Qur'anic message of the prohibition extensively in consistent and harmonious way with the general principles and objectives of Shariah, but it seems that this consistency has not been well understood. Islamic scholars are of the view that the explanations made by Prophet (saw) are related to other areas of *riba* which was not familiar with Arabs in pre-Islamic period. However, these kinds of *riba* may be considered as practical examples of *riba* related to goods sale transaction or trade.

The *ahadith* of the prophet (saw) that explain different aspects of the prohibition of *riba* would be discussed in the context of juristic exegesis and their technical interpretations, in the following section of this chapter and completely in chapter four. Therefore, we briefly mention here a few authentic and well-known *ahadith* of the Prophet (saw). There are numerous *ahadith* (traditions) from the Prophet (saw) about the prohibition of *riba*. Perhaps the best known of them has been reported by Ubadah Ibn al-Samit who said: "The messenger of Allah said gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, in equal weights, from hand to hand, if these species differ.

²⁹ Ibn Jarir Al-Tabari, *Ibid.*, vol.3, p.102

³⁰ Al Qasim *Ibid* vol:2.

then sell as you like, as long as it is hand to hand³¹." From Abu Sa'id al-Khudri is reported that the Messenger of Allah has said": Do not sell gold for gold except when it is like for like, and don't misappropriate one through the other, and do not sell silver for silver except like for like and do not misappropriate one through the other and do not sell things absent for those that are present". Agreed upon by both al-Bukhari and Muslim. In another version the messenger said": Gold for gold weight for weight, like for like, silver for silver weight for weight like for like if one gives in excess or acquire in excess it is *riba*" reported by Muslim". The Prophet (saw) has condemned *riba* dealings in clear and most obvious words not only those who take *riba*, but also those who give *riba* and those who record the transaction or act as witnesses to it.

2.2 JURISTIC STUDIES OF RIBA

The early Islamic jurists have examined the subject comprehensively on the light of the Qur'anic injunctions and the elaborations of the Sunnah. They decomposed the concept of *riba* and classified it into two broad categories, i.e., *riba al-nasiah* and *riba al-fadl* in order to figure out the underlying rationale or '*illut*' of the prohibition of each and to identify the scope and extension criteria of the concept. *Fiqh* scholars have established a vast literature and rich resources of diversified views in this field as the issues related with this intricate element are receiving fresh insights and ongoing discussions. Our review of juristic studies of *riba* in this section concentrate on the following points, the technical interpretations of *riba*, *Fiqh* debate on the intended meaning of the term, classifications of *riba* in Islamic jurisprudence and the rationale or effective cause (*Illat*) underlying in the prohibition of *riba* considered by various *Fiqh* schools of thought. We also take into account some reconsideration made by number of the modern *Fiqh* scholars.

2.2.1 Technical Interpretations of Riba

We have seen it before *riba* has the literal meanings of increase growth height or superiority. However, the technical interpretations of the concept have taken different shapes according

³¹ It is reported by Muslim in (Sart)

to Islamic juristic schools. We may sum up the main technical definitions given by the majority of them:

1. Hanafī jurists defined it that "riba is a specific increase entitled to either party without counter value".³² In another version is also as follows "riba is an excess which has no corresponding value in the exchange (bay')." ³³
2. According to Shafī'i school. "It is a contract on exchange of a thing for a specific thing with unknown equivalence in legally a standard unit of measurement at the time of the contract or delaying both or one of the counter values."³⁴
3. Hambali school of thought defined it that. "riba to be disproportion of things delayed but of specified terms".³⁵

Examining the above interpretations, we find that according to Hanafī school of thought *riba* is an "excess" or "increase" in real terms, i.e., selling a dirham for two dirhams whether on a spot or on credit; or on deferred terms such as selling a dirham of the present time for a dirham in the future for there is an increase in judgement³⁶. The phrase "without a corresponding equivalence" implies that the said "excess" has no counter value in exchange" which shows that according to this definition *riba* stems from the transactions of goods or assets not from gift, charity or other financial dealings but in the context of exchange. Some of the short comings of this definition are pointed out such as: It does not cover the dealings in loans as the main sources of *riba Jahiliyyah* or *riba* in pre-Islamic Arabs was based on loan transactions and the loan is not part of exchange or sale is argued. If we consider the term *bay'*, its comprehensive meaning of exchange in which implies substitution of any two things it will cover any two things used for exchange including loans as they are exchange of the

³² *Al-Nihaya fi Sharhi Hidayah*, vol.2, p.524

³³ Al Sarakhsi, *Al-Mabsut* vol.12, p.109

³⁴ Al-Sabaki, *Takmilat al-Najmi*, vol.10, p.22, or *Al-Mughni Muhtaj*, vol.2, p.21.

³⁵ Ibn Qudama, *Al-Mughni*, vol.4, p.221

³⁶ Omar Abdul Aziz Al-Mutrik, *Riba and Banks transaction in Islamic Shariah*, Darul al-Asimah, 1st.ed, 1414 H, p.40. Saudi Arabia

present benefit for that which will be available in the future³⁷. The Maliki school of thought is almost in conformity with this view. According to it the increase and delayed payment *riba* falls within the frame work of sales for being parts of *riba*. Ibn Rushd is quite clear about *riba* in exchange in all sales and in what is determined as liability³⁸. Nevertheless, most of the jurists of different schools of thought are on the view that *riba* concept takes place in sales and debts as we will see in the discussion of the juristic interpretations of the technical meaning and divisions of *riba*. However, we may turn now to the debates of *Fiqh* scholars on the intended meaning of the term *riba* in *Fiqh* injunctions.

2.2.2 Juristic Debate on the Intended Meaning of the Term Riba

There is almost a complete agreement on the literal and practical usage of the term *riba* among earlier Islamic jurists, which means an increase to a thing. However, the reconciliation between the literal meaning of the term and its technical interpretation was subject to long discussions and debates which gave rise to the question about the intended meaning of the word by Islamic injunctions. The classical Islamic jurists inquired whether the word *riba* is a generic term as can be understood from its linguistic usage or it is undeveloped one which has inchoate meanings like; prayer and *Zakah*. In elaborating this issue and drawing a line between these two dimensions of the subject, it is pertinent to explain the notion of inchoate or unelaborated word. Ibn Rushd the prominent Maliki jurist gave the following explanations:

1. The purpose of using the general word is to understand it clearly due to its generality until something comes to specify it.
2. The use of the word has an inchoate meaning implies to where the intended purpose is not clearly understood by utterance alone, but it is supported or explained by other words to clarify the meanings.³⁹

What is important to be inquired is that the effect of the concept of the inchoate or general and the reasons compelling to be associated them with *riba*. Simply the reason is to

³⁷ Omar Bin Abdul Aziz Al Mutrik, *Ibid.*, p.41.

³⁸ Ibn Rushd (the grand father) *Ibid.*, p.236

³⁹ M. Ibn Rushd, *Al-Mughadimat*, vol.2, p.179

identify and comprehend the intention of the law giver from using the term of *riba*. Zakaria al-Birri in his book "Origins of Islamic jurisprudence" has explained the meanings of general and inchoate words; "The general word is what which is given to denote one meaning for the purpose of generality and to cover all its units without being restricted to a specified number thereof. Inchoate word implies that the meaning of the term is not clear in itself where the ambiguity might arise which can be clarified by a statement of the speaker. i.e., the words of prayer and *Zakat* have a linguistic meaning such as a call for good and growth respectively. However these words according to the objective and intention of the Shariah have specific meanings which could not be apprehended except by a clarification from the legislator. Thus, the practical and spoken Sunnah came to explain what is intended in these inchoate words in the Quran.⁴⁰ The main causes of these two different views may be grasped from the underlying reasons of perceiving the inchoate nature of the term *riba*.

1. According to Jassas the thing that Arabs were familiar with and practiced was the lending and borrowing of dirhams and dinars for a fixed term with an increase over original sum . . . Allah has annulled this *riba* as well as other kinds of sales named them *riba*. The Arabs were not familiar with that the sale of gold for gold and silver for silver with an increase to constitute *riba*, while according to Shariah it is *riba*. So, from the context of the words, it appears that what is intended by Legislator its annulments were of kinds of sales. Thus, the verse "*riba* is banned" means the ban is covering all its individual elements, because the appellation covers all through Shariah."⁴¹
2. As we mentioned above the existence of some technical term in Shariah which have different practical interpretations from their linguistic usage and explained by the Prophet (saw) such as Prayer and *Zakat* the Jurists on this line i.e. Hanafi school has followed in the same analogy that the term *riba* also has an inchoate meaning and it is undeveloped word.
3. In Hanafi school a general word is absolute in its connotation to all its

⁴⁰ Zakaria Al-Birri, *Origins in Islamic Jurisprudence*, vol.1 Shariah & Evidence 2nd ed. p.265 & 232. See Nabil Saleh, *Unlawful Gain and Legitimate Profit*.

⁴¹ Al-Jassas, *Ahkam al-Qur'an*, vol.1, p.552.

individual elements. So the jurists in this view considered *riba* may not be the similar. That is so, in order to observe the conformity of the application of procedural rules of their school of thought. Otherwise the general term would mean that every increase is banned so long as *riba* is increase, and it is well-known that every increase is not forbidden.

Ibn al-Arabi of Maliki jurist mentioned that, "it is correct to assume that *riba* as a general term because the people used to exchange sales and practice usury which was known to them." A man used to sell to another with delayed payment for a term and upon the expiry of the agreed term the creditor used to say 'will you pay or increase?'. Allah (swt) forbade *riba* which is in the increase⁴². al-Nawawi of Shafi'i school mentioned different opinions on the subject. It is stated our jurists differed about the stipulations of the Qur'an which bans *riba* in two respects. Firstly, it is undeveloped word which was interpreted by the Sunnah. So all the rules brought about by the Sunnah are an explanation of what is general in the Qur'an. Secondly, that the interdiction stipulated in the Qur'an covers the delayed payment *riba* and the requirement for an increase in the money in consideration for the extension of the term. Which had been known in pre-Islamic times? Then the Sunnah stipulated *riba* in each, which is in addition to the stipulation of the Qur'an.⁴³

2.2.3 Classifications of Riba in Islamic Jurisprudence

Generally, there is a common agreement in the *Fiqh* literature that, *riba* is divided into two major categories, such as;

I. *Riba al-nasia*, pre-Islamic *riba* (*riba al-jahiliya*), *riba al-duyun* or *riba* in Qur'an, the term *al-nasia* comes from the root *nasiah* which means to postpone, to defer or wait and refers to the time that is allowed for the borrower to repay the loan in return for the addition or the premium, i.e., where someone owes to another a certain amount of debt and when it matures the creditor asks the debtor to pay or to increase, this kind of economic dealings existed before the Islam. According to Hanafi jurists "it is excess that arises from the maturity or

⁴² Ibn Arabi. *Ahkam al-Qur'an*, vol.1, 1st. ed., 1952, p.241.

⁴³ M. bin Sharaf Al-Nawawi. *Al Majmu': Sharh Al-Muhazab*, vol.9, p.442

time of real asset in debt measured on weight of they are different specie, and without measuring if they are similar in kind. In other words, *riba* arises from an exchange of a good for itself or for another good but in an excess amount on the base of delay.⁴⁴ This is what is known as *riba al qurud*. *Al qard* literally is to cut, *qaradahu*- he cuts it, is what to put forward or give to someone to receive it back later on. Technically it is what to give in order its similarity be received in later. It is a specified contract of giving or payment of money to someone to repay it in similar. The loan is permissible in the Qur'an Sunnah and the consensus of the Muslims. In the Qur'an (2:28), in Sunnah, the Prophet's saying "whoever release a Muslim from one of the hardships of the world he will be released from one of the hardships of the hereafter by Allah...) And Ibn Masud reported that the Prophet said that "no Muslim to lend a Muslim a loan for two times, If he does so it is like charity of once". And the Muslims in a consensus have agreed on the permissibility of the loan. The essence of a loan bears the meaning of help and sympathy for the urgent need of the borrower. In the present time it is considered to refer to the interest on loans. There is no difference between Islamic jurists and common Muslims and it is almost settled that in this sense the Qur'an has very clearly declared its prohibition stating that " Allah has permitted sale and forbidden *riba*" (2,275). And this is the *riba* which the Prophet (saw) referred when he said; "there is no *riba* except in *nasiah*," which does not mean that the concept of *riba* to confine in *nasia* only, but, it can be understood in the sense of his statement " Al-hajj is *Arafah*," it conveys that the dominant and essential part of *riba* is that falls under *al-nasia*.

II. *Riba al-fadl, riba al-bay'* or *riba* in *hadith* was explained by the Prophet (saw) and elaborated it, although its prohibition is very clear, the nature of *riba al-fadl* in the context of exchange as the *ahadith* of the Prophet(saw) presented was alien and unfamiliar to the companions of the Prophet (saw), so, the Muslims could not easily grasp its rationale and limits of its prohibition. Although the *riba* concept revolves around these above aspects, the Islamic jurists have further elaborated by extending its scope, some times expressing a same thing in a different way.

- According to Hanafi jurists. It is an excess of tangible property stipulated in the exchange contract on the basis of legal criterion in the similarity of the two items.

⁴⁴ Suhaili, *Fiqh Al Islam Wa Addillatuhu*, Vol. 4, p.346

- Shafii jurists viewed that it is an exchange with an increase in one of the trade items over the other.
- According to Hambali jurists. It is an increase in one of the exchange items identical in kind of measurable and weighable goods.

The definition given by the Hanafi jurists can be explained that "excess" according to them is in absolute and the phrase "*Aynul al-mal*" shows that the increase is attributed to the exchange item itself so it is an increase of a thing itself in the exchange contract when they are identical in kind. According to Shafii School *riba* arise from exchange as a discrepancy of two trade items." But, in the views of Hambali jurists *riba* occurs only in weigh able and measurable exchange items as it is common in their reasoning of *riba* which exist only goods of the same specie with the measure & weighing. Al-Jassas elaborates this division of *riba* which is *riba al-fadl* was not known to pre-Islamic Arabs. According to him this *Riba al-buyu'* is of two kinds namely: -

1. Increase *riba* which is realized where an item subject to *riba* is sold for its kind with an addition on the part of either consideration over the other.
2. Delayed payment *riba* which is realized in case of the sale of an item subject to *riba* for an item of its kind or of another kind where the cause is common to both items *riba* is committed in the later case if the payment of either consideration is delayed⁴⁵. The benign of both cases of sale *riba* is provided in the *ahadith* of the Prophet (saw).⁴⁶

Ibn Rushd divided, the liability arises from sale into two forms in addition to the well-known pre-Islamic one he added; "a reduced part of what you owe to another in order to pay something of what you owe." According to the Author of *Fathu al-Qadir*. *Riba* exists in any thing measured or weighed which is exchanged for its kind. The author of *Mughni al Muhtaj* mentioned a similar view. Al-Mitwali a Shafi'i Scholar has added another kind of *riba*, that

⁴⁵ Al-Jassas, *Ibid.*, vol.1, p. 552.

⁴⁶ See Abu Zahra, *Nomenclature Delayed Payment Riba*, vol. 6, p.26.

is; loan *riba* which stipulates for advantage. Ibn Hami the author of *al-Muhalla* was also of the view that *riba* can only be in sale, loan, or *salam*. According to S. Hamoud this trend is most acceptable division of *riba*. Ibn Qayyim in one of his treatise divided the *riba* into two kinds namely overt and covert, or hidden *riba* and manifest *riba* where the former is *riba* by way of deferment and the latter by way of increase. According to him hidden *riba* is not forbidden in itself, but only it is a way to abstain from manifested *riba*. In other words it is banned to block the road leading to overt *riba* which is forbidden by itself. As a result manifested *riba* cannot become lawful except in the case of pressing necessity on the contrary hidden *riba* can be lawful in case of need (*haja*) only⁴⁷.

2.2.4 The Underlying Effective Reasons (*Illat*) of Riba

As the Prophet (saw) mentioned (saw) only six items, such as; gold, silver, wheat, barely, dates, and salt. The Islamic jurists have over centuries debated the question of whether *riba al-fadl* is confined only to these six items or it can be generalized to include other commodities if so what would be the reasoning (*illat*) used for this purpose⁴⁸. Except the Zahiri School which sees that *riba* to confine to the six commodities mentioned by the Prophet (saw) which accordingly does not see any need for searching *illat*, the majority of the jurists agreed that the prohibition of *riba* is to be extended to other commodities besides these six items provided that *illat* or the cause of the prohibition exists in the goods under consideration. In order to derive criteria applicable to all goods the jurists have paid a lot of efforts in examining the common features and essential attributes of these six items. Before we go into the details of *illat* it is pertinent to mention the meaning of *illat* itself. To mention what is meant by '*illat*' in the *Fiqh* literature in general, the following principles are noted; *illat* in the interpretations of Islamic jurists, it is the underlying principles or the rationale and driving objectives of Shariah inductions. It is generally agreed that analogical reasoning is valid when the following conditions are met:

- a. The *illat* should represent the compelling factor which has motivated or intended by the legal rule, which essentially must be clear and consistent.

⁴⁷ Ibn Qayyim. *I'lamul Muwaqi'in An Rabil Al Alamin*, vol.2, p.135-6.

⁴⁸ Umer Chapra, *The Just Monetary System*, 1985, p.58

- b The same *illat* must appear in both elements of the analogy, object as well as the subject. A mere resemblance between attributes is not enough.
- c. The legal rule governing the object of the analogy should be of general application and not restricted to specific case

Now let us examine how the different *Fiqh* schools of thought have applied the above principles on the nature of *riba*, in order to understand the rational behind the extension of its scope and the various criteria used for this extension.

- i. **General Criteria;** According to Hanafi school the determining factors of *riba* in the six commodities are common to all of them, such as;
 - a. Similarities of species of the goods, and
 - b. Similarities of the unit of estimation.

As the practices in the time of the Prophet, Hanafi school assumed that gold and silver are estimated in weighing, while other four items are estimated in measurement. Accordingly, if species are the same, i.e., wheat for wheat, both equality of estimation and spot in the transaction are necessary, but if the species are different only immediate transaction is required, the coined money and paper currency are considered to have a different unit of estimations and allowed different in their exchange by Abu Hanifa, while Abu Yusuf sees that their species to be the same, so, no excess is allowed⁴⁹. Thus, this view implies that an exchange in any two kinds of items with the same unit of estimation, irrespective of their difference in quantity, can take place only in spot transaction, otherwise there is *riba nasia*, which is strictly prohibited by Shariah, and if the method of estimation and the specie of the items are different, i.e., silver and wheat, no *riba* factor involves this trade. In order to, study the issue in depth and to simplify the matter, most of the Islamic jurists divided the six commodities mentioned in the tradition into two groups, gold and silver in one group and other four items in another group, for some common characteristics in each category and

⁴⁹ Al-Sarakhsi, *al-Mabsut*, vol.12, p.116-20

accordingly they applied different criteria for determining the underlying causes of *riba* in each group.

ii. ***Criteria of predominantly monetary.*** According to Shafi'i jurists, gold and silver are mainly monetary terms and this feature is very specific to gold and silver only, so, the underlying cause in this group is considered as mainly currency-value. This criterion may not cover paper currency and some non monetary items made of gold or silver.

iii. ***Absolute Monetary criteria.*** According to a view attributed Imam Malik, as well as, the view of Ibn Taymiyah the cause is the monetary nature, in its absolute term, as this phenomenon is not specific to a particular good, it is applicable to any item being used as a medium of exchange. Therefore, as this view implies, the exchange in monetary items should take place immediately and on a spot in both cases, but, with an equal amount if the items are the same specie, i.e., silver for silver.

iv. ***criteria in non-monetary goods.***

There are different views in non-monetary things, e.g., corn, barely, date and salt the reason of being *riba* in their exchange.

- a. According to the criteria of Hanafi the similarity of the unit of volume (*Mukil*) and species are the determinant factors, so that, there is *riba al-nasia* if the exchange is not hand to hand due to the former and *riba al-fadl* if there is any discrepancy due to the later or combination of the two criteria, this view is followed by al-Imam Ahmed.
- b. According to Al-Imam Shafi'is; for the other four goods the *illat* is their being foodstuff, which is understood by the Shafi'is to be all kinds of food used to sustain the body whether as principal nourishment, spices, fruit or medicine, But contrary to the Hanafi view, the Shafi'is consider as a matter of principle that the exchanged articles belong to the same genus is a requisite for the *riba* prohibition and not an element of the *illat*⁵⁰. In this case the underlying causes are two things: the nature of the goods being food staff and the similarity of the unit of measurement (volume).

⁵⁰ Al-Sarakhsi, *al-Mabsut*, vol.12, p.116-20

Which implies that the exchange in any two food items must be immediate and with equal quantity as well, if they are the same kind of species.

- c. Hanbali: As Ibn Qudama in his famous treatise *al-Mughni* quoted three slightly different versions relating to *illat* attributed to Ahmad Ibn Hanbal the first view is similar to that of al-Hanafi, the second one is coinciding with that of Shafi'is, while the third one is holding that goods to be foodstuffs at the same time measurable and weighable.⁵¹
- d. Maliki jurists are on the view that the underlying cause is, being the four commodities mentioned by the Prophet (saw) 'storable food staff', Ibn Rushd mentioned that 'the reason of prohibiting of excess and delay in exchange of these items is because, they are all food staff and storable'⁵². Accordingly exchange in any two storable or preservable food items is subject to *riba*.
- e. Rabi'a opined that the reason of the prohibition is the 'necessity of *Zakat*' hence, *riba* is not applicable to any thing which not chargeable to *Zakat*. Perhaps, according to him the four items are not liable to *Zakat* payment, and in his view *riba* and *Zakat* go together, therefore, any thing falls under *Zakat* obligation is subject to *riba* as well.
- f. Ibn Sreen argued that 'the similarity of the specie is the cause' and all that is of the same kind is vulnerable to *riba*, this covers every fungible or non-fungible property or any good, i.e., cloth for two clothes, camel for two camels or egg for two eggs. This view is followed by Abibakar Al Awdhani of Shafi'i jurists. Said bin Jubair also opined nearly a similar view saying that "every good their utility is closely related their direct exchange is not allowed," in other words ... " they must be equal in exchange⁵³." But, Ibn Qudamah rejected this view that it does not appropriate or work. This view has relatively narrowed the scope of *riba* to exchange in identical items. so, only the exchange in the same kind of goods is subject to *riba*.

⁵¹ Ibn Qudama, *al-Mughni*, vol.4, p.5-9

⁵² Ibn Juzay, *Qawaninal-Ahkam al- Shar'iyya*, p 279-80

⁵³ Ibn Qudama, *al-Mughni*, vol.4, p.5

2.2.5 The Consideration of Similarity in Kind

Mostly all prominent *Fiqh* scholars are on the view that the exchange items which are similar in kind or genus both increase and deferments in their exchange are not allowed. But, what is the similarity in kind or genus, there are different interpretations according to *Fiqh* schools of thought (a) for the Hanafis two species are deemed to be similar if they belong to one genus-if they bear the same name if they are of the same origin and have the same specific use, i.e., meats of the same kind of animal; goat, lamb, or camels while meat and fat are bearing different names and used for different purposes even though they belong to the same origin to single type of animal on the other hand all varieties of dates are considered one genus.⁵⁴ In the first case one article can be sold for another with an increase but in hand to hand not deferment while the second case should be in equal and without any delay of either on (b) Shafi'is consider a flour of different products of soil are different genera even though they bear the same name. The similarity in origin is essential in considering them the same genus⁵⁵. Thus lamb fat can be exchanged for beef with an increase provided it is in hand to hand transaction for they belong to distinct genera. Use is also taken into consideration, i.e., different of a given animal belong to different genera. (i.e. fat, meat etc.) when they are needed for different purposes⁵⁶. And relating to one origin makes the species under one genus, i.e., all dates are of the same genus even though they may be of different species. But when the two species although they bear the same name are of different origins they are considered as two genera, i.e., Flours from corn and wheat, vinegar from dates and grapes, these are two genera as they are two kinds of flour or two kinds of vinegar. Ibn Qudamah further mentioned that when two species are of the same origin they are under the same genus even though their purposes are different from each other⁵⁷(c) for the Malikis the close relations of the purpose of the two species makes them of one genus even though the names of the origins of the species are different. Therefore, Lead and Zinc, which are of different origins cannot be exchanged unless it is the same quantity for the same quantity in hand to hand. For various kinds of wheat barely & rye are one genus; maize, millet and rice are one; meats are three

⁵⁴ Al-Kasani, *Badai al Sanai Fi tartib al Sharai*, vol. 5 P:188.

⁵⁵ Al Nawawi, *Minhaj al Talibin*, translated by E.c. Howard, P:125.

⁵⁶ Al-Hythami, *al Futuhat al Kubra* vol.2 p.239.

⁵⁷ Ibn Qudamah. *Al Mughni* vol.4, p. 24-5.

genera for all meats of quadrupeds meats of winged, animal's meats of fishes. Processing of all these species does not change the origin of these articles, i.e., grinding of wheat kneading of flour, the grilling of meat and extracting fat from milk etc.

2.2.6 Views of Modern *Fiqh* Scholars

Rashid Ridha following the jurists, approach has divided *riba* into: -*riba* in the Qur'an and *riba* in Sunnah. He maintained that the primary form of *riba* is prohibited by the Qur'an and this prohibition is to be maintained at all times. On the other hand the text of the Sunnah prohibits an insignificant or secondary type of *riba* which is generally prohibited but may be permitted in case of necessity (*darurah*). He considered *riba al jahaliyah* or *riba al-Qur'an*, relying on the literal meaning of the term *riba* as interpreted by the commentators. *Riba al-nasiah* is also the *riba* in the Qur'an, but the *bay' al-nasia* that is sale with a period of delay and any increase that arise as the enhanced price of the item itself is part of credit sale. It is expected the seller in such a case will charge a slightly higher price than on cash one. Thus, the seller and the buyer used to agree upon a period within which the payment would be made and the excess in price was not stipulated separately when the fixed period was over, the seller demanded his money from the buyer saying "will you pay or increase the amount due, in lieu of further delay." If they agree on further delay the due amount would be increased or even doubled over time then this process may continue for few more periods of delays. Thus, in this way the amount of the original sum was doubled or multiplied.⁵⁸ Abu Zahra drawing the distinction between *riba al-nasia* and *riba* in the Sunna or *riba al fadl* stated that ". . . the legal issue related to *riba* which is the excess in lieu of the period is *riba al-jahiliyya*. It is also called *riba al-nasia* because the excess in it, is in lieu of the period of delays. This is *riba* of the Qur'an. The second form of *riba* is the *riba* of sales (*bay'*). It is settled the matter in the *Fiqh* . . . as a secondary to the prohibition which may be permitted in the case of need".⁵⁹ Abu Zahra in this connection has concluded that. The first division is pre-Islamic *riba* which is the debt *riba* where sum is loaned as debt; The principal sum of the debt increased every time the maturity date is extended where the surplus will be in consideration of the term of the debt. Such an, increase constitutes usury according to the verses of the Qur'an which were revealed

⁵⁸ Sh. Rashid Ridha, Ibid

⁵⁹ Sh. Mohammad Abu Zahra, *Khatun Al Nabyyin*, Ibid

its banning". He further more, asserted that "It is the sale *riba* which is the *riba* because the Prophet (saw) called it *riba*".⁶⁰ Abu A'la Mawdudi also made this separation, according to him. "*riba al-fadl* is the excess that is found in the spot exchange of two things of the same genus. The messenger of Allah (swt) has prohibited this form". Studying the writings of the modern jurists on the subject of *riba* we observe a general trend of Muslim scholars who viewed *riba* in its general and comprehensive meaning. The concept that *riba* is divided in to two kinds has been established and almost all of them maintained this classification.

Omar al-Mutrik tried to synthesize these definitions and presented that: *riba* is an increase in specified items and increase of a debt in exchange for extension of its maturity in absolute terms⁶¹. The juristic technical interpretations of *riba* is not far from its lateral meanings. Thus, *riba* is an specific kind of increase and excess. Muslim jurists have technically defined the term *riba* as follows "*riba* is the excess stipulated in one of the two counter values in transaction or exchange (bay')⁶².

2.3 CONTEMPORARY ISLAMIC ECONOMIC LITERATURE

The elimination of *riba* is one of the basic requirements for the establishment of an Islamic economic system. Hence a correct understanding of *riba* is a prerequisite for appreciating what needs to be avoided and adopting an appropriate policies for its elimination. In post colonial era the subject of *riba* was the focal point of scholastic studies, contemporary Muslim economists and *Fiqh* scholars have extensively researched and over emphasized its legal importance and economic implications. And for the last three decades in particular *Fiqh* scholars and Muslim economists have paid a large efforts in identifying the prohibited *riba* and its economic implications on one hand and finding economically feasible legally acceptable alternatives for this on the other. In this section we review the explanations of *riba* presented by contemporary Islamic economist. We briefly outline the main views and various trends of Islamic economists and Shariah scholars about the subject

2.3.1 Interpretations of Islamic economists

⁶⁰ Abu Zahra, Ibid.

⁶¹ Ibid Abdul Aziz p.42.

⁶² Al Imam As Sarahsi, Al Mabsut

In recent years a good deal of attention has been paid by Muslim experts in economics, banking and finance to find ways and means of doing away with *riba*. A tremendous efforts and intensive work has been directed to figure out the conceptual meaning and practical implications of the term *riba* in Islam. Large number of *fatwa* rulings have been issued on the prohibition of *riba* at individual, institution and government levels. The report of IIC of Pakistan is considered as the turning point and important development of thought on the Islamic Financial System. In 23 December 1969 the Council categorically pronounced that all forms of interest were *riba*, irrespective of the purpose, parties, rates and duration involved. This report was landmark in the efforts for Islamizing the financial institutions in Pakistan. In order to implement this report the State Bank of Pakistan started issuing a circular to the banks for transforming their operations on the Islamic lines from first January 1981. Islamic windows were opened in all Nationalized Commercial Banks. During 1981-1984 the SBP prohibited the banks to accept any interest bearing deposits. This efforts of Islamization economy results the historical decision of the Federal Shariah Court in the form of its landmark judgement of the prohibition of *riba* in Islam. In November 1991 FSC decreed that *riba* embraces all forms of interest including the prevalent system of mark-up. The FSC has decreed that a " transaction which contains excess or addition over and above the principal amount of loan, which is predetermined in relation to time or period to be conditional to the payment of predetermined excess or addition payable to the creditor constitutes *riba* and any sale, transaction or credit facility, money or in kind to be considered transaction of *riba*, which is unlawful (haram) in the territory of Islam and in Muslim society. There is a consensus of Muslim jurists on it"⁶³. The report on Banks and Financial Institutions (yet unpublished) categorically took the position that all forms of interest were *riba* and prohibited. This modern trend toward the Islamization of knowledge in general and economics in particular is the natural result as an institutional form of the contemporary Islamic revival. Almost all Muslim countries have experienced more or less some forms of this Islamic oriented reformation of economy. More than 30 *fatwas* and *Fiqh* rulings have been issued by *Fiqh* Centers in Makka and Jiddah as well as al-Azhar al-Sharif that bank interest, whether credit or debit is *riba* and utterly forbidden by the Qur'an and Sunnah and the consensus of Islamic jurists⁶⁴.

⁶³ FSC, judgement, p.104

⁶⁴ Abdel Hamid El-Ghazali, Profit versus bank interest in economic analysis an Islamic law. Islamic Economic translation series No.2, IRTI.IDB 1994.

However, reviewing the contemporary literature of Islamic economics, although there is a complete unanimity Muslim Scholars on the prohibition of *riba*, one may encounter with a definition problem of the subject. There are diverse interpretations of the concept of *riba* in the contemporary studies to mention few of them we find as follows: "*riba* is generic Qur'anic terminology for all kinds of excess above the value of a thing⁶⁵." As Choudhary defines it, according to this view any increase or growth in the value of a thing falls under the sphere of *riba*. A. Mirakhor & M.Khan observed that "*riba* is an Arabic word for the predetermined return on the use of money" as Omar Chapra (1985) noted that "technically *riba* is the premium that must be paid by the borrower to the lender along with the principal as a condition for a loan or extension in its maturity⁶⁶." There is a general agreement among Muslim scholars that the interest (usury) is the prohibited *riba* in absolute terms. Khurshid Ahmed elaborated the matter in detail and came up with that "*riba* as any claim in excess of a principal sum, the differential between the amount received by the borrower and the amount paid by him is interest and that is what exactly *riba* is."⁶⁷ In another place he considered *riba* to be "any premium or excess small or moderate or large which is contractually agreed upon at the time of lending money, as a fixed rate of return for its use over a period of time and this is what has been described as an interest."⁶⁸ In economic terms this means that Islam prohibits predetermined pricing capital. The contemporary *Fiqh* scholars, without elaboration, are almost in a consensus on this equivalence on the basis of the Qur'anic verse "And if ye repent, ye have your principal" as a recognition of right to collect the principal only without any increase whether high or low, and the reports from the Prophet(saw) that prohibits any gain that may be derived from loans. The FSC has conducted a survey about the identity of *riba* and in this connection it has distributed a questionnaire to the leading Shariah scholars and Muslim economist in the Muslim World. In responding to this almost all of them have emphasized the equivalence and one to one correspondence of *riba* and interest terms, asserting that whatever is known as interest in the conventional economy is *riba* in Islam. To outline the views of several of them we find as follows: According Rafi Osmani *riba* is considered as all loans that carry payment in addition to the (amount of) loan or every loan

⁶⁵ M.A.Choudhry, *Riba, Financial Interest. Foundations for Islamic Economics*. 1991, p. 103.

⁶⁶ Omar Chapra, *Ibid*.

⁶⁷ Khurshid Ahmad, *Elimination of riba from the economy*, 1993, p. 38

⁶⁸ Khurshid Ahmad, *Ibid*.

that derives a profit comes in purview of *riba*."⁶⁹ He asserted that "*riba* as quoted above discards also every quantity of return by way of profit."⁷⁰ Hassanuzaman, M. Uzair and Faiz M. held similar views that the interest (*riba*) whether simple or compound is *unlawful (haram)* in other words interest is prohibited in all its forms and that usury and interests are one and the same thing."⁷¹ Similarly A. Kharofa asserted that "*riba* is synonymous with interest and there is no difference between the two words "usury" and interest". He further noted that "I have been reading writing and lecturing about usury for the last thirty years and I have concluded that interest is usury (*riba*)"⁷². However, M. Zia-ul Haq gave the opinion that *riba* is unjust exchange between two parties in which no recompense, counter values or return is given by one to another party. On the basis of this interpretation he noted that "*riba* covers the interest charged by modern banks for loanable funds illegal usury, all speculative sales of future values, share cropping etc."⁷³. N. Siddiqi however, observed that "the Sunnah has also prohibited *riba* involved in barter and exchange of currency which often served as a cover to what was in reality *riba* in loan transaction the relevant traditions are well known, but, they do not concern us here as they only broaden the scope of the definition of *riba* without diluting in any sense the crux of the definition given above."⁷⁴

This predominant view of the contemporary Islamic economists is perhaps the replications of the great Islamic revivalists of this century like Sayyid Qutob, Maulana Maududi Who gave their observations on the basis of the practical operations of the matter expressing that "*riba* to be a contractual increment received by the lender from the borrower over and above the original principal capital."⁷⁵ The Islamic economist based their arguments on " if a loan is given or taken for moral or humanitarian purposes, the principal amount should be protected and any excess on that loan is forbidden as an immoral and exploitative instrument. If loan or investment is made for economic reasons, then the owner of the capital has no right to demand a fixed rate of return. One cannot legitimately ask for any additional payment without sharing the risk of business. Thus, if a simple loan is advanced without risk

⁶⁹ Maulana M. Raji Osmani, of Federal Shariah Court (FSC) Judgement on *riba*, 1991, p.263.

⁷⁰ Federal Shariah Court, Judgement on *riba*, Ibid, p.263.

⁷¹ FSC Judgement, Ibid, p.273.

⁷² FSC. judgement, p.288.

⁷³ Ibid, p.292

⁷⁴ FSC. Judgement, p.280

⁷⁵ Maulana Abu Ala' Maududi, The Sood- Interest, 1950. See also, Principles of Islamic Finance, IRTI, IIB, 1994, p 21

sharing any additional payment small or large, in excess of the original amount of the loan constitutes *riba* and as such it is forbidden⁷⁶." The contemporary Islamic economists have maintained the view that all commercial transactions or noncommercial individual or corporate, private or public, which involves a predetermined rate of return on loan, in money or in kind fall within the scope of *riba* and as such they are forbidden. According to S. Munawer Hassan, interest or *riba* is excess over the principal and such covers the modern interest in all its forms."⁷⁷ Ziauddin Ahmed also affirmed that the fundamental justifications of this equation to be based on that "in interest system the provider of capital funds is assured a fixed return while all the risks borne by the user of the capital funds. Justice which is the hallmark of the Islamic system demands that provider of the capital fund should share the risk with the entrepreneur, if he wishes to earn profit. It is easy to see therefore, for that matter all devices which involve a fixed predetermination return on capital are no real substitutes for interest including mark up, *Bay ul Mu'ajjal* or *Murabaha*. It is asserted that *Mudaraba* on fixed rate of profit is not only incurring a doubtful thing but it is acquiring *haram* itself. With this predetermination the profit share of one party is guaranteed in any situation, while the other party alone is facing the uncertainty of profit and loss and this is the real *riba* prohibited according to authentic revelations."⁷⁸ The predetermination of the outcome or fixity of the return in advance is considered as the essential features of both *riba* and interest and hence they are treated as one and the same thing in absolute terms. In this context the contemporary literature treats the same with the fixed rate out profit or business real outcome and fixed rate out of loan principal. Monzer Kahf and Tariqullah have pointed out in their study on the subject "the difference between contractual return on lending and contractual return on sale and leasing-based financing have not been spelled out in the literature under the review."⁷⁹

2.3.2 The Main Approaches of Contemporary Muslim Economist

In connection with the technical analysis of the term *riba*, the views and methodologies of contemporary writers on the subject may be divided into several main interpretations. These may be summarized as follow;

⁷⁶ Elimination of *Riba* from the Economy, ed. IPS, p.37

⁷⁷ M. Muslihuddin, Banking and Islamic Law, Islamic Research Academy, Karachi, 1974, p.1.

⁷⁸ M. Salah M. Sadi, *Mushkilatul al-Bunuk al-Islamiyya*, Darul al-Mujtama' 1990, p.542

⁷⁹ Monzer Kahf and Tariqullah Khan, Principles of Islamic Finance, IRTI, IDB, 1994, p. 21

i. Riba to be equivalent to usury which is exorbitant interest

According to this view the prohibited interest in Qur'an is only that which takes the nature of doubling and redoubling which were the practices of pre-Islamic societies and ancient nations in the past. This is the view of mainly Jawesh, Rahman, Jafri, Qadiruddin and others. However, the shortcoming of this view is undoubtedly obvious from the start, if the following considerations are taken into account;

- The above verse is an intermediate verse where the final injunction states that. "If you repent then ye have your principal ye do not wrong and you would not be wronged" which does not leave room to accommodate any such partial quotations and misinterpretations.

- According to the above definition, as *riba* is specific kind of incremental growth apart from the principal lent, doubling and redoubling is the natural essence of *riba* which can take place at any rate, irrespective of being, simple or compound. While trade is a sale of an article once for all, *riba* transaction is selling the same thing in multiple times, In this sense, the phenomenon of doubling and doubling and redoubling is the essential nature of *riba* itself.

ii. Riba covers the meaning of the term 'interest' in conventional economic literature

This meaning is mainly focusing on the nature of fixity and predetermination of the rate of return on capital lent as the basic rationale of the prohibition of *riba*. It is strongly argued that the underlying reason of the prohibition of *riba* squarely associates with "its essential feature of being a fixed rate of return on guaranteed principal lent."⁸⁰ As a result, the forbidden *riba* in Islam, is identically equal to the generic meaning of prevailing interest in modern economic system. Although, this view is the general belief among Islamic economists, but this predominant view seems to be a crude equality and shallow conclusion, for it is devoid of in-depth investigation of the subject due to the following reasons.

- The theory of interest itself is controversial in conventional economics, as we may see in the next chapter, where the modern conventional theories of interest do not distinctively

⁸⁰ *Iqtisad al-Islami Magazine*, Issue 193, Dubai Islamic Bank, 1997, p.920

separate between what is profit and what is pure interest and therefore, equating *riba* what itself is inherently obscure, makes the concept of *riba* to put the same position or at least, equally vague and subject to unending debate over its identification.

- This view concentrates only on partial aspect of *riba* that relates to credit loans or *riba al-nasiah*, while it is totally ignoring the other part that arises from transaction, or *riba al-fadl*. Therefore, within the limits of this view the concept of *riba* seems to be incomplete. And as a result, its elimination as well; would seem to be partial.

iii. **Riba equals to all economic injustice**

According to this view *riba* is not only equal to its corresponding concept, namely, usury or interest, but to all kinds of economic injustice and exploitative practices, such as, profiteering, monopoly, and speculative measures, or any returns which have no counter value. As we have mentioned above, the Muslim economists in this category argued that the substitution of interest with profit sharing as a crude and raw deal which may keep the capitalist evils in tact. Thus, they envisage that the concept of *riba* may not confine the conventional term of interest, but it encompasses all kinds of economic injustice and market mal practice. This view is expressed by considerable number of Muslim economists including by Abu Suleiman, Zia-ul Haq, Naqvi and Choudhary. Nevertheless, although, injustice is a very important factor underlying the prohibition of *riba*, it seems to be quiet general view, too abstract and unhelpful for identification of the prohibited *riba* by itself alone. For *riba* has its own identity and unlike other measures its banning has been very specifically restricted, in repeated revelations, to particular kind of economic advantage.

iv. **Riba as an excess from exchange in identically homogenous items**

Feeling dissatisfaction with the methodological treatment of the concept of *riba* which shows some diversion from addressing its essential nature, S.Tahir (1993) has presented an innovative attempt and original interpretations that combine both *riba alfadl* and *riba al-nasia* without losing the sight of juristic technical explanations;

"Riba is a discrepancy which results from the contractual obligation of a party in the

context of a direct exchange of items of the same general kind between parties."⁸¹

On the light this definition, some important conclusions may be highlighted, the distinction between *riba al-nasia* and *riba al-fadl* is inconsequential for the purpose of adjudging *riba*. The *ahkam* on *riba* requires all loans and debts to be settled on an absolutely equal basis. A violation of this principle retains the concept of *riba* in the transaction. A loan essentially represents a case in which ownership of the object of a loan is transferred along with claims to its usufruct. Analyzing the basic ingredients this definition we may decompose it into several elements; such as the followings; (a) *riba* is a discrepancy (b) contractual obligation (c) direct exchange (d) items of the same general kind between the parties. As far as its nature of being discrepancy is concerned, there is no any disagreement among Islamic scholars that *riba* to be excess, increases or difference of two items. (b) points out that the activity should be a contract that creates an obligation, however the jurists also take into considerations in gift case, where someone may provide gifts to someone in consideration of more gifts from that one. In this kind of gift transaction the *Fiqh* scholars recognized it as a kind of *riba* transaction. Incorporating this with the next point (c) concept of exchange may take care of (b). So as long as there is an exchange or trade unlike gift or charity there is a contract that generates obligations which must be fulfilled. Perhaps, the word "direct" if it is associated with the next feature, i.e., items of the same general kind, shows reciprocal transference of similar items. The similarity of items transferred each other itself is a direct exchange. The opposite is through intermediation via third items of different kind. Precisely, the basic message of these interpretations is very close to the juristic interpretation of *riba* as al-Imam Sarakhsi has interpreted *riba* to be in Shariah stipulated excess (discrepancy that goes to either party) without counter value in the exchange (*bay'*). Later on Zak al- Din Badawi also reduced the concept of *riba* in the context of exchange in similar items. He emphasized that this similarity to be the underlying reason of giving rise to *riba* that is doubled and multiplied. He stated that " realized after research and comparison of traditions and opinions of that the purpose of a majority of the transactions incorporating *al-riba al-jahli* was the contract of sale with delay in which excess in cash was stipulated over the price of a sold commodity at the time of commencement of the contract . . . this was the most important point Allah(swt) made

⁸¹ Sayyid Tahir, 'What is *riba*, *Hikmat- e Qur'an*. Nov. 1994.

me in this issue converting me from my (erroneous) opinion to the correct view."⁸² Or as Muslihudin presented, "it is a monetary advantage without a counter value which has been stipulated in favor of one of the two contracting parties in exchange of the two monetary values."⁸³ While Muslihudin confined the two exchanging items as some monetary values, S. Tahir preferred to use in its broad sense, Perhaps the truth lies within these two polar points. Without incorporating the concept of similarity Niyazee also recently discussed the problem in the context of sale.⁸⁴ Thus, although the condition of similarity as we will see in later chapters is extremely important but, what does similarity of items exactly mean is a crucial matter for *riba* doctrine. However, the legal foundations and economic implications of these profound thoughts of S.Tahir have yet to be discovered, and it requires more critical understanding of its central thesis and far reaching ramifications in the field of Islamic financial system.

2.4 CONCLUSION

Although the linguistic usage of the word is very clear, there have been unresolved issues of finding the intended meaning and implications of the term *riba* in the Qur'an and in the context of the *ahadith* of the Prophet (saw). There is probably a missing linkage between the literal interpretations of the term and economic comprehension of the subject. Following the methodology of jurists, such as, examining *riba al-fadl* in isolation from *riba nasiah*, someone may realize the complicated nature of the problem and get puzzle about it, when he could not reach any convincing answers for these crucial dimensions of the subject. However, these extensive scholastic studies seem to be repetitious exercises producing typical insufficient and unsatisfactory answers. As a result of these insufficient responses, certain fundamental questions are used to emerge frequently in the minds of not only the opponents of the *riba* elimination process but even among its front proponents. Some of the common sense questions which could be often encountered but have not yet been answered convincingly. Do *riba* in Qur'an and that mentioned in Sunnah denote for a single concept or for two different concepts and how?, If they are the same and single entity, what is precisely the prohibited area of *riba* or what does exactly the term *riba* stand for?. In literal context the

⁸² Zaki Din Badawi, *Nazariat al Riba al- Muharrama*, Cairo, 1940

⁸³ M. Muslihuddin, *Ibid.*, p.3

⁸⁴ See Imran Niyazee, *Concept of Riba and Islamic Banking*, 1995

Arabic word *riba* is usually interpreted as an increase expansion or growth, or as an additional amount over and above the original level of a thing. But *riba* which prohibited by Islam is not any increase or growth as this is a common phenomenon of profit as well. There is any difference among *Fiqh* scholars on that mere increase of the principal debt is not the Qur'anic *riba*. For *Mudaraba* financing -the most favored mode of financing also entitles increments to the principal amount, despite the fact no personal participation is involved on the part of the financier in the relevant venture.⁸⁵ It can thus, be concluded that *riba* is not increase simplicity but, in the Shariah, it is special kind of increase.⁸⁶ Therefore, the prohibited increase should be necessarily very specific kind of "excess" in physical magnitude or value, which can be assessed in measurable, recognizable and avoidable form. The early Islamic jurists as we have seen above focused and addressed on this particular point. They have laid down the foundational principles of understanding the true meaning of the concept of *riba* in the context of its usage in Qur'an and Sunnah. However, despite the present state of academic achievements in modern economic literature, not much further, developments have yet been made⁸⁷. The current Islamic economic literature on the subject shows a general tendency toward cosmetic surgery of the issue by equating *riba* simply to the conventional term of interest and prohibiting them together without teaching what is nature of this equivalence which perhaps seems for the common man as an equation of two unknown variables. Thus, matching the inherently unstable concept of interest with *riba* as we may see in the next two chapters will never solve the problem. The lack of sufficient clarification of what really the term *riba* does stand for in the present complex economic and financial dealing is the major cause of the confusion.

⁸⁵ M. Anwer, Interest Bearing Debts can Islamic Banks Settle Them, Journal of Pakistan Bankers, p. 54

⁸⁶ FSC. Judgement, Para, 78

⁸⁷ Arshad Zaman, *Conceptual Foundation of Riba*, JIB 1993.

CHAPTER 3

THEORETICAL REVIEW OF PROFIT, RENT & INTEREST IN THE MAIN STREAM ECONOMICS AND ISLAMIC PERSPECTIVES

There is no doubt in the tremendous advancement of knowledge and sophisticated methods, intellectually fascinating theories and development of scientific techniques that are available for the use of economic analysis. The empirical methods which are designed for verifying the refutable hypothesis and accuracy of the existing economic theories could be easily employed in this computer age. One may get amazed on the face of this colossal progress of human creativity in an academic sphere of economic state of arts. However one may wonder to the same extent once he comes to know the fundamental concepts and initial ingredients of all economic theories are in most ambiguous and obscure state, such as; profit, rent and interest. Despite, the fact that profit plays an extremely important role in a market-oriented economy, and despite the general agreement among economists that profit-oriented activity plays a key role not only in allocation of scarce resources but also in providing an incentive for efficiency and innovation, no concept is more maligned or misunderstood than profit. And there are a lot of confusions in its substantiation. It is also very surprising to know that there is no agreement among economists about the fundamental nature and origin of profit, interest and rent. In this chapter we examine the significance of this reality and illustrate the main theoretical inconsistencies that associate with these elementary concepts. Section 3.1 will highlight the nature of profit and its sources in mainstream perspectives and confusion associates in the usage of profit and interest. It would draw to the attention the influence of the said confusion on Islamic economic literature. Section 3.2 will look into the concept of profit in Islamic perspectives and examine the nature and source of profit in *Fiqh* perspective as well as in the contemporary Islamic studies. It would briefly consider the Islamic economists views of a profit-maximizing hypothesis, the *Fiqh* discussions on pricing, profit margin and its entitlement. Section 3.3 reviews certain theoretical apprehension associates with the nature of renting in conventional economics, it highlights the conceptual ambiguities in lending and leasing. Comparatively, on the other hand it discusses in section 3.4 the nature of renting(*Ijara*) according to Islamic jurists and current Islamic economic literature. It will briefly elaborate the modern applications of leasing mode of finance and it will clarify the difference between renting and time value. We deliberately avoid the concept of interest in this context for we have elaborated *riba* exclusively in the previous chapter. However, we will make a brief theoretical comparison among profits, rent and interest wherever we feel it

to be necessary.

3.1. THE NATURE OF PROFIT IN THE MAINSTREAM LITERATURE

Profit is normally held to be the amount by which the total revenue of an enterprise exceeds its total costs. There has been great confusion in the literature over its terminology since the classical school of economics. A. Smith speaks of the profits on stock' and he says "high profits will eat up rent." In the same passages he tries to distinguish between profits and interest. According to him "the former is the reward to 'stock' or capital while, the latter are the price of borrowed money.¹ Again he stated that "the compensation which the borrower pays to the lender for the profit which he has an opportunity of making by the use of money. Part of that profit naturally belongs to the borrower, who runs the risk and takes the trouble of employing it and part to the lender who affords him the opportunity of making this profit. The interest of money is always derivative revenue²" J.B.Say the follower of Smith seems to make a sharp break with Smith by considering profits as a special type of wages.³ T.R. Malthus gets around these profit problems. He considered the profit as "the difference between the value of capitally advanced and the value of the commodity when sold or used."⁴ But, he did not explain why is the difference? Ricardo in his principles⁵ normally treats profit as a real cost which must be paid to maintain the supply of capital. In another place Ricardo clearly defines profit as "the return to capital and its organization in production."⁶ Perhaps Ricardo was the prominent advocate of surplus theory. He observed that 'profit to be purely the result of the ability of society in cooperation with nature to produce a surplus'.⁷ Thus, the classical theory neglects uncertainty and is vague about the micro foundations of profits⁸. However, for radical school this surplus concept is known as exploitation theory of profit or equally is called a bargaining-power theory of profit. According to this theory profit is the residue after the

¹ Adam Smith, (1776) *Inquiry of the Nature and Causes of the Wealth of Nations*, Cambridge, Cambridge University Press, 1977, p.48

² Adam Smith, (1776) *Wealth of nations*, p.52. See also Obrinsky,(1983) *Profit theory and capitalism*, p.15

³ Say, *Treatise on Political Economy* (Philadelphia:J.B.Lippincott & Co. 1860), p.330. or see M.Obrinsky,*Profit Theory & Capitalism*, p.15.

⁴ Thomas Robert Malthus, *Definitions in Political Economy*, London:John M.1827, p.240, 241

⁵ See works and Correspondence, vol:4, p:41

⁶ Ibid.

⁷ David Ricardo, *An Essay of on the Influence of a Low Price of Corn on the Profits of Stock*, Works vol.4, p.15

⁸ Carlo Paneco, In *New Classical Theories of Profit*. The New Palgrave Dictionary of Economics vol: 4 p.1018

deduction of the rent and interest and in this context profits are considered as a symbol of exploitation on the part of labor.⁹

This perhaps, is the natural consequence of the dominant view of neoclassical economists. The use of the aggregate production function in neoclassical growth theory in the 1950s accomplished two things; It could link the rate of growth of the economy to the rate of profit in some cases the two could be equal and in other cases for instance according to Arrow Debreu equilibrium, profit is zero. With the 1870s, the neoclassical economic analysis emerges as the main stream vision. Perhaps, its essential feature is its turn toward the market as the key to understanding the economic phenomena. The switch from production-based theories also means the dropping the surplus notion.¹⁰ It is the market which now explains all categories of income(wage, rent and interest) as the rewards of factors of production (labor, land and capital). In this context the opportunity for profit substantially shrinks. There are only two possibilities: there is either a fourth productive factor whose services are rewarded by the profit income, or profit exists only because of imperfections in the market that pays less reward to the other three factors than they generated. As a result of this new economic world, the profit theory is set to one side, removed from the core of economic theory. For instance, Walras, in his general equilibrium model has come to the conclusion that "in a state of equilibrium in production, entrepreneurs make neither profit nor loss."¹¹ In another place he says "So far as profit is concerned, in the sense of profit of enterprise the English classical school fails to see that it is the correlative of possible loss that it is subject to risk, that it depends upon exceptional and not upon normal circumstances, and that theoretically it ought to be left to one side."¹² Clark is of the view that on the basis of universal static economic phenomena there is no room for profit. According to him "Dynamic changes, therefore, may produce profit, but only temporary profit, which the laws of static state rapidly eliminate. Thus, profit is an elusive sum, which entrepreneurs grasp, but cannot hold."¹³ However, in Knut Wicksell the entrepreneur ceases to perform any function at all, hence, he receives also no income for doing this. According to him the laborer may serve as entrepreneur, for organizing of production does not require a particular talent. It is not

⁹ K. Marx, *Theories of Surplus Value*, Vol. I, p.48-49

¹⁰ M. Obrisky, *Ibid.* p.39.

¹¹ Walras, *Elements of Pure Economics*, London, Allen & Unwin 1954, p.423.

¹² Walras, *Elements of Pure Economics*, *ibid.*

¹³ Clark, *The Distribution of Wealth*, New York, Macmillan Co. 1899, p.32.

surprising, then, to find that Wicksell considers it is "obvious that entrepreneurial profits as such must always tend to zero. For the work and thoughts which the entrepreneur devotes to managing the enterprise, he should have, of course, receive wages like any other worker."¹⁴ This means that the entrepreneur would receive no payment for his special activity of organizing production to outperform the competing firms. In this case, the motivation to creative work and continue this activity would vanish and production would cease. If profits are only implicit factor payment or monopoly earnings then 'pure' profits must be zero. Perhaps similar result holds for the notion of profits as the payment for risk-bearing in a world where all known risk can be, and usually is covered by insurance company, it would appear that only the insurance company would be receiving this profit payment¹⁵. The innovation theory also reaches a similar abandonment of equilibrium, so long as innovation is continual. If not, neither is profit which must then be regarded as of "accidental" character, a mere windfall that only temporarily justifies entrepreneurial activity.¹⁶ Innovation suggests that profits are only temporary phenomena, while monopoly implies that they are not general, but, exist only in an abnormal situation of market operation. Thus, the student of this subject is inevitably left with the impressions that profit theory is an odd collection and a morass of confusion better left alone.¹⁷

It is realized that the problem underlying profit is indeed difficult, but need not be as vexing and formidable as general equilibrium would make it. Sraffa considered that wages and profits to constitute surplus value. According to him wages may no longer become merely the costs of production, but, part of the value added. He tried to solve the conflict between the rate of profit and the share of wages in total surplus¹⁸. Sraffa implicitly takes the technical conditions of production as guaranteeing that a surplus exists, for the profit rate is not an explicitly negotiated rate nor it is a price. He does not however pursue the question of the origin of profit. According to him the owners of capital goods will receive the price as their own reward but this is not profit. He argued that "no need the price of capital assets has any

¹⁴ Knut Wicksell, *Selected Papers on Economic Theory*, ed. Erik Lindahl, Cambridge Harvard University Press, 1958, p.96

¹⁵ Samuelson, *Economics*, 9th ed. 1973, p.619-24

¹⁶ Samuelson, *Ibid.*

¹⁷ M. Obrinsky, *Ibid.* p.13

¹⁸ Piero Sraffa, *Production of Commodities by Means of Commodities*, Cambridge University Press, 1960, p.3-5. See also *Laws of Return Under Competitive Conditions*, p.541.

specific connection with the rate of interest: as an inter-temporal price the interest rate links the price of any commodity to that of its substitute is available at a different date."¹⁹ Shackle synthesizing Keynes' view of long-run expectation puts forward the notion of potential surplus to the profit or loss attached to the enterprise. Keynes in his *Treatise on Money*, also envisaged profits as disequilibrium phenomenon and insists the exclusion of a profit factor from national income calculations.²⁰ The extreme variability of the firm's net income is well recognized as a fact of life in the business world. It is associated with much more stable capital for factor. This appears to create two rates of return for the same factor. Thus, this approach holds no promise for a theory of profit.²¹

3.1.1 Origin and the Sources of Profit

In order to explain the factors originating and generating profit, economists presented deferent models and analytical work starting mostly with zero-profit models which all tend to converge ultimately to the classical assumption of perfect competition. According to the classical economic theory, profits are important only as a magnitude. For this theory, profits together with the rent constitute the economic surplus. Smith regarded the surplus produced by agriculture as a necessary, but, not the sole source of surplus. Since, the productive labor was another source. In smiths' writings there are no clear rules about the division of the surplus between rent and profit. According to David Recardo defined the rate of interest as the lower limit of the rate of profit. There is the first attempt to define the rate of profit and considered it as a pure number which will be free from problems of valuation. Recardo tries to solve the conflict between rent and profit by integrating them with the theory of growth. Physiocrats also regarded land (nature) as the only source of surplus. The emergence of profits as a disequilibrium category comes from the gap between savings and investment. This implies that unregulated profit can never be contractually guaranteed because profits are the residual of two bargaining processes that take place in two different markets.

However, according to the leading conventional theorists, profits are considered by nature as an abnormal disequilibrium phenomenon. There are several hypothetical theories illuminating

¹⁹ Profit & Profit theory *The New Palgrave Dictionry of Economics*, 1987, vol.4, p 1015.

²⁰ Obrinsky, Mark, (1980). 'Profit Theory & Capitalism, p.98.

²¹ Obrinsky *Ibid.*, p.164

the nature and sources of profits. The main stream economists proposed several explanations as the main factors that indicate the origin of profit including the followings:²²

- (i) A residual value which cannot be a price attributable to any factor of production, i.e., wages, rent or interest on capital. The economists in this view consider profits as a surplus of business earnings over contractual payments whose origin lies essentially in progressive dynamic change.
- (ii) Compensatory or functional theory that focuses on the notion that above normal rates of return is the result of the ability of certain firms and entrepreneurs to outperform their competitors. The term profit is to be distinguished from the earnings of managers. Profits are considered in this context as the difference between the money value of the product and the money value of the goods and services used up in the process of production from its initiation to its culmination in the sale of the product. More precisely it is the difference between revenue and costs. It is the magnitude determined by the market through the price of the products and factors of production. Profit belongs to both enterprise and capital.
- (iii) Friction or monopoly profit hypotheses. According to this theory, profits are due to nonmarket clearing economic activity or disequilibrium. In other words it is due to the market imperfections in the adjustment process of economic forces. In this connection some firms may earn above normal profit rates of return and they erect barriers to entry in which they can insure themselves of earning economic profits.
- (iv) Technology and innovation hypotheses of profit. This contends that earning economic profits is necessary reward for inducing individuals to undertake the risks associated with developing new products, new production techniques, through this they earn higher profits like discovering a new marketing

²² M. Hirschey, J.L.Pappas. *Fundamentals of Managerial Economics*, 4th ed. The Dryden Press International Edition, 1992, p. 10.

strategy.²³

But as it may seem, all these propositions are built on a temporary situations and occasional phenomenon. For instance, the last proposition which is regarded as the most powerful justification for the existence of profit appears as a momentary or incidental result for the competitors will gradually erode their positions unless barriers might be erected. Schumpeter placed emphasis on technological change symbolized by innovations that were crucial for agricultural economy on the road to development as the entrepreneurs were the engines of this development which generated profits then profits were their reward²⁴. However, according to Knight profit arises because of the unmeasurable uncertainty²⁵. all true profits are linked with uncertainty. He stresses that risk taking must be rewarded "profit is treated as a residual like rent earned by the entrepreneurs as a result of their correct decisions taken in the present to bear fruit some time in the uncertain future period."²⁶ In this view Knight threw up more than one theory of profit and profit concept, his analysis demonstrates that profit as a wind fall element resulting from the errors of forecasting in all the income factors. Wenston states that "profit theory is now arising from the difference between transferable risk and nontransferable risk the former involves not only into measurable risk but others also that may be reduced or even eliminated through insurance organized market law and technology"²⁷. According to this view it is non transferable risk which generates profit. So profit is the difference between exact and expected incomes. Or expected and actual incomes. To Wenston profit is not the whole residual, it is only the unexpected part of this residual as the rest goes to the factors of production²⁸.

Although an ambitious attempt to link profits to the economic growth was made by Schumpeter, but he came up with the conclusion that profits to be a disequilibrium phenomenon, in terms of the rate of profit, which, itself is indeterminate but it is inter-industrial deferential in the rate of which needs to be zero in equilibrium. A persisting deferential of non-zero indicates either disequilibrium or imperfectly competitive elements.

²³ M. Hirschey, J.L.Pappas, Ibid., p. 11

²⁴ Schumpeter, Ibid. 1934:131.

²⁵ Obrinsky, Mark (1980) , 'Profit theory & Capitalism'.p:34-35

²⁶ M. Hirschey, J.L.Pappas, Ibid. p. 10.

²⁷ Wenston J.Fred, A generalized uncertainty theory of profit, American economic review, March, 1950. P.158

²⁸ Wenston J.Fred, Ibid. P.158

Schumpeter's theory is in fact the only one that associates the profit to actual productivity where there is a clear link between the monetary system that finances production and the real system that generate profits. According to him the source of profits is innovation which can comprise introduction of a new good or a new method of production, opening new market or discovery of a new source of supply of raw material or the carrying out of a new organization of an industry²⁹. Thus, for Schumpeter the source of profits is the superior productivity achieved through innovations and the agent of the change is the entrepreneur. His view reconciles zero profit stationary equilibrium with the observed facts of profits. But, despite its appealing comprehension, the theory is suffering from a lack of sufficient analytical details to prove a source either of the developments in profit theory or as a tool for empirical investigation.³⁰

The obscurity of interest concept is also self evident and widely recognized among economists and extensively noted in modern economic literature. It is not appropriate here to enumerate the profound disagreements among economists regarding the definition and theoretical conceptualization of the interest rate. However, briefly pointing out the unending debate on its theory among economists may be sufficient to quote few of them. For instance, Halbeller has rightly noted, in his writing on prosperity and depression, that: "The explanation and determination of the interest rate still give rise to more disagreement among economists than any other branch of general theory³¹." Although, there is a common opinion that interest in its essential nature is fixed value added to the borrowed capital. Nevertheless, the economic rationale of this general belief has, so far, remained extremely vague. Almost all theories of interest have substantially failed to answer the fundamental question of its *raison d'etre*, i.e., why interest is to be paid? . Interestingly, refuting almost all preceding theories of interest, the modern inter-temporal theory reduces the concept of interest squarely into price of temporal exchange of capital fund or consumer time preference. E. Manisfield has come to the conclusion that the rate of interest to be a price and expressed that "it is the price of a dollar today in terms of dollars a year after."³² The paradoxical situations of this conceptual equation of price and interest will be discussed in the context of pure exchange economy and in the

²⁹ Schumpeter, Joseph A. The theory of economic development: An inquiry into profits, capital, credit, interest, and business cycle. 1954. p.645

³⁰ Obrinsky, Mark. Ibid., p.35

³¹ Halbeler, G. ([1939] 1958). Prosperity and Depression, Cambridge, Mass, Havard University Press.

³² Edwin Manisfield, Microeconomic Theory and Applications, 6th, ed. 1988, p.530.

domain of time (Chapters five and six respectively). In further investigation of the relation between interest and profit in this conventional context we try to see whether there is separating line between these two concepts or how far these conceptual confusions about their essence extend to this aspect.

3.1.2 Confusion in the Usage of Profit and Interest

The ambiguity related to the basic concepts of profit and interest is deep rooted in conventional economics, as the nature and originating causes of these terms in their separate entity have been the confusing matter commonly confronted by the economists throughout the history. Reviewing the conventional economic literature we generally find that there are extreme conflicting views and vague concepts associate with the essential features that distinguish between profit and interest. And if we examine the modern economic literature someone may conclude that there is no clear cut separation between interest and profit concepts. A brief assessment of conventional economic literature on the subject reveals a lot of confusions and collection of contradicting views on profit and interest terms extending, some times, forms the total denial of their very existence³³ to identifying any kind of return as an interest. On one hand it is argued that identifying the interest rate "it seems to be searching for a black cat in a dark room at midnight."³⁴ Most doubtful perception is expressed over the very existence of interest by Robertson "the rate of interest is what it is. because, it is expected to become other than it is, if it is not expected to become other than it is, there is nothing left to tell us why it i, what it is, the organ which secrets it has been amputated and yet it some how still exists - a grin without a cat."³⁵ On the other hand it is argued that the interest rate is the foundation of all forms of production and that all kinds of returns are in one way or another a form of interest, as the price of, or rent for, or use of money, irrespective of the fact that interest is not an endogenous element of production, but it is considered to be an exogenous factor imposed and controlled by monetary³⁶. Since, the beginning of nineteenth century there has been a dominant view among economists related to the inter-dependance of rates of interest and profits: while monetary factors determine the everyday fluctuations of

³³ Sami Hamud Islamic Banking 1985 p.136

³⁴ See, A. El-Ghazali, 'Profit versus Bank Interest in Economic Analysis and Islamic Law,' IRTI, IDB, 1994, p. 16

³⁵ Robertson (1940, 25)

³⁶ El Ghazali, Ibid. p.17

interest rates, its average value over long period depends on the rate of profits to be made from the employment of capital in production³⁷. According to classical economists the concepts of interest and profits were identical, profits being a rate of return on capital of the same dimensions as the rate of interest.³⁸ The rate of profit is determined on the basis of a surplus theory in the tradition of English political economists. Ricardo presented a coherent analysis of how the theory of the interest rate and money has to be integrated with the classical theory of value and distribution when a real wage rate is taken as a given³⁹. According to Ricardo, the average interest rate and the general rate of profits always move together⁴⁰. Both Trower and Malthus supposed that profit of stock and interest of money moved together.⁴¹ In the *Principles*, Ricardo confirmed this opinion and took the average interest rate as an empirical indicator of the general rate of profits.⁴² This idea of correlating the general profit rate to the average interest rate was the firm point in Ricardo's analysis and maintained in all his writings.⁴³ He asserted also that the average interest rate is regulated by the general rate of profits. In this view the average interest rate was considered as a portion of profit. However, Malthus went further and claimed that the average interest rate always moves not only in the same direction, but also in the same degree as the general rate of profit.⁴⁴ Tooke & J. S. Mill criticizing Ricardo's view claimed that interest rates can be determined both temporally and permanently because they are independent of what happens to the rate of profits. However, later on a new trend was reflected in the analysis of the relationship between the rates of profits and interest which had a tendency to identify interest and profit and use them as synonyms⁴⁵. Tooke and Senior were of the view that the term of interest equivalent to the term of profit, implying therefore, that variation in one rate result in variation in the other.⁴⁶ Senior explicitly used the two terms interchangeably. In the context of his abstinence theory he expressed that "if the value of the return is inferior to that advance, he is obviously a loser: he is a loser if it is merely equal as he has incurred abstinence without profit, or in ordinary

³⁷ Schumpeter, Joseph A. *Ibid.* 1954, p. 176.

³⁸ J.M.Joshi & R.Joshi, *Microeconomic Theory: An Analytical Approach*, 1992, p.427

³⁹ Carlo Panico. *Interest and Profit*, *The New Palgrave Dictionary of Economics*, vol:2,1987, p.877.

⁴⁰ This opinion was expressed in 1814, in a Letter to Trower. See Ricardo vol. 6, p.103-4

⁴¹ Ricardo, VI, p. 108-10, see also Carlo Panico, *Interest and Profit in the Theories of Value and Distribution*, 1988, p.15,

⁴² Ricardo, I, p.110

⁴³ C. Panico, *Ibid.* p.15

⁴⁴ See Ricardo, VII, p.199

⁴⁵ Carlo Panico, *Ibid.*

⁴⁶ Tooke, *Considerations on the State of the Currency*. London, 1826, p.7-8

language he has lost interest on his capital."⁴⁷ In another place he explicitly denied the usefulness of distinguishing between these two terms. Gilbart observed this general belief of interest-profit relationship "it has been the opinion of most of our political economists that the rate of interest is regulated by the rate of profit."⁴⁸

Schumpeter has exposed this cluttered situation and noted that "there has been presumed causal links between the rate of interest and profits which proceed from the later to the former." He also documented position of classical economists "Since, pure interest was perceived nothing, but the bulk of business profits, the fundamental problem was the explanation of those business profits: there was no separate problem of interest at all . . . all the theories throughout the nineteenth century are based on the acceptance on this view, including Ricardo's, Marx's, and later on Bohn-Bawerk's."⁴⁹ He stated also that "these economists had used the concepts of interest and profit as synonyms". On the basis of this common apprehension Schumpeter has justified for himself to use these terms alternatively for the same meaning and stated that "Since business profits were conceived as essentially a return to capital goods . . . interest was identical with the net yield of capital goods, we will henceforth use the term for (the bulk of) what Smith Ricardo, Senior and Marx called profit."⁵⁰ Then, interest and profit terms are used as synonyms and interchangeable terms.

Tooke, Wilson and other economists have made the observation as Panico noted " a permanent change in the interest rate was the same thing as a change in the rate of profits. No one spoke any longer of independent movements of these two rates. Indeed, the whole analysis of the relationship between the average rate of interest and the rate of profit faded away. The only issue left for discussion was the temporary fluctuations of the market interest rate."⁵¹ In these discussions, it is shown that the natural interest rate and the general rate of profits were the same thing. Panico continued that the relationship between the rates of interest and profits can, thus, is considered one of the most open and controversial subjects of political economy. It is also argued that if profits are conceived as the return to capital the distinction between interest and profit lost, particularly if the net income earned by the firm is identical in

⁴⁷ Senior, *An Outline of the Political Economy*, 1836, p.93, Reprinted London, 1938, Allen & Irwin

⁴⁸ Gilbart, J.W., *The History and Principles of Banking*, London, Longman, 1834, p.166

⁴⁹ Schumpeter, *Ibid*, p.647

⁵⁰ Schumpeter, *Ibid* 1954, p.647

⁵¹ Carlo Panico, *Ibid*.

substance to the cost to that firm of borrowing money⁵².

Under the assumption of certainty and perfect competition, the main stream of conventional economists contends on the existence of equilibrium between the marginal productivity of capital (profit) and interest. In other words the presence of uncertainty in any observed non-zero profits is considered as the random deviation of actual return from the expected. Or as Samuelson and D. Patinkin say "the rate of interest is equivalent to the rate of profit anticipated to be certainly realized."⁵³ Dougharty, in his critical assessment of the theories of profit and interest has also observed that "one has the well-known Fisherian proposition that if all the appropriate assumptions (i.e., under perfect competition and certainty) are satisfied the rate of profit is equal to the rate of interest."⁵⁴ Further more, he noted that "the Fisherian model in its simplest version predicts that there is triple equality in every time period, where the rate of interest will be equal to the rate of time preference and the rate of profit."⁵⁵ This proposition, in principal, forms basis for a refutable hypothesis. Dougharty testing this proposition of Fisherian triple equality has come up with positive conclusions, safe once introduced of taxation measures in this model. In this situation he asserted that "in case of perfectly competitive economy taxes would be responsible for discrepancies between the rate of profit, the rate of interest and rate of time preferences."⁵⁶ Similarly, most of the pre-Kenesian theory assumes that the rate of interest and the rate of profits are almost interchangeable terms. One should also note that Keynes marginal efficiency of a capital schedule also preserves the link between the rate of profit and the rate of interest⁵⁷. Atkinson has addressed the issue squarely in positive sense and writes that "the matter of profit is complex, and often varies with its everyday meaning."⁵⁸ However, he argued that "what economists call normal profit is really the (implicit) wages, rent and interest costs associated with the factors of production supplied by owners themselves. While, these above distinctions are important to the study of profit, they are rather sterile they do not capture the

⁵² Wood, Adrian. A Theory of Profits, Cambridge: Comridge University. Press 1975

⁵³ Samuelson, P., Economics, 7 th ed., (Mc Graw Hill, New York, 1967). p. 577-578. See also El-Ghazali, Ibid. p.22.

⁵⁴ Dougharty, Profit and Interest, 1980, p.29

⁵⁵ Ibid, p.39

⁵⁶ Ibid, p.41

⁵⁷ Ibid, p.104-5.

⁵⁸ Atkinson Liol C, Economic Analysis: The Science of Choice, Irwin, Inc., 1983., p.465 .

essence of the choices people make between selling services of the resources they own to others and setting up their own business enterprises, or joining with others in a shared ownership of a business." According to him "that is why, perhaps, the profit income is viewed as different from wages, rent and interest."⁵⁹

On the basis of this review of conventional economic literature, there is a sufficient reason to believe the existence of a serious theoretical confusion about fundamental concepts of profit and interest. This fact is perhaps what realized by Hausman who seriously conducted a philosophical assessment of the contemporary theories of profits and interests. He noted the theoretical confusion and conceptual impasse of the subject and stated that "in their (economists) linguistic applications profit and interests are not the same thing, neither in ordinary language nor in the technical usage of economists. Economists usually distinguish interest which is equal to the return on a secure loan from profit. However, the classical economists usually called the whole of the return of an investment profits."⁶⁰ He concluded that; "For this purpose there is no reason (understandable) to distinguish between profits and interest or distinguish between the rate of profits and that of interest. He discussed the problem as there is no excess or pure profit. Thus, there is no important difference between what classical economists called the rate of profit and what neoclassical political economists, since the 1870s have more often called the rate of interest. He asserted that physical cost theories of exchange value do not appear to allow for profits or interest. They thus seem doomed right from the start."⁶¹

On the face of these conflicting views and bewildering state of conventional economic literature about the basic concepts of interest and profit, it is pertinent to ask what is the position of Islamic economics? In order to answer this question two things should not be confused, the positions of Islamic economics on the subject and the individual views of Muslim economists. As far as the first position is concerned, it is beyond any doubt that Shariah has maintained to hold clear and realistic measures in each aspect of life, hence essentially there should be at least general remedies for this problem. The Islamic position on this vital issue will be the focal point the subsequent chapters of this research. However, it

⁵⁹ Ibid.

⁶⁰ Danial A. Hausman, *Profit, Price and Capital*, 1978, p.14.

⁶¹ Danial A. Hausman, *Ibid.*, 1978, p.15

is important to sum up briefly, the views of Muslim economists on this vital subject.

3.1.3 Indeterminate View of Muslim Economists

The above theoretical confusion of conventional economy about interest and profit has infiltrated in the writings of Islamic economists. Although Muslim economists are generally unanimous on that profit element or profit sharing is the sole and viable substitution of interest, one may get surprise to note their apprehension of regarding the summation of the two terms- profits together with interest of conventional economics to mean profit in Islamic economics. For instance, Umer Chapra has asserted that "It must be clearly understood that the return on equity in an Islamic economy must not be equal to just 'profit' but will rather be the sum of what constitutes interest plus profits in the capitalist economy and is called the return on capital (equity + borrowing). It will include the reward for saving and risk taking on the one hand and entrepreneurship, management and innovation on the other"⁶² Further more, he asserted that "the divergence of the value of outcomes of productive enterprise from the value of inputs (costs) is regarded as one integral phenomenon caused by the forces of the market reflecting from the changing social valuations which is capable of being objectively subdivided into pure profits and productivity of capital (or interest)"⁶³. Moreover, a number of Islamic economists outlined the positive correlation between the rates of profit and interest. According to Naqvi (1985) the mutual agreed proportion of the profit and its variability rate: if they are put together lead to the general view that rental (not rent) on capital should be a function for profit which tend to vary with business conditions. So, two things are significantly important in this analysis such as⁶⁴. (i) Interest may not be fixed term, for it can vary with the variability of the economic situations and (ii) that interest is positively related to the rate of the profit. Naqvi is of the view that profits can perform the function of an interest rate in a dynamic economy. Then with this assertion whether there is a substitution of profit for interest if possible as such in formal mathematical sense, the answer is affirmative because dynamic equilibrium of the interest rate and the marginal profit rate must necessarily be equal. This relationship follows because in general the profit rate (or rental on capital) is defined as "pure" interest rate plus a risk factor in probability terms. And the expected value

⁶² Umer Chapra, *Towards a Just Monetary System*, Islamic Foundation, 1985, p.114

⁶³ M. N. Siddiqi, *Issues in Islamic Banking*, 1989, p.87

⁶⁴ Syed Nawab Hider Naqvi, *Ethics in Islamic Economics* 1985, p.124.

of the marginal profit rate is equal to the sum of these two terms, the expected values of the pure rate of interest which is risk-less and the corresponding value of the risk factor. Now in an economy where the outcome can be predicted with perfect certainty, the risk factor becomes zero. In this case, the marginal profit rate must be equal to the rate of interest. Naqvi continued in his discussion that the rate of profit should be sufficiently high to attract participation of the maximum number of firms in investment activity for the high risk takers are only those who have large financial resources. Hence, the explicit provision for a risk premium is to be sufficiently large to cover the risk. Naqvi termed this consideration as a warning against thinking of mechanical substitution of profit for interest⁶⁵. Ariff commenting on this view pointed out that the confusion here is caused by the application of capitalist terms to an Islamic system without exercising any caution the term profit in a capitalist world refers to the reward for enterprise, where as in the Islamic context it is a reward which has to be divided between capital and enterprise.

Nearly similar observations of this correlation between interest rate and profit can be found in the recent writings of M.A.Choudhry. He based his arguments on the notion that the prohibited *riba* or usury to be an exorbitant excess over the market value of money. Hence, he tried first to determine what the market value of money means, and thus, what does constitute the excess over this value? In answering these questions, he decomposed the total price of capital into a profit component which according to him equal to marginal productivity of capital (MPk), a service charge component and expected risk component including unobservable or a statistical error term. Choudhary tried to prove the correlation between profit and pure interest incorporation with the risk element. According to him the profit component is based on marginal concept and expected component in any economic system is left its final determination by the market, these two components will always be shown to acquire high values abruptly or by sequence of upward rising trends. The service charge component is imputation of a management fee for service rendered in financial transactions and so is a fully determined value at any time and has no relationship with subjectivity and statistical error. Choudhary presented the definition of the interest as a function of expected profit rates, expected risk level and service factor. According him the expected profit rates unlike actual profit rates is an increasing function of the expected profit levels for a given time

⁶⁵ Ibid p.125.

period and in relation to an ordinal expectation parameter. For a risk factor is unconstrained variable and in case of risk averting the degree of risk is an increasing function of the level of profit. Since expected profit is unconstrained variable also, the risk parameter as well, is an over increasing function of the expected level of profits. Now the two subjective components taken together show the fast escalating effect of increasing levels of expected profitability over increasing ordinal values on interest rates⁶⁶.

The common conceptual flaws of Muslim scholars arise from their usage of the terms of interest and profit interchangeably. Although Uthman expressed surprise, why money economists confused interest and profit and why did they treat them as one and the same? But, Uthman himself noted that "contractual interest (on loans) and natural interest (or profits), which Schumpeter explains that interest payment is a contractual profit, and the interest rate is an explicitly negotiated price of (debt)."⁶⁷ Perhaps, Zia-ul Haque has exhibited this confusion clearly in his lengthy discussions on 'The economics of *riba* interest and profit'. Examining his conceptual analysis, it is very difficult to find any difference between his notions *riba*, profit and interest. According to him *riba* is synonym to profit, he writes that "so *riba*, in the sense of increase or profit, is all-pervasive."⁶⁸ Asking the relevance of *riba* theory to modern capitalist mode of production he expressed that "can this theory of (*riba al-fadl and riba al-nasia* categories) be any help to us explaining the nature of all profits (interest, rent, etc.) earned in the context of capitalism"? He equated the terms of profit, interest and rent and on the basis of the means of earning them, that is through ownership arguing that "this profit (rent) is similar to the interest of a moneylender who charges it on his capital as he is its owner, where neither moneylender nor the landlords contribute any work or any productive labor."⁶⁹ According to him both are "usurious". Further more, he expressed that "when *riba* was abolished as an illegal economic system based on illegal profits (rents). Therefore, both these bans on *riba* and lease of land are correlative and complementary".⁷⁰ He strongly argued that "therefore, the notion that one part of aggregate profit (interest, usury) is unlawful, but other part is legal is contradictory and misleading", for him the *Mudaraba*

⁶⁶ Choudry, Masudul Alam(1992) 'The Principles of Islamic Political Economy'.

⁶⁷ Usamah A. Uthman, Debt and Equity Contracts in the Theory of Social Economy, Review of Islamic Economics, vol.3, No.1, 1994, p.1-18

⁶⁸ Zia-ul Haq, Islam and Feudalism, The Economics of Riba, Interest and Profit, p.130

⁶⁹ Ibid, p.118

⁷⁰ Ibid, p.119

mode of finance is part of capitalist economic system, and profit or riba-based economy must be rejected or accepted in its entirety" for "profit-earning is the sole purpose of *riba* and Mudaraba".⁷¹ The contemporary *Fiqh* scholars also made to some extent similar flaw, they are probably misled by careless choice of words and terminological mishandling. Without elaboration a large number of them assumed the equivalence of the terms of riba and profit on the basis of their interpretations of the Holy verse "And ye repent, ye have your principal" as a recognition of right to collect the principal only without any increase whether high or low, and some of them interpreted the reports from the Prophet (saw) to imply that all lends that carry profit is riba, in other words, any kind of profit that is chargeable on principal is declared interest, is it simple or compound."⁷²

3.2 THE CONCEPT OF PROFIT IN ISLAMIC PERSPECTIVES

Actually there is an extreme scarcity of Islamic literature on this very important aspect of the economy. It must be admitted that the Islamic scholars have not substantially elaborated the concept of profit. The classical jurists have not apparently discussed the nature and causes of profit in detail as they did in the case of *riba*. Perhaps, due to their problem solving tendency they have not considered conceptual elaboration of profit to be economically crucial matter and demanding exercise⁷³. Among various means of earning living and acquiring wealth Islam places business one of the most beneficial and the noblest of economic activities and it considers business as a social obligation of the individuals. Islamic jurists classify business in the category of *fard kifayah*, i.e., a duty, the performance of which is obligatory on the general Muslim society: where, if it is not performed sufficiently by one or group of them, all of them are responsible for its negligence. Shariah provides detailed instructions to the people for conducting their business affairs in a way conducive to social well being, and in general it requires:

- (i) All business transactions must be free as far as possible from traces of *riba*, speculation, *gharar* and debit.
- (ii) Production relations are based on the principles of trust mutual benefit and

⁷¹ Ibid, p.119

⁷² See FSC, Judgement, IRTI. IDB., p.246

⁷³ See Hamoud. Ibid.

cooperation⁷⁴.

Islam balances the individuals life in both, Here and Hereafter. It urges the believers to engage in almost every good material pursuit, specially trade and productive efforts, in order, to acquire and seek profits as Allah's bounties. Islam recognizes man's inordinate love and excess passion for worldly gains. So, it instructs people to observe moderation in the drive for business profits and they are prescribed acquiring only exclusively legitimate benefits. This is to bring the pursuit of profit under Islam's moral principles. The Islamic ideal of economic justice necessitates that each factor of production to get ultimately what it contributes to total output⁷⁵. The Qur'an explicitly declares that: "Allah created the Heaven and the earth for justice ends and in order that each soul may find the recompense of what it has earned" (45:22). Islam aims at shaping all exchange relations among people on the principle of cooperation mutual benefit collective interest and fair plays. It directs men not to expose themselves or inflict loss on others or inconvenience with the possibility of avoidance. Therefore, any financial contract or business dealings must be *gharar*-free as far as possible.

3.2.1 Nature and Origin of Profit in Fiqh Perspective

The concept of profit is not controversial issue, as there is no different opinion about its theoretical understanding in Fiqh literature comparing to *riba* concept. However, we have not met any authentic delineation of the term and there is a general feeling that the '*Ulama*' should get together and try to define the word "profit" precisely'.⁷⁶ Islamic scholars, to explain concept, they refer it to the linguistic usage of the word "profit" that means growth or increase by trading, '⁷⁷. In this way, the terms of profit, benefit and advantage are more or less giving close connotations. Ibn al Arabi has acknowledged the accounting definition of profit. He expressed that the profit in seller's point of view is the difference between the price fetched by his commodity or service and its cost⁷⁸. In the Qur'an the word profit is used in one occasion clarifying the irrationality of the infidels and states that "these are they who have

⁷⁴ Zubair Hassan. Profit vs.Secular, in S. Tahir, et al (eds.) Reading Microeconomics in Islamic Perspectives 1991, p. 244.

⁷⁵ Zubair Hassan. Ibid.

⁷⁶ Akram Khan Introduction to Islamic Finance, 1993

⁷⁷ Ibn. Manzur. *Lissan al Arab*, vol. 2, the term *Ribih*.

⁷⁸ Ibn. Arabi. Quoted by Ismail, Ibid..

purchased error in exchange for guidance their trade has brought them no profit" (16:2). Al Tabari has interpreted the above verse of profit, and noted that " a trader makes a profit if he exchanges the commodity which he owns for a more precious commodity or at a higher price than that he paid for it: But, whoever exchanges his commodity for a commodity of inferior quality and lower price than that he paid for it is a loser in that trade."⁷⁹

The general technical comprehension of the profit by the jurists is not different from that of the literal meaning or as that is used in the Qur'an. According to the literature of Islamic jurisprudence profit is the increase of the value assets actually realized in exchange. The Islamic jurists considered the increase arises either through the repetition of commercial activities such as; purchase and sale operations keeping the good in its original state or through transformation of the good purchased into higher value-added state. Through these processes the commodity may fetch a higher price than its origin and consequently generate more income known as profit. However, profit may be the result of a natural process of growth without any effort or cost on the part of the owner. That is by mere changes in the conditions of supply and demand rather than any contributing efforts from the part of the asset owner⁸⁰. In any case the profit is considered as an incremental value accrues to the original capital or additional value of the initial principal. However, the concept of higher value added have not been explicitly discussed in Fiqh literature as the main source of profit. Although the introduction of transforming mechanisms or the conversion process is acknowledged as the main profit generating vehicle, it does not in general go in conflict with the essence of the trading operation. Further more, the majority of the classical Fiqh scholars are of the view that profit is from trade only and it is not called profit except what is grown from sale and purchase⁸¹. " And since the basic motive of the contract is to generate profit (which must be shared in partnership) and profit cannot be generated except through commercial activity, Ibn Hazm has logically concluded that "Mudaraba is permissible only in sale and purchases."⁸² No doubt this transformation requires human effort, and perhaps, that is why profit is always linked with work. S.R.Naqvi made the following observation "One thing is however, obvious that the amount which is surplus to the capital cannot be called profit unless it is coupled with

⁷⁹ AL-Tabari, Ibid.

⁸⁰ Hamoud Ibid p:136

⁸¹ Ibn Hazm, *Muhalla*. Ibid.

⁸² Ibn Hazm, Ibid.

the work, and unless the surplus was the result of an exchange which converted the capital from one state to another and the trader earns through transaction repetition a profit by transforming money into commodity⁸³." Identifying the magnitude of the profit necessitates that the transformation circuit to be complete and end with the original state of the process. For instance, the individual has in the beginning some amount of money and purchases certain amount of a good at this stage the trader does not know whether he is at profit/gain or loss even if he is at a gain he is not sure how much is that gain, unless he sells this commodity and transforms it into money again. One important issue is that what originates the profit is different from what causes the entitlement of the profit. The first is related to its basic existence of the profit while the second is related to the distribution right. As we have mentioned above the prominent Islamic jurists see that profit as a kind of growth of property resulting from the investment of such property in a business activity. Thus, the physical transformation of capital from one state to another is noted as an essential element for generating profit, e.g., Trading where money is transformed into merchandise and then it is re transformed into a larger sum of money, this process of generating profit, necessarily requires human efforts and business skill. In this way the man's property management and as a reward of his efforts is entitled to compensation⁸⁴. Al-Kasani has pointed out that profit primarily becomes due on the ground of ownership, work, liability or guarantee. Entitlement due to the ownership or property ownership is obvious because profit represents a growth in the capital and as such being the case, the owner of money that is to utilize the money in the business operations, is entitled to profit. As far as the entrepreneurial position is concerned, his participation in the business becomes entitled to profit for his effort and due to his work. As for liability, money is guaranteed by active partner, he becomes entitled through setting the guarantee versus *al-Kharaj* as the Holy Prophet (saw) stated that "*al-Kharaj* is in consideration of liability". In the opinion of Ibn Qudama a guarantee entitles man to a profit as it is evident in participation of the corporate⁸⁵

⁸³ S. R. Naqvi, *Banking in Islamic Law*, 1993, p.43

⁸⁴ Hamoud, *Ibid*, p. 137

⁸⁵ Shauki I. Bhehat, *Islamic Concept and Principles as Practiced in Islamic Banks. Aspects of Islamic Economics*, Faridi (ed.) 1993.

3.2.2 Contemporary Treatments

Despite the general need for precise identification of the term profit, it is hardly to find a fresh look and distinctive explanations of the subject. There is no problem to use the terms profit, return or gain, as there is no need to be dogmatic about the terminology. Language is arbitrary and conventional and there is no harm in using terms, provided that they are well and clearly defined and that they convey the meaning aimed at.⁸⁶ However, there is a pressing need for precise definitions of concepts and clarifying the denotation of each term particularly in academic works. A. El-Ghazali has rightly argued that it is appropriate to use the term "profit" as it has been used by Islamic jurists more than twelve centuries before it was ever adopted by Western economists. Despite this fact, there are a large deviation and divergence between the classical Fiqh interpretation of the concept in its simplistic and pragmatic form and the modern enigmatic state of the profit theory. The ambiguity of the matter is recognized by both conventional and Muslim economists. The contemporary Islamic economic studies show general acceptance among Muslim economists of the intricacy and complexity of the concept "profit." Z. Hassan has observed that "There is a long-drawn-out controversy on the determination of the profit. The most tricky questions have been the valuation of assets, the capital profits, the past losses, etc. So far, no law has been able to define this concept clearly and precisely. Most of what is being believed depends on court rulings."⁸⁷ Some of the Islamic Scholars have, to some extent, tried to clarify the confusion they have only duplicated the conventional exegesis. Without justifying on Shariah points of view they have explained profit according to the mainstream views of the subject, which we have mentioned above such (i) profit as an accentuated reward of an entrepreneur for an innovation. (iii) profit as a risk premium or as a reward for risk-taking (iv) profit as a monopoly power.

The contemporary Muslim economists have recognized that profit emerges from labor efforts and risk bearing, innovation, and monopoly. R. Al-Misri (1989) writes that, if the rent is the return to land and wage as *ujra* is the return of work and labor, the profit is the reward of risk bearing, innovation or monopoly power. But, consequently they adopted in general that return on risk-bearing capital is to be termed "profit."⁸⁸ R. Misri has explained the reason and

⁸⁶ Abdel Hamid El-Ghazali, Profit versus Bank Interest in Economic Analysis and Islamic Law. IRTI. IDB. 1994, p.23

⁸⁷ Zubair Hassan, Ibid, p:245

⁸⁸ A. El-Ghazali, Ibid. p.23

concluded that "for the reward of innovation are temporary phenomena and innovation itself involves high risk and uncertainty, so, this return also is a kind of reward for risk-bearing. Therefore, profit can be precisely called purely a return for risk and uncertainty⁸⁹." In this connection, Fahim Khan has strongly argued on this view and contested this reason to be the perhaps the sole justification for the legitimacy of profit. He asserted that "Profit by definition is the reward for risk-bearing only" in another place he stated that "there is no profit for guaranteed principal and any profit for guaranteed principal means predetermined positive return or time-value of resources which is not permitted in Islam."⁹⁰ El-Ghazali also stated that this term is used directly to indicate the return on the risk-bearing labor(i.e., entrepreneurs) - the conventional risk bearing factor in economics.

In the connection of entitlement, most of the contemporary Islamic economic writers are of the view that profit arises from human activity, and it is based on work (effort) and risk. It is achieved through productive activities and it is manifested in the form of selling goods or services, but no profit is reaped unless the original capital is entirely maintained through the assessment on actual or potential basis. On the light of the above the profit is closely related to work which is represented in human efforts. No doubt that work is a main cause for entitlement and as the profit is the growth of capital. The profit or the return can be possessed either through ownership, work or liability. However, the owner of the capital to gain the growth of his asset is very realistic irrespective of whether the business is of his own or he is a partner of the business. According to Zubair Hassan in the context of business firm both interest and profit are payments for the use of capital yet interest is not allowed in Islamic while profit is encouraged. He is of the view that the level of interest is determined merely by the state or monetary authority as a part of monetary policy manipulations. And all of the funds are intermixed in the asset formation of the firm which are equally productive and exposed to the same type of risk and uncertainty. In free enterprise of market economies the sum of the factor payments deducted from the revenue product of the firm leaves surplus that accrue to the entrepreneurs. This profit partially represents capital compensation which is taken act of the gross profit, to arrive at its new component. As far as the role of monopoly power is concerned, Majority of Muslim economists are of the view the profit that arises from

⁸⁹ Al Misri Rafiq, *Usul al Iqtisad al Islamic* Darul al-Qalam Dimishiq, Syria 1989 P:215-22.

⁹⁰ Fahim Khan: *Essays in Islamic Economics*, 1995, p.54.

monopoly is not permissible so it should be eliminated according to Shariah principles. According to R. al Misri "this kind of profit will erode with the price regulation which must be observed."⁹¹ Sharukh also went on, further expressing that "this would clearly lead to *riba* and is therefore unacceptable. The idea is that if it does so, the authority mechanism would have to eliminate it by antitrust action."⁹²

3.2.3 Profit Margin and Maximization Hypothesis

One of the leading examples that man is actuated only by self interest which influenced the content and nature of economic theory over many years is the proposition of that profit maximization. This is invariably a non refutable hypothesis of business rationality in conventional economics. The firm is rational only when it attempts at maximizing its profit irrespective of the market conditions under which it operates.⁹³ While, Allah (swt) has strictly forbidden eating up each others' property in vanities or faulty ways such as: stealing gambling deceit and through *gharar* sales. Allah(swt) has allowed that believers may eat up each others property through a contract of exchange conducted by mutual willingness on the part of the two contracting parties. Ismail (1992)⁹⁴. Building upon this Ibn al Arabi points out the main purpose of any party entering into an exchange contract is to either obtain and satisfy his need or earn profit. Allah(swt) allows this profit as long as the buyer and seller have legal rights in their respective commodities or service offered in the transaction. Ibn al Arabi elaborated the matter and analytically illustrated that the resultant profit magnitude in any transaction would depend on the relative need of the buyer and seller for their respective items in order the exchange to take place. He expressed that "if the need of the seller for the price or money is relatively stronger he would add more of his commodity or services for a given price. If on other hand the relative need of the buyer for the commodity is stronger, he would add more of his price for a given commodity or service."⁹⁵ In other words the outcome of pricing and profit margin for a given commodity or service in any transaction depends on its supply and

⁹¹ R. Y. al-Misri, Ibid

⁹² Sharukh, Profit & Loss Sharing, 1985, p.78

⁹³ Zubair Hassan, Profit Maximization Secular Versus in S. Tahir, et al (eds.)Islamic Reading in Microeconomics in Islamic Perspectives, 1991, p.239.

⁹⁴ Ismail, Deferred Transaction in The Qur'an, in 'Introduction to Islamic Finance, Sh. Ghazali Sh. Abud et (eds.) 1992

⁹⁵ Ibn Arabi quoted by Ismail, Ibid.

demand. Such profit margins may vary with different market situations of the transactions. Ibn Khaldun, considering the commercial activity as a necessary means and attempt to generate profit stated by increasing a capital through buying goods at lower price and selling them at a higher price the accrual is called profit⁹⁶.

However, there are certain crucial principles governing exchange business in Islam such as: Freedom of choice, mutual trust, honesty and mutual consent. Islamic injunctions have clearly manifested and repeatedly emphasized on the importance of justice in Islam. And mostly justice refers directly to transactions and economic dealings. A just standard of exchange focuses on the market and its moral values. Islamic concept of just prices implies a fair order and free play of market price that may fluctuate induced by purely economic forces of demand and supply. The participants are given as a complete freedom of conducting contracts and at the same time the obligations to fulfill them are prescribed. A businessman who complies with Islamic rules is ranked with Prophets & Martyrs and truthful believers of Allah (swt). The Prophet (saw) stated that; 'The mercy of Allah be upon a man "*Samhan*" when he buys, when he sells and when he takes back.'" On another occasion he said: "The trading parties if they speak truth and give advice, their trade gets blessed. But if they cheat and tell a lie their trade is deprived of blessing' (Bukhari & Muslim)⁹⁷.

It is also noted that if the transaction is free of any unlawful will and manipulations there is no upper limitation of profit. Some people may see that profit should not exceed certain limit, i.e., 10% or 33% but, this view has no any supporting evidence in Islamic Shariah. Moreover, on the other hand we find in the Qur'an numerous verses which encourage the people to seek profit as the bounty of Allah (swt), while reminding them the blessings of Allah (swt) that He bestowed upon them by creating the means of making ships and subjecting the large seas and great oceans for their benefits. Allah (swt) has stated "And Allah is who has subjected the sea (to you) that you eat there of fresh tender meat and that you bring forth out of it ornaments to wear. And you see the ships ploughing through it, that you may seek (thus) of His Bounty (by transporting the goods from place to place in trading) and

⁹⁶ Ibn Khaldun: *The Muqaddimah & Introduction to History*. Tranzee Rosenthal: Translation Ballingen Foundation, 1958, p.336-38

⁹⁷ Maulana Mohammad M.Nomani, *The Meaning and Message of the Traditions*. Translated by M. Asif Kidwai *Darul Isha'at*, Urdu Bazar Karachi-1, 1983.

that you may be grateful (14:16) "Your lord is He who drives the ship for you through the sea, in order, that you may seek of His bounty (profit) truly, He is ever most merciful towards you" (66:17). It is narrated by Hakim bin Hizam that once the Prophet (saw) gave him a dinar to buy an animal of sacrifice for him upon which he a ram for it and then, sold it (to a buyer) at that very place for two dinars. He later on, bought an animal of sacrifice for one of two dinars, and came back and delivered the animal along with the (remaining) dinar to the Prophet (saw). The Prophet (saw) gave away the dinar in charity and prayed for Hokum bin Hizam's success and prosperity in business (Tirmizi & Abu Dawood)⁹⁸.

Hamid Al-Ghazali mentioned that *al-ghubn*, i.e., selling a good below its market price, is common in trade and permissible. He named it as a part of *Ihsan*, as long as there is no deception and misinformation then taking excess level of profit is not injustice and some of the Islamic Scholars noted that if the *ghubn* exceeds 1/3 or 33% it necessitates option in the trade contract.⁹⁹ Sheikh Yusuf Addajor of Maliki school is in the opinion that *al-ghubn* if it exceeds 1/3 of the goods' price, the trade contract is to be commented. However, Ibn Rushdi acting upon the Prophets' saying that 'the present should not sell for the absent one', he said 'let the people be in their unawareness and Allah (swt) provide *rizq* (sustenance) from one another'. He also mentioned that it is a permissible *al-ghubn* even if the price varies from the general prevailing levels, in more or less, and even if the purchaser is aware of this difference, unless the selling party commits deception and falsehood¹⁰⁰. In the context of this framework the market is an autonomous & self managing institution provided that it works naturally and there is no bad will human intervention. But, some of the Islamic economists have expressed certain reservations over the impersonal market mechanism of capitalist system and argued that market in Islam is necessarily regulated one. Nevertheless, regulations may be needed as long as undesired human behavior influences its natural operations and autonomous mechanisms.

3.2.4 Existing Views of Muslim Economists

As we have elaborated in preceding paragraphs, Islam allows private ownership of property.

⁹⁸ M.Nomani, Ibid.

⁹⁹ Hamid Al-Ghazali, *Al Ihya'u ulumuddin, Iqtisad al Islami*, (Magazine) DIB.,Dubai, Nov. 1997

¹⁰⁰ Iqtisad al slami (Magazine). DIB. Nov. 1997

grants freedom of enterprise, hails profit as a form of Allah's bounty, and permits a role for a price mechanism in resource allocation and output distribution. Despite this clear above position of Shariah injunctions and the view of Fiqh scholars about a profit margin, we find that the contemporary economists have shown an uncomfortable impression about the profit-maximizing hypothesis that. Despite this general understanding of Islamic jurists in this consideration that is encouraging the man's pursue in the object of profit seeking and its maximization, the contemporary economists have shown strong reservation in this hypothesis. They raise doubts on whether there is a need for retaining the profit-maximizing hypothesis in an Islamic theory of the firm¹⁰¹. And they argue on that 'producers would not be maximizing their profits if and when they feel by lowering their profit margins they can further enhance the welfare of the society by satisfying unsatisfied needs. Of course, there is no disagreement among Fiqh scholars on that no producer in any circumstances will increase his profits at the cost of explicit injury to the customers or to his competitors. Mannan has expressed concern about the profit maximization assumption and stated: "Islam has recognized the concept of profit only in a restricted sense because the unrestricted and abnormal profit which capitalists generally obtain is the result of monopolies and cartels which became the main features of capitalist economy. Therefore, Islam is for normal profit which refers to that level of profit at which there is apparently no tendency for new firms to enter a given trade operation nor for old firms to disappear out of it."¹⁰² According to him even this tendency is not enough. Hence, the fundamental principle which should be kept in view is that at no section of society should be deprived of its legitimate share in the process of production.

M.N. Siddiqi also recommends that in Islamic framework producers will generally be content with satisfactory profits. And he has explained "satisfactory profits" by taking ceiling and bottom limits. The ceiling limit is the highest profit permitted by the circumstances (without violating any legal binding part of Islamic code of conducts). The bottom limit is that level of profit which would afford the producer a decent living and some surplus to average out losses. Any profit between the two limits is satisfactory profit¹⁰³. Nevertheless, according to number of economists, this idea seems to be subjective and vague. Arif & Kahf also rejected the concept of profit maximization in situations of monopolist oligopolies and

¹⁰¹ Zubair Hassan Ibid, 240

¹⁰² M. Abdul Mannan, Introduction of Islamic Economics, p.168

¹⁰³ M.N. Siddiqi, Ibid, 1972, p.136.

monopoly etc. Ariff suggested that Muslims entrepreneurs should look for equality of $AR=AC$ instead of $MR=MC$. But in another place Ariff contested that "profit" in Islamic system consists of return to capital and a reward for enterprise, therefore, what may be called "excess" profit in capitalist model may well be normal in Islamic model."¹⁰⁴ Although, these views are good wishes in social respects, the basic logic and their economic reasoning are questionable and subject to critical appraisals. The activity and efforts paid for profit seeking should not be mixed with those related to brotherly or humanitarian considerations or *Ihsan* and charity. *Ihsan* oriented activity is outside the business oriented activities which are essentially carried out for gaining more profit under the Shariah framework. High rates of profit mostly arise from the relative scarcity of the concerned goods and the intensity of the respective demands for concerned items.

Z. Hassan is in the opinion that the pursuit of maximum profit is apparently avaricious and it seems to inflict with the moral code of Islam, but still, it is needed in Islamic economics as well. Secular economics has retained this hypothesis for two reasons. First, price theory which is the core economic science cannot stand erect without it. Secondly, the critics of the tradition have not so far been able to propose an alternative behavioral rule with the same or superior predictive value and lead to empirically testable conclusions¹⁰⁵. Profit maximization as a business objective has a globe character and it is for that reason to be appropriate both for explanatory and predictive purposes in this area of human behavior. However the pursuit of this goal can be possible with a minimum of conflict between self seeking and social good will, only if the concept of profit sheds its exclusive income character and some sort of sharing becomes its institutional attribute. Under dynamic uncertain conditions, profit maximization manifests the firms endeavor to create, enlarge and keep open as much as possible the profit yielding space between the total revenue and total cost curves by equating their slopes ($MR=MC$) would keep increasing¹⁰⁶. Through this process of profit multiplication must eventually transform the perfect competition into Monopolistic competition, product differentiation in the widest sense of the term is now possible and only helps to hasten the process of market domination.¹⁰⁷ According to Naqvi profit maximization

¹⁰⁴ M. Ariff, (ed.) Monetary and Fiscal Economics of Islam, ICRIE., 1982, p.8

¹⁰⁵ Zubair Hassan, Ibid. p.240

¹⁰⁶ Z. Hassan, Ibid.p. 241

¹⁰⁷ Zubair Hassan. Ibid. p.234

as understood in economics is consistent with both normal and abnormal profits in the sense of marginal cost being equated with marginal revenue in both instances. But the capitalist philosophy of profit maximization itself is value loaded and therefore, there is no place for it in Islam. However, Naqvi contested that " while positive profits are not consistent with an optimal situation a positive rate of interest is"¹⁰⁸

3.3 THE NATURE OF RENTING IN CONVENTIONAL ECONOMICS

Renting is another form of combining the factors of production in economic activity, where one party is related to owning and maintaining fixed assets and selling their usufruct, while another party buys this usufruct, the same way, as one may buy the labor hour of laborers. In the first case the outcome or the profit after their cost is the benefit which may be extracted from the fixed assets. And the second firm gets the benefits of assets directly. In any society there may be different legal formulations for the combination of productive factors which influence the distribution of risk. Fairness, in transaction also, requires that exchange contracts must be compensating and balancing between the responsibility and the gain. This is considered as the human rationale in Islamic system. Rent charges are the payments or prices for the use of a resource, whether they may be land labor, equipment, ideas or even money. In a main stream economic literature the rent for labor is called wages, the payment of land and equipment is often called rent, the payment for use of the idea is known as royalty and the payment for the use of money is called interest.

To early classical economists, rent meant payments for the use of land. Recardo in particular considered it as the payment for the uses of the original and indestructible powers of the soil. The concept of economic rent is usually depicted in graphical illustrations by employing the standard demand and supply curves, assuming a vertical supply curve of rental resources at a fixed amount the concerned factor of production(land) all prices, the entire return to the resources is an economic rent. Or it may be called a quasi-rent a term apparently initiated by Alfred Marshall.¹⁰⁹ Virtually every existing resource is like an economic rent for at least a short interval time. If a rental payment stream to an existing resource is not sufficient

¹⁰⁸ M. Ariff (ed.) Ibid., 1982, p.8

¹⁰⁹ Alfred Marshall, Ibid., 1920, p.74, 4261-6.

to recover the costs incurred in its production, the durability of that existing resource will, nevertheless, enable the resource to continue to provide services at least for certain period of time. In other words, because of the resources' durability, the durability of that will continue to yield services even at a rent insufficient to recover its costs of production but sufficient for current costs of use. Thus, any excess over those current costs is a quasi-rent. In this sense, quasi-rent resembles an economic rent. If the resources received a payment exceeding all the initially anticipated and the realized costs of production, it will have achieved a profit that is more than pure interest over the resources investment costs.

The question is, whether quasi-rent means that portion of the rent in excess of the minimum operating costs over the remaining life of the asset or all the excess including profits if any. According to Marshall any excesses over variable costs of operation were classified into quasi-rent, interest on investment and profits.¹¹⁰ Hence, rents for the use of the services in this context may be different, though equal in every relevant respect. However, whether, specific use of resources is created by natural talents or sheer an accident may not make any special differences in use value. Supply differences and payments for these particular features were often called Ricardian rents to distinguish them from differences in rent obtained due to monopolizing or unnatural restrictions. Examining the conventional economic literature on this fundamental subject, we find certain inherent obscurities and conceptual inconsistencies.

3.3.1 Conceptual Ambiguity in Lending and Leasing

In general, economists mean, by rent notion, a return earned by factors of production in excess of its opportunity costs. The interest and profit shares of income are closely related to the process of capital accumulation indeed some of early economists used the two income concepts interchangeably as measures of the return to capital. Today most economists distinguish the two terms into income or return on debt capital which is an interest and return on equity capital that is profit. To many people, profit represents an income that is earned by exploiting other, its existence is taken as evidence of the presence of economic injustice and corporate greed in the economic system. This hostile reaction is often disputed by others who view profits as essential to the growth prospects of the economy an instrument critical to the

¹¹⁰ Marshall, *Ibid.*, p. 412.

improvement of living standards the participants of the business in particular and perhaps the whole society in general.

But, in ordinary language rent means a payment for the services of a material asset for specific period of time. As such, rent is comparable to wages under the heading of hire value. However, classical economists applied this term for the return on various forms of capital investment or factors of production. In modern economics it is used as a part of the income of any productive factor. Rent is also defined as excess of expected return over cost or simply as an excess of return over cost. The determination of the rental or hire value of an asset is generally a specific instance of the determination of the prices of productive services. All of the forces that affect rent in the sense of rental or hire value also affect rent as the excess of expected return over cost. For any particular unit of the productive service actually devoted to the specific use, rent is merely the ordinate of the factor supply schedule at that quantity at which the particular unit enters into the specific use. Loans need not always be made in the form of money sometimes they were made in the form of a commodity, i.e., wheat, dates, barely in the ancient times. The rate of interest on such loans is frequently called the own rate of interest - a term or originated by Keynes¹¹¹. Because the anticipated price movements of various commodities differ their own rate of return, which need to be equal to each other or to the rate of interest on money loans. If there is perfect arbitrage in equilibrium the interest rate on money loans is approximated as the own rate of interest on the loan of a commodity plus the anticipated rate of the increase in the money price of that commodity. ($I_n = I_c + S_c$). If this formula is applied to commodities in general, it becomes an expression of Fisher's celebrated distinction between the money rate and the real rate of interest. Where the real rate is the rate of interest measured in terms of commodities and accordingly is approximated by $I_n - S_c = I_c$. (Fisher, 1930). In prehistoric agricultural communities loan of seeds was actually recognized type of arrangement to be repaid by greater quantity of seed at harvest. But this arrangement is noted to be near to what we call today crop sharing or partnership. for the failure of harvest no repayment was required. Although no very satisfactory theoretical treatment of general relations between interest and risk has yet been worked out, but, for a practical purpose, a good usage is to limit interest to fairly safe loans and stable or standard market quotations, and to designate by some other term such as dividends or profits to the

¹¹¹ Keynes (1936). p.22-39. Also see Lerner (1953), p. 354. 56.

other uncertain and less standardized rates.

In the modern text books, the confusion and conceptual inconsistency in the identifications of income groups from economic resources are common and some extremely critical. Almost any attempt made towards enlightening these conceptual ambiguities, results paradoxical consequences. For instance, Boris and Thomas renowned conventional economists have displayed the misleading usage of these terms in theoretical treatments of the text books and their similarity in practical implications they have tried to clarify this terminological confusion and noted in their book of money and banking "in our economy we see innumerable instances of items being lent, rented, or leased for interest payments and lease payments, actually all three terms express the same thing and, strictly analytically, there is no difference among them. It is purely arbitrary habit of speech that leads us to say that I "borrow" money but "rent" a house and "lease" an office machines¹¹². G.S. Maddalla and E. Miller also, in their very recent basic text book of 'Economics' have illustrated the equivalence of interest payment to the concept of rental price of capital. They have, in this connection asserted "It is nothing but the rental price of money citing an example. If you have \$.10,000/- and you lend it to another at a 10 percent rate of interest for one year, you are in essence, renting your money for \$1000 and you get back the rent and the principal at the end of the year ¹¹³. M. Abu Saud observed these theoretical misconceptions and expressed that, "treating money capital as to be equivalent to capital goods is considered as the subtle mistakes which help them (conventional economists) to find a warrant for charging interest on borrowed money."¹¹⁴ As we have seen above this confusion between interest rent and some times with profit is very common in the modern text books. For instance, Samuelson has made the notion that interest is the price or rental of the use of money considering its services exactly as the service of a medical doctor or of a tractor¹¹⁵. We would find some difficulties to reconcile his description of money as a means of "transforming one good to another by exchange rather than by production." With his view about interest "when money is sold, someone should pay a price and if it is borrowed one should pay a rent¹¹⁶." Perhaps what Samuelson has missed is that the separation between rentable things and non-rentable ones like money. He ignored the fact that

¹¹² Boris P. Pesek and Thomas R., *The Foundations of Money and Banking Saving*, 1968.

¹¹³ Maddalla and Miller, *Economics*

¹¹⁴ M. Abu Saud, *Riba Interest and Qirad*, in Khurshid (ed.) *Islamic Economic Studies*, 1980, p.39

¹¹⁵ M. Abu Saud, *Ibid.*

¹¹⁶ Samuelson, P. (1967), 'Irvin Fisher and the Theory of Capital', W. Felner (ed.)

every rentable asset can be sold but the vice versa does not hold. Joan Robinson writes "the rate of profit earned by a given stock of capital is governed by its marginal productivity. The rate of profit thus, depends on the relative scarcity of capital and falls as the stock of capital falls. The rate of interest is the price at which money can be rented (borrowed). So, like other factor prices the rate of interest is determined by supply & demand."¹¹⁷

3.4 THE NATURE OF RENTING (*IJARA*) ACCORDING TO ISLAMIC JURISTS

The simplicity and clarity of Islamic injunctions would emerge from this very vital financial instrument in the Islamic economics. The early Fiqh scholars were in fact pragmatic and practically oriented in this matter. They gave a due attention to examine this subject thoroughly and they came with impressively profound views resolving entirely the conceptual and practical dimensions of the subject. *Ijara* contract in Shariah is quite compliant and is open to the incorporation of additional conditions. Without going into the detailed discussions of the legal conditions of parties to the *Ijara* contract, its format the asset leased and the amount of rent one may easily compare *Ijara* with *bay'* (sale)¹¹⁸. Classical Fiqh scholars consider *Ijara* contracts as part of sale transactions in its broad sense.

Islamic Fiqh injunctions have clearly manifested the flexibility of *Ijara* instrument and its competence to cope with the prevailing situations and it is harmonious with the variations of business conditions. If it is desired so, at the beginning of each period, can be made renewable as long as, the asset exists. The important point is that, both the leased asset and the amount of the rent must be clearly known to both parties in the contract. If there is an advantage or benefit, to either party it should be the same kind, because the rentals sale of an advantage or utility may be different according to its locality, type of the property for rent and the purpose of its usage. An advantage which is obtained against a wage (rental) must have a definite object or definite form known to both parties. Similarly advantages are identifiable by the object as in the case of hiring a man for tailoring a suit, where the kind of the work required should be specified and identified advantage. However, the accuracy of identification of the advantage does not necessarily to be accompanied with the actual acquiring of such an

¹¹⁷ William J. Bounal & Bhinder, *Microeconomic Analysis* Alan 2nd ed. 1992, p.592

¹¹⁸ *Ibid*, p:29.

advantage, and it is not condition for the accrual of the rent, i.e., a lease contract of a house is concluded for two months whether the lessee takes the advantage of residence or not. The same is applicable to a man who hired himself to another where the worker will be entitled to receive the wage even if his employer does not make him to work during the contract.

In its linguistic usage, *Ijara* means selling usufruct\benefit and its technical definition in Shariah is similar to this literal usage¹¹⁹. Hanafi defined it as a contract on usufruct for exchange (*iwad*) of something. In more comprehensive interpretation " *Ijara* is a contract intended to give ownership of a determined and legitimate utility (*Manfa'a*) of a rented corporeal object (*al-ayn*) against a consideration¹²⁰." For the Shafi'i " *Ijara* is a contract where the subject matter is determined, assignable, and lawful usufruct of an object against consideration." Maliki school referred it to "a provision of utilities of a lawful thing in substitution for specified period of time." A similar interpretation is given by Hanbali School. According to Maliki, *ajr*\ remuneration is used for reward of human effort and the word *Ijarah*\ rent is used for properties in spite of these different nomenclatures, the rules are the same. For the wage or remuneration is the price of an advantage regardless of whether the advantage is derived from the work of a person or from the services of any thing turned to advantage¹²¹.

The Fiqh scholars had explicitly and implicitly established that renting or *Ijara* in Islam is a specific kind of sale transaction for its peculiar features. Ibn Rushd " *Ijara* observed its resemblance to a sale contract where the price and the use of *Manfa'a* are exchanged¹²²." The magnitude of the use should be determined either by the duration of the contract or by its subject matter. Further more, the use should be lawful and not a mandatory duty. Thus hiring a mother to feed her own baby is invalid. Al Bahuti has described *Ijara* as a contract where the subject matter must be lawful and defined utilization (*Manfa'a*) of a lawful and specified corporeal object (*ayn*) for a specific period of time¹²³." As Bahuti noted in al-Kashaf, It is also

¹¹⁹ Ibn Manzur, Lissan ul Arab vol.5, Term "*Ajr* or *Ujra*". See also, Hamoud, Ibid. p:141 see also, Mu'jam Al Wasseet vol.1 Term '*Ajr*'.

¹²⁰ *Jami'i al Fiqh ala al Madahib*, vol.3 P:94.

¹²¹ Jamaludin Abidin, Encyclopediad of Islamic Jursprudence, part:2, p:199

¹²² Ibn Rushid, *Bidayaat al Mijtahid* Vol:4 P:215.

¹²³ Al Bahuti. *Al Kashaf Al Qina*, part:3, p:470

a contract for providing a defined work for a fixed price¹²⁴.

According to the usage of the term, wage (*ajr*) or rent is the price of an advantage or service which is concluded by the parties. According to the above juristic definitions the *Ijara* contract implies the appropriation of advantage against consideration. Thus, for the *Ijara* is a sale of utilities of a thing. Accordingly the Fiqh scholars pointed out that it should not be a physical portion of that object itself such as renting a tree for its fruits or sheep for its milk or its wool or its fats, or renting a well for! its water. In all these things the usufruct is part of the rented property. Therefore, for *Ijara*, it is necessary that the intended utility should be separate as a product that may stem from the object, but the advantage or usufruct should be the object itself, so that it may finish with its use. The object should be intact at least during the time of using it or even after the use of its utilities.

Ijara in its broad sense, does not confine to specific kind of utilities but, it covers a large area of economic activities, it embraces any thing or property which is used to supply on price, any sort of useful services, such as: accommodations, transport, communication, entertainment, taking leisure and even sitting under a tree. All these are subject to renting as long as the user can derive some kind of reasonable utility or pleasure. Nevertheless, any thing which its utilization is causing that both its usufruct and the object itself to go together and perish at the same period cannot be hired, but it can be sold. Jurists considered any assessable utility which is permissible in Shariah is valid for renting, i.e., It is reported in *Nihayatul Muhtaj* that . . . if a tree is hired to be used as a shade or for tying it with an animal. If a bird is hired for enjoying its singing or watching a peacock to enjoy its color all these are valid for rent because the advantages or utilities mentioned are intended and assessable¹²⁵. Ibn Hazmi is in the opinion that rent is allowable in every thing having an advantage which is hired for use and is not consumed. In *al-Mughni* the lease of dirhams and dinars is permissible for weighing and for using for ornament for a definite term Abu Hanifa and one version of Shafi'i view is siding with this¹²⁶. In *al-Kashaf* is reported that the lease of coins is valid, i.e., dirhams and dinars for definite period because its advantage is permissible and can be perceived to leave the item intact but, that is restricted to their use for

¹²⁴ Al Bahuti, Ibid, p.470

¹²⁵ Al Ramli Ibid, vol.4, p.174

¹²⁶ Ibn Qudamah: '*Al Muqni*' vol. 5, p:404

different purposes other than monetary usage such as an intermediate instrument. The jurists are generally on the view that any thing useable while keeping its physical nature in tact is rentable, but, the vice versa is not permissible. They are also on the view that as long as the rented object is in tact physically this rent period is valid. Ibn Qayyim is in the view that the tangible thing which occurs over period of time with maintaining or keeping itself intact and has a physical existence is subject to renting. It can take the rule of utilities, i.e., fruits of a tree, milk of the animal, water of the well. Ibn Qayyim equated here the tangible thing to the intended utilities from it.¹²⁷

These definitions show that *Ijara* is a bilateral contract where the utility of a corporeal object is exchanged for a price. The rules for averting *riba* apply to *Ijara* and these rules as we have previously seen varying from one school of law to another. We have also seen that with *Ijara* the subject matter would be materialized gradually by the lessee making use of a hired object over certain period of time. This is a tolerated exception which particular to *Ijara*. However, the basic requirement is that the subject matter should be in existence at the time the contract is concluded. The requirement cannot be met when work or use is the subject matter, the latter are necessarily nonexistent at the time the contract is concluded but comes progressively into the being by the gradual implementation of the contract¹²⁸.

Islamic Jurists are in a complete consensus on the permissibility of *Ijara* according to the following verses of the Qur'an. Allah (swt) stated: "Then if they give a suck to the children for you give them their due payment and let each of you accept the advice of the other in a just way" (6:65). In another place the Qur'an preserved the contract that mutually agreed by Musa (saw) and Ya'qub(saw) "And said one of them (the two women) O' my father! Hire him (Musa)! verily a best of men for you to hire is the strong the trustworthy" (26"28). He (the father) said, I intend to wed one of these two daughters of mine to you on condition that you serve me for eight years, but if you complete (it in) ten years it will be (a favor) from you (27:28). The Prophet (saw) said also. " Give the hired (man) his due before his sweat to dry up."

¹²⁷ Wahab Suhaili, *Fiqh Islam wa Adillatuhu* , vol.4, p.729-34.

¹²⁸ Nabel Saleh, *Unlawful Gain and Legitimate Profit*, 1992, p 87

3.4.1 General Rules of *Ijara* for its Modern Applications

An operating lease or *Ijara* is based on a contract between the lessor and lessee for use of some specific assets. The lessor retains the ownership of the asset and the lessee has possession and use of the asset on payment of specified rentals over specified period. The rentals are in-sufficient to enable the lessor to recover fully the initial capital outlay. The rentals should be made at the disposal of the lessee through disposing or releasing the equipment or *Ijara* capital from any other users or engagements. *Ijara* contract does not require the beneficiary of the usufruct of the asset to pay the price of that asset. All that the beneficiary pays is the (rent) price of usufruct. Furthermore, the usufruct of an asset is divided over time and is usually defined in terms of units of time. *Ijara* contract, in fact, is a sale contract whose subject is usufruct. As *Fuqaha* usually say the usufruct is measured by time and therefore the user can have a certain consecutive number of periods in which *Ijara* contracts are defined. According to Islamic economists, the Shariah permits a fixed charge associated with tangible assets on the base of converting financial capital into tangible assets the financial have assumed risks for which compensation is permissible.¹²⁹ Islamic institutions regularly enter into financial leases with the lessee bearing all the risks. However, the innovations in the leasing structures used by these institutions are prompted mainly by business considerations rather than Islamic financial principals. According to the prevailing business norms in this field, the lessee is responsible for the following aspects: - (i) providing security in the form of an investment in the lessors investment amount, (i) to provide additional guarantees or collateral, (iii) the lessee has to maintain a current account with the lessor and the lessor debits this account for advance payment of lease rent when it becomes due, (iv) the lessee has to maintain the lease asset and is also responsible for buying Islamic insurance known as *takaful*, (v) the risk of loss lies with the lessee (vi) the lessee may also be charged damages for later payments based on the average returns of the lessor during the relevant periods, (vii) at the end of the lease term the lessee has the option or the obligation to purchase the assets at pre agreed price¹³⁰.

¹²⁹ Islamic Banking an Over View, Ed. Daphne Buck Master IIBI London (1996) p.28-29.

¹³⁰ M. T. Usmani, Brief Notes on Basic Features of *Murabaha* and leasing in the Light of Shari'a, *Al-Batagh* international 1991.

Although leasing mostly concentrate on financing big tickets, i.e., aircraft, ships etc. it is also used to finance smaller items of equipment such as a medical equipment or small scale equipment leasing. It also got way in home financing¹³¹ decrease applies or at the time of contract. The rent may be fixed in the first period and subsequently be varied and made it known before the beginning of each renewal period. In the *Ijara* contract the lessor is required according to Shariah to keep the leased asset in a shape that allows the lessee to extract from it the intended usufruct. This implies that maintenance spending related to the basic characteristics of the asset is the responsibility of the owner, while maintenance expenses related to its operation are to be taken care of by the lessee¹³². The expenses carried by the owner are two kinds predictable periodical expenses after certain period of functioning depending on the nature of the asset these kinds of expenses may actually be charged to the lessee as a part of the rent such as periodic repairing and insurance expenses. There may be some maintenance expenses which are not predictable and unexpected changes in the cost of insurance these expenses also are born by the owner which according to Kahf makes the *Ijara* contract non risk-free investment, although most of the unexpected changes in costs are usually insurable. Taqi Osmani has outlined a general frame work of leasing operation, such as the followings; (a) the period of the lease must be determined in clear terms such as; defining the period of the lease contract which would be necessary for determining its price in unit terms of each interval, in the entire period of the lease contract and in the long-run aspect of renewing and changing the lease contract (b) the purpose of using the leased property must be specified in the lease agreement. (c) the liability of the lessee to compensate every harm to the leased asset caused by any misuse or negligence on his part is acknowledged and the leased asset to remains in the risk of the lessor throughout the lease period (d) and the final termination of the lease agreement may be noted.

As we the above discussions of Islamic jurists have indicated that, it is very important to stress in this connection on the fact that 'the separability of the services or usufruct and the thing itself is crucial necessary and condition for the rentability of a thing. What is for sale is the utility derived from the thing or the benefits associated with the property, but, according to established Shariah injunctions, it should never imply any part of the object itself. So,

¹³¹ Ibid. p. 29.

¹³² Ibid, p.28

anything that is not possible to use it without depletion, is not subject to leasing. Therefore, the rent is the price of the utility supplied by the thing not a price of the thing itself. So that the lease cannot be affected in respect of money and any perishable item which is consumable, i.e., fuel food etc. for their use is not possible unless they are consumed up. If any thing of this nature is leased out, it will be deemed as a loan contract and all the rules concerning the transaction of a loan will accordingly apply it. Any rent charged on this invalid lease will not be considered rent, but, it is an interest charged on a loan.¹³³ In this way Islamic Fiqh presents a very clear distinction between a loan and leasing, and consequently the rent of *Ijara* is totally different from the conventional term of interest rate. Moreover, as the corpus of the leased property remains in the ownership of the lessor all the liabilities emerging from the ownership will be borne by lessor but the liabilities referable to the use of the property will be born by the lessee.

3.4.2 Leasing as a Mode of Finance

In fact, in Fiqh studies the *Ijara* was not originally considered as a mode finance or it was not popular in profit-oriented business. It was simply a transaction meant to transfer the usufruct of a property from one person to another for an agreed consideration. However recently the financial institutions adopted leasing as a mode of finance used in place of interest. This kind of lease is generally known as the "Financial Lease as distinguished from the operating lease and many basic features of actual leasing transaction has been dispensed with." Since leasing is a lawful transaction according to Shariah, and it has a considerable market, it is felt that leasing to be appropriate in using as an interest free mode of finance. Therefore, leasing has been adopted by the Islamic financial institutions. Nevertheless, many of them paid attention to the fact that the "financial lease" has a number of characteristics more similar to interest than to the actual lease transaction. Suppose, the lease purchase ("*Ijara wa iktina*") on the other hand is more like financing leasing. The rentals during the term of the lease are sufficient to amortize the leasing companies investment and provide amount of profit. Lease and purchase technique is increasingly getting popular among Islamic modes of finance. IDB defines this concept as a medium term mode of financing which involves purchasing and subsequently transferring the right of use of equipment and machinery to the beneficiary for

¹³³ M. T. Usmani Ibid, p.28

a specific period of time, during which the bank retains the ownership of the asset. *Ijara wa Iktina* is a contract in which an Islamic bank purchases equipment building or an entire project and rents them to the client.

The client agrees to make payments into an Islamic investment account which will eventually lead to the clients purchase whole of the equipment or the project from the bank. The profits which accumulate in the investment account are paid to the client. The profit element in an *Ijara wa iktina* is permissible despite its similarity to interest charge¹³⁴.

Islamic leasing and lease purchase are now accepted as financing instruments ranging from valueless and building machinery to equipment and even aircraft. However, *Ijara* is considered suitable for small and medium scale business and at the same time it helps growth in investment and capital formation. Therefore it is not sufficient for this purpose to substitute the name of interest by the name of rent and replace a mortgage by leased asset. There must be a substantial difference between a leasing and interest-bearing loan. Perhaps, the problem arises from the implementation the lease rather than its nature. In most cases of the financial lease the lessor, i.e., the financial institution purchases the asset through the lessee himself. The lessee purchases the asset on behalf of the lessor who pays this price to the supplier in some lease agreements the lease commences on the same day on which the price is paid by the lessor regardless of whether the lessee has taken delivery of the asset or not. It means that the metering of the rent starts before the lessee takes the delivery of the asset. The Fiqh scholars have clearly the injustice that this practice involves and its contrary to Shariah principles. Taqi Osmani has expressed its un acceptance in Shariah, because it amounts to charging rent on the money given to the customer which is nothing but interest pure and simple¹³⁵. According to Shariah the rent is charged after the lessee has taken delivery of the asset and not from the day the price has been paid. If the supplier has delayed the delivery after receiving the full price, the lessee will never be liable for the rent of the period of delay.

The leasing is not itself a mode of financing in its origin. However, the transaction may be used for financing subject to certain conditions. The basic differences between the contemporary financial leasing and the actual leasing allowed by the Shariah are indicated

¹³⁴ Anas Zarqa, *Al-Istijrar*, Islamic Economics studies.vol., 1997, p.

¹³⁵ Taqi Osmani, *Ibid*,

below. If the supplier has delayed the delivery of the asset, the lessee will never be liable for the rent of this period of delay¹³⁶. It should be kept in mind that when the lessee himself has been entrusted with the purchase of the asset intended to be leased. There are two separate relations between the institution and client which come into operation one after the other, as follows; in the first instance the client is an agent of the institution to purchase the asset on behalf of the institution. Up to now the relation between parties is nothing more than the relation of principal and his agent. The relation of lessor and lessee has not yet come into operation. The second instance begins from the date when the client takes delivery from the supplier. At this stage the relation of lessor and lessee comes to play its role. During the first stage the client cannot be held liable for the obligation of a lessee. In this period he is responsible for carrying out the functions of an agent only. But when the asset is delivered to him he is liable to discharge his obligations as a lessee. In leasing the asset remains in the risk and ownership of the lessor throughout the leasing period because the ownership has not been transferred. As the lessor is the owner of the asset, he is liable to pay all the expenses incurred in the process of its purchase and its importing to the country of the lessor. Moreover, he is responsible for the freight and the custom duty etc. He can include all these expenses in his cost and accordingly fix the rentals he is responsible for bearing all as a matter of principle being the owner of the asset as a basic principle of leasing the lessee is responsible for any loss caused to the asset by his misuse or negligence. He can also be made liable to the wear and tear which normally occurs during its use.

3.4.3 Renting and Time Value

Probably one of the most misunderstood points of this subject includes the relationship between time value and renting, that is, on the base of the existence of a fixed rate of rent per given period of time is perhaps the main source that makes it confusion with an interest rate. As a result of this and ambiguity surrounding in conventional theories of interest. as we have seen in the above discussions, a number of contemporary Muslim economists feel uneasy to accept the constant rate of rent on capital while rejecting the rate of interest. To clarify this point we may emphasize on the fact that may be deduced from the above *Fiqh* injunctions and the practical reality on the ground to assert that the only feasible standard unit of measurement

¹³⁶ Ibid p. 24.

for all services is the time, hence the utilization of the services provided by a given asset and the amount of advantages which are spreaded over period of time can be estimated only on the base of time length that it has taken place. The humanity has not yet, developed a universally accepted standard unit of measurement, other than duration, for this vast area of economic activities. This is so, the gross income of the owners throughout the period in case of lease contracts is caused by the nature of its output (usufruct) not time value, and it can be measured only by units of assets per unit of time. According to Kahf (1994) this fact does not mean that there is a time value of money involved in rent if it exceeds the assets depreciation. To illustrate this point, Kahf presented as an example, a transportation whose output is measured by passenger per mile, in this case we cannot derive a distance value of money simply because the output of transportation industry occurs only through distance and when transportation fare exceeds its cost and depreciation, as any business industry, it tends to gain more than its lay out, otherwise there is no reason for conducting any enterprise, if there is no profit or surplus outcome¹³⁷. Therefore, as Kahf has concluded there is no time value of money in the lease business even if the rent exceeds a fixed assets depreciation rate. Because the increment obtained is a profit of the lease enterprise as the rent in leasing being a price is subject to the same factors that determine any other market price. The time element involved in the lease business is part of the nature of the product of this business itself. Time here serves as the unit of measurement where the supply of the services or usufruct takes place smoothly over time and similarly the users of these services and utilities derive them from the suppliers over period of time which necessitates that the service activity is to be measured in per unit time, in order its price per unit of time to be determined, i.e., hourly daily, monthly, or yearly. The operation mechanically similar to renting of transport and fixing its price per unit of distance, i.e., miles, Kilometers, meters, etc. for both of them stand for selling benefits continuously.

3.5 CONCLUSION

As we have mentioned above there is an extreme misconception about the basic terms of economics profit, rent and interest. It is hardly possible, in conventional literature, one to identify any difference between interest and profit or profit and rent concepts on one side or even the rent and interest on another. In this jungle of ambiguities and interchangeable usage

¹³⁷ M. Kahf, Time Value of Money and Discounting in Islamic Perspective, Re-visited, Review of Islamic Economics vol.3, No.2, 1994.

of basic terms, it is very difficult to express confidently that the prohibited *riba* in Islam is absolutely equivalent to the conventional term of interest. Unless and until specific and exclusive definitions are carefully coined for each of these terms, a simple equation of *riba* to interest leads only into unending controversies and the situation is more complicated than this shallow equation. Even if we are familiar with the economic terms of price, profit and rent in Islam, we have this fictitious strange element of interest that is assumed to hold mysterious power of embodying itself in the form of profit, rent or price. With this prevailing reality, the favorite approach of seeking the solution from equating *riba* to a conventional term of interest, in order, to figure out the desired element of profit is founded on an untenable postulation. Western economists admit the underlying complexity and vagueness of the term interest, but there are few Muslim economists who acknowledge this puzzle. After lengthy elaboration of its implications Uzair has accepted the challenge "there can be an endless controversy on the subject. The deeper we go the more involved does the concept of interest becomes. Ironically, people consider interest a 'neat' and 'simple' instrument, though theoretically and conceptually, it is too complex and inexplicable" For this reason we opted the Qur'anic method which addresses profit versus *riba*, instead of the debatable approach of profit versus interest. Hence, the main task of the subsequent parts of this research will focus on studying these two terms and exploring their essence, origin and legal conditions on the basis of economic rationale and Shariah perspectives. However, this task requires a rigorous effort of reinterpretation of the *riba* doctrine and reconsideration of profit theory. The next chapter is aiming at discovering a certain neglected aspect of the former and tries to provide it stronger theoretical justifications in logical and legal consistence. And the rest of this research work will focus on studying these two terms and exploring their essences.

PART TWO

**AN INTEGRATED THEORY OF EXCESS VALUE
AND EXCLUSIVE ENTITIES OF PROFIT AND RIBA**

CHAPTER 4

PRINCIPLES OF INTEGRATED THEORY OF RIBA IN ISLAMIC JURISPRUDENCE

Riba and *gharar* are two fundamental concepts for the Islamic financial system. Despite a lot of juristic work in sorting the distinctive features and the implications of these two concepts, in the light of the Qura'anic injunctions and *ahadith* of the Prophet (saw), the identification and elimination of these two terms are still hotly-debated issues in the modern age. The contemporary endless contentions on the matter indicate the existence of either some ambiguities or unresolved concerns and uncomfortable with the proposed theories of *riba* and *gharar*. Given these realities there is a growing need for reconsidering the text and basic message of Shariah injunctions. It is frequently recommended a rigorous reexamination of Prophet's (saw) teachings related to the subject and probing into the missing points or neglected aspects of the matter.

Thus, in response to this mounting demand for an investigation of legal wisdom and economic rationale of the prohibition of these concepts, this chapter is a serious attempt of recontracting a unified view of *riba* doctrine. The basic arguments of the subject may run as follows; Section.1.0, presents a brief outline of the jurists' treatment of the subject, some unresolved issues of conceptual predicaments. Section.2.0, examines the basic content and textual components of the related *ahadith*, that is to decompose the central message of the Prophet (saw) into certain manageable principles or axioms such as: quantitative, qualitative and ascertaining principles. In this context we elaborate that each principle addresses independently an important dimension of the problem. Section_3.0, elaborates on the nature of loan transaction and its contours, loanable goods, repayment conditions. Section_4.0 presents an integrated concept of *riba* with reference to common characteristics and essential features of sale and loan transactions, in the context of exchange in homogeneous things. Based on these postulations we conclude that the *illa* (effective reason) of *riba* is the homogeneity of the items or the similarity in kind of the exchange items. It also presents Islamic juristic definition of the similarity notion. Section 5.0. examines the role and economic implications of the ascertaining principle. In this connection we substantiate the central message of the *yadan bilyad* clause and we present its broad applications in business transactions as a precautionary measures of both *riba* and *gharar* elements.

4.1 TRADITIONAL CONCEPTUAL PROBLEMS

Although the linguistic usage of the word is very clear, there have been unresolved issues of finding the intended meaning and implications of the term *riba* in the Qur'an and in the context of the *ahadith* of the Prophet (*saw*). There is probably a missing linkage between the literal interpretations of the term and its economic comprehension. Following the methodology of jurists, such as, examining *riba al-fadl* in isolation from *riba nasia* is perhaps causing great conceptual difficulties about this very vital subject, someone may not reach any convincing answers for these crucial dimensions of the subject. In the coming paragraphs we outline the traditional thinking of the subject and basic problems that may act as the major hindrance in establishing a concrete model of theory of value in Islam. Starting from the problem of definition we will discuss the identification of *riba* and its scope, the problem of classification pinpointing certain conceptual inconsistencies of juristic interpretations. Then, we will investigate the rationale or effective reason of *riba* and the problem of justifying the essential attributes presented by the classical jurists in order to extend *riba* on the basis of analogy. Finally we outline the problem of assessment which may represent for one of the conceptual flaw of the given juristic interpretations in assessing the exchange items.

4.1.1 Definition Problem

Although *riba* literally means increase, growth, height or superiority, but, the juristic technical interpretations of the concept have taken different shapes in various *Fiqh* schools of thought. While *riba al-nasia* was well known in the *Jahili* era, the concept of *riba al-fadl* was considered a new thing which required a fresh interpretation introduced by Islam through the traditions of the Prophet (*saw*)¹ The incompatibility of the literal meaning of the term *riba* as it is used in the Qur'an and practiced it by the pre-Islamic Arabs with the teachings of the Prophet (*saw*) is noted even by the classical jurists. On the basis of this difficulty, number of *Fiqh* scholars held the view that term *riba* to be an inchoate or undeveloped word like Zakat and prayer, consequently some of the contemporary scholars abandoned the literal interpretation of the concept emphasizing only its practical fitness.² The technical definitions given by classical *Fiqh* jurists focused on *riba* in

¹ Omar Chapra *Just Monetary System*, 1983, Islamic Foundation, UK. p.46

² Sayed Tahir *Riba al fadl*, Hikmat-e Qur'an 1995, See also M. Akram Khan. 1996.

the context of sale transaction rather than *riba* in debts. So, they emphasized the essential features of the contract, i.e., quantitative equivalence of the exchange items, the essential conditions for exchange of *ribawi* items, i.e., physical presence or reciprocal delivery of both considerations in the same session and the condition of counter value. According to them "*riba* is a specific increase entitled to either party without counter value."³ Or "an excess which has no corresponding value in the exchange (bay')." "⁴, or "A contract of exchange of a thing for a specific thing with unknown equivalence ... or delaying both or one of the counter values."⁵ "*riba* to be disproportion of things delayed but of specified terms".⁶ However, the contemporary interpretations reduced the term squarely in the domain of credit transaction and hence, equated with the conventional term of interest or usury with complete silence about *riba al-fadl*. The leading Contemporary Muslim scholars like Sayyid Qutob, Maulana Maududi stressed on the contractual nature of *riba* charged on loans "*riba* to be a contractual increment received by the lender from the borrower over and above the original principal capital".⁷ So, the loan given for specified period on condition that with the expiry of the period the borrower should repay it with some excess. This is considered as the *riba* or *al jahiliya*, or *riba* prohibited in Qur'an, while, *riba al fadl* is considered as a secondary to the prohibition which may be permitted in the case of need".⁸ These two views have perhaps roots with the interpretations of the teachings of the Prophet (*saw*) Although the *ahadith* reported by Ubadah bin Samit is providing the complete and most comprehensive message of the matter.

4.1.2 Classification Problem

There is a general agreement among *Fiqh* scholars on that *riba* exists in sale and loan". The latter has also two forms; (i) *riba al Jahiliya* agreed on its prohibition and (ii) '*Tha' wa ta'jjal*' (reduce and claim immediately) which is subject to different opinions. But, *Fiqh* scholars also agreed upon

³ *Al-Nihaya fi Sharhi Hidayah*, vol.2, p.524

⁴ Al Sarakhsi, *Al-Mabsut* vol.12, p.109

⁵ Al-Sabaki, *Takmilat al-Najmi*, vol.10, p.22, or *Al-Mughni Muhtaj*, vol.2, p.21.

⁶ Ibn Qudama, *Al-Mughni*, vol.4, p.221

⁷ Maulana Abu Ala' Maududi, *The Sood- Interest*, 1950, See also, *Principles of Islamic Finance*, IRTI. IDB, 1994. p.21

⁸ Sh. Mohammad Abu Zahra, *Khatun Al Nabyyin*.

⁹ Ibn Rushdi, *Bidayat al-Mujtahid*, vol.2, p.128

that *riba* in sale consist of two forms: *riba al-fadl* and *riba nasia'*.¹⁰ The Shafi'i jurists added third form of *riba* and called it *riba al-yad*.¹¹ According to the *Fiqh* interpretations, *riba al-fadl* exists if either of the following situations exists ¹² (i) if there is an excess in the transaction of two goods of the same kind (species), (ii) if there is a delay in delivering of either object during the contract in exchange of *ribawi* items of the same genre or items sharing the same criteria. In other words the exchange constitutes *riba nasiah* if either consideration was not delivered at the same session. Al-Mitawali, a Shafi'i Scholar has also added another kind of *riba*, that is an advantage which is stipulated in loan. Further more the debt *riba* or *riba duyun* on the other hand arises from a loan as well as credit sale. It is an increase of the debt/loan on account of the extension of its maturity. Ibn Qayyim also in one of his treatise divided the whole concept of *riba* on the basis of its clarity and significance into two kinds namely concealed or hidden *riba* and manifested *riba* where the former is *riba* by way of deferment and the latter by way of increase. According to him hidden *riba* is not forbidden in itself, but only it is a way to abstain from manifested *riba*. In other words it is banned to block the road leading to overt *riba* which is forbidden by itself.

Examining these juristic classifications of the subject we find *riba* on one hand is a physical increase of the exchange objects provided they are similar in kind i.e. salt for salt or barely for barely. While, on the other hand, a mere absence of mutual delivery of items or delay on the part of either party constitutes to *riba nasia*, in case of loan transaction this has been completely omitted. However, the most significant kind of *riba nasia* known in *Fiqh* literature is the one which associates with loan transactions. Putting these two notions together, one may face conceptually conflicting situations. Where the former has only conceptual existence in terms of time discrepancy between the contract and the delivery of objects while, the problem is not the time difference in case of the later but the physical excess over the principal amount. The first case reveals prohibited pure time value and the same thing is ignored in the second one. This may seem to someone a paradoxical situation of allowing and rejecting the same thing. However, if the physical discrepancy is the subject matter for the existence of *riba* in the case of a loan contract irrespective of the time element that it may involve, then it seems to be a part of *riba al-fadl*. Thus, except their contractual difference the subject matter of prohibition is the same in both cases. Moreover, considering *riba nasia'* as part of *riba al-fadl* may cause another kind of

¹⁰ Ibn Qudama, *Al Mughni*, vol.4, p.123.

¹¹ Khadab, *Almughni al Muhtaj*, vol.2, p.21

¹² Sami H. Hamoud, *Islamic Banking*, 1985.

conceptual problem. While the majority of *Fiqh* scholars consider these kinds as a part of *riba al-fadl* the Shafi'i jurists introduced this new division of *riba al-fadl* called *riba "al-yad"* as a third category of *riba al-fadl* according to them "It is an exchange with deferment of either article." They argued that it is different from *riba al-nasia*, for *al-nasia* is a conditional delay stipulated in the contract even for a short while and *riba al-yad* is merely a delay conditioned in the contract or absence of either article at the time of the contract without preplanned arrangement. Being strict to the literal meaning of the condition 'hand to hand' or "*yadan bilyad*" If by any case the traders get apart before physical transference of both considerations where as from one to another would not take place, this transaction contains *riba* and according to Shafi'is the contract is null and void or invalid¹³. The majority of *Fiqh* scholars, consider this *riba al-yad* as an integral part of *riba nasiah* and to them both are the same. The rationale of equating the legal state of physical excess (*riba al-fadl*) and mere time difference in the delivery of items is hardly conceivable to the modern readers of the subject. *Fiqh* scholars conceptualized the later as an estimated or assumed value arises from the time difference. If simply the absence of mutual reciprocity amounts to *riba nasiah*' then the established view of rejecting time value of financial assets seems to lose its essential *raison d'etre*. In an attempt to reconcile this conceptual clash some of learned scholars came up with a compound form of *riba* associates with loan transactions which consist of *riba al-fadl* and *riba nasiah*.¹⁴ Hence, the classifications of *riba* under the above definitions create another dimension of the problem.

4.1.3 The Rationale and Analogy Problem

Although the authenticity of *ahadith* on *riba al-fadl* did not call at any stage for a question, the rationale and the economic justification of their basic message have been subject to a logical test. Contemporary studies raised certain crucial questions related to the specifications of the six commodities, reciprocal requirement of the exchange goods inquired the underlying effective reasons (*illat*) of *riba*¹⁵ It seems that the intended meaning was not very clear even to many of the classical jurists. For this reason, some opined that the prohibition of *riba* particularly in what came in *riba al-fadl* is to be obeyed and followed as in the case of faith and worship and that its intended purpose is not comprehensible, so it is not subject to logical exercise. This confusion has

¹³ *Al Mughni Muhtaj*.

¹⁴ Imran. K. Nyazee, *Concept of Riba and Islamic Banking*, p.23

¹⁵ Sayyid Tahir *Riba al Fadl* Hikmat-e-Qur'an P.4.

remained and sustained over time with more practical complications due to a general paucity of literature about understanding the rationale of prohibition (wisdom) since the classical jurist. For instance, Imam Al Razi has clearly shown his view of this issue and expressed that:

"The prohibition of *riba* is proved by a text (of the Qur'an). It is not necessary for humanity to know the rationale of duties. Therefore, the prohibition of *riba* must be regarded as definitely known even though we do not know the rationale of its prohibition."¹⁶

Al-Imam Razi emphasized that searching for the prohibition wisdom is not important and humanity has to abide by it. But, as there is no general agreement on the nature and sources of what touches the heart of commercial transactions and so sinful an act as its practice implies a war against Allah(swt) and his Prophet (*saw*), it seems very difficult for the common sense to accept this attitude towards the rationale of the prohibition *riba*. Thus, it is of the utmost importance to refer to the rationale in order to arrive at a practical and justified view of what exactly the term *riba* may stand for. That is why the classical Fiqh scholars undertook a lot of pain in probing its hidden facets and underlying *hikmah* of its prohibition. Except Tahiris the *Fiqh* scholars are in a consensus on the extension of the prohibition of *riba*. They arrived at different reasons on the basis of the general features and attributes of these six commodities. However, even if all proposed reasons are considered their practical significance fall short. In case of gold and silver they came up with the view that *illat* is their currency nature or being monetary items, except Hanafi school which see the similarity in specie and the unit of estimation, such as: weigh and volume to be the considered *illat*. But in case of other four items *Fiqh* scholars presented different reasons ranging from storability and nourishment (Maliki), foodstuffs measurable in weight and volume (Hanbali) being merely foodstuffs (Shafi'i) to the similarity of any thing measurable in weight and volume/capacity (Hanafi). However Ibn Seren came up with the view that the similarity in kind is the basic *illat* of the prohibition Besides, Zahiri school who does not accept analogy as a principle of Islamic jurisprudence, there are number of prominent of classical *Fiqh* scholars such as, Tawus and Osman Al-Batta of Hanafi school and Ibn Aqil of Hanbali who are unsatisfied with the reasons presented by the majority of the classical *Fiqh* scholars and they expressed that 'the *illats*- reasons considered by some of the prominent *Fiqh* scholars are not

¹⁶ Imam Razi *Tafsir Al-Kabir*, vol.2, verses of *Riba*

appropriate ones'. Abdulaziz Al-Mutrik commenting on these diverse views produced the impression made by San'ani while discussing matter in *Subul Salam* stating that 'for they could not find an authentically approved *illat* in Shariah, they differed (on this subject) largely on the issue which would make the knowledgeable observer to support the view of Zahiri school'.¹⁷

4.1.4 Evaluation and Assessment Problem

Tas far as the assessment of the matter of *riba* is concerned the Islamic *Fiqh* scholars have constantly focused on one particular consideration of equality, they generally emphasized only the quantitative difference of the objects, on the basis of weight or volume irrespective of their quality standard. This traditional dichotomy of evaluating the exchange of homogenous goods by the *Fiqh* scholars as well as the contemporary Islamic economic writers is probably one of the most serious flaws in the subject. They almost expressed in similar statements that "*riba* arises from quantitative discrepancy in either consideration of identical species even if they are different in quality aspects." Hamoud (1983). These kinds of interpretations are very common even in the contemporary economic literature, but with more explicit terms, for instance, Rafiq Al-Misri (1987) clearly asserted that if the two dates are different in quality even then, they must be equal in quantity on the basis of a standard unit of estimation. In this way, the owner of the superior one would be "Muhsin" generous to the owner of the inferior date."¹⁸ Other wise they should interchange through third good. Sh. Faisal Moulawi (1990) stated that if the Muslim wants to sell his goods of these four items mentioned by the Prophet (*saw*) for items of the same species. He must not give any consideration to the quality difference of the two items, i.e., if he wants to sell 100 kg of dates for dates of another quality, he must receive only 100 kg of dates, irrespective of the difference in superiority or inferiority of the dates¹⁹. Consequently the predominant view of Islamic scholars maintained in the loan context that the lender must ignore the qualitative difference between the thing given and that taken back and treat the two same, in terms of the relevant units of exchange, rupees in the case of rupee-dominated loans, tons (bushels) for wheat lent by tons (bushels) and so on.¹⁰

¹⁷ San'ani, *Subula Salam*, vol.3, p.8.

¹⁸ Rafiq Younis Al-Misri, *Riba al Qurud wa Adillatu Tahrimihi*, 1987, p.8

¹⁹ Sh. Faisal Moulavi, *Al Riba wal Fawaid wal Masarif*, 1990, p. 30.

The argument is squarely built on the literal apprehension of certain *ahadith* of the Prophet(*saw*).²⁰ For instance, the *hadith* reported by Bilal(ra) of selling superior dates for the double of the inferior is taken as an essential requirement for equality condition. In our subsequent discussion we reconsider and critically examine these apprehensions. Studying these issues rigorously, we may realize that the basic message of these *ahadith* is clearly in favor of the consideration of the quality difference rather than neglecting it. This is very clear from the text, as reported by Abi Said al-Khudriyi "Bilal (ra) came one day to the Prophet (*saw*) with *sa'a* of dates of superior quality, the Prophet (*saw*) asked/inquired, from where did you bring this? Bilal said, we had dates of inferior quality so I have given two *sa'a* of those dates against one *sa'a* of dates of superior quality: Hearing his explanation, the Prophet (*saw*) responded to him stating "this is clear *riba*! Do not do it again, if you wish to acquire dates of superior quality, first sell the dates of inferior quality and then with the sales' proceedings, purchase the superior dates you want"²¹ (Bukhari & Muslim). In another place with the same authenticity Abi Said reported that the Prophet (*saw*) employed a man in Khayber, who brought superior quality dates, the Prophet (*saw*) asked him "are all dates of Khyber like this? The man said no "O! messenger of Allah" we used to exchange *sa'a* of this for two *sa'as* or two *sa'as* for three, then the Prophet (*saw*) said. Don't do that sell the sum for dirhams and purchase the dirhams for superior dates." In another version recorded by both Muslim and Bukhari is reported that Abi Said has said: we were provided a collective sum (of dates) which were mixed amount of dates (superior & inferior ones) and we used to sell two *sa'as* for one *sa'a*. The Prophet (*saw*) said: "no two *sa'as* for one *sa'a* and no two dirhams in exchange for one dirham".²²

The contemporary *Fiqh* scholars established from the typical interpretations of the above *ahadith* that the Prophet(*saw*) has rendered a cancel and considered useless the qualitative difference of exchange items of similar kinds, i.e., dates, dirhams, etc.²³ The *hadith* reported by Ubadah in this connection is considered as the most complete and comprehensive *hadith* in the

²⁰ M. Taqi Osmani, *Buhuth fi Qaddaya Fiqhiyya al-Mu'asara*, Maktaba tul Ulum, Karachi, H.1415. p.191-92. The seminar on indexation held in Jiddah in 1987 also declared that the purpose of *ahadith* of *riba* and loan transactions essentially demand for similarity in kind and quantity in legal terms that is weigh volume, and counting not value/quality. What the Sunnah of Prophet(*saw*) showed is to cancel and completely ignore the quality consideration in trading items or *ribawi* goods. A similar view is expressed also in the report of IIC of Pakistan.

²¹ This is the only feasible way of guaranteeing that both articles are fairly valued by measuring with market price.

²² Mohammad Fuad, *Al-tu'lu' wal Marjan Bima Itafaqa Alayhi Shekhan*, vol. 2, 1994 p. 458-9.

²³ See Rafiq.Y Al Misri, *Ibid.*, p.8. See also Sami H. Hamoud , *Islamic Banking and Faisal Maulawi. Ibid.*

subject of *riba al-fadl*. Imam Shafi'i made this *hadith* as the foundation and the principal *hadith* in the topic of *riba al-fadl*. It is usually mentioned in this connection the six items: gold, silver, wheat, barley, date and salt which are known in *Fiqh* literature as *ribawi* goods. According to them the Prophet(*saw*) recommended their quantitative equivalence, volume, weigh, or counting must be strictly observed, irrespective of their relative superiority or inferiority to each other.²⁴ But, seriously examining and critically probing into the central message of these *ahadith* we find that the central message of Prophet's teachings is not endorsing this perception of disregarding the quality dimension of items for sale. There is no any indication of Prophets'(*saw*) words about ignoring the quality difference. As we will elaborate later on, the Prophet (*saw*) recommends the way of knowing their actual values rather than observing their crude quantitative equality. That is through market price and in reference to its exchange values.

Thus, in search of a consistent view of the subject and demonstrating its simple and pragmatic ruling principles, it is pertinent to study the *ahadith* of the Prophet (*saw*), that is to conduct rigorous textual analysis of the Prophet's directives in consistent with the teachings of Qur'an. The central idea of the revealed message would be decomposed into several workable principles or axioms. Believing that the identification of these principles and their operational scope is the crux of the problem, we try to substantiate them in the subsequent discussions.

4.2 TEXTUAL ANALYSIS OF INTEGRATING PRINCIPLES

Incorporating with all these dimensions of the problem, we try to build a consistent picture and coherent view of the *riba* doctrine in Islam. This objective essentially requires a serious analysis and critical study of the textual elements of the principal *ahadith* on the subject and to discuss the meanings of the fundamental axioms mentioned in the *ahadith* referring to their literal and linguistic usage without losing the sight of its intended Shari'a objectives. Basically there are three important axioms which are explicitly mentioned in the most comprehensive *ahadith* of the Prophet (*saw*) particularly its complete version that reported by Ubadah bin Samit. In the modern terminology they may be presented as follows:-

²⁴ M. Taqi Osmani, *Ibid.*, p.175.

- i. *Sawa'an bisawa'a* - Principle of Quantitative Equivalence.
- ii. *Mithlam bil Mithl* - Principle of Qualitative Equivalence.
- iii. *Yadan bil-yad* - Principle of Equivalence Ascertainment

Before we go further into the details of the above axioms, one thing must be kept in mind that is, the first and second above mentioned principles are restricted to the exchange of identically homogeneous goods or the same genus such as gold for gold silver for silver, wheat for wheat, date for date, barley for barley and salt for salt or any other two items of similar kind used for sale transaction, while the third principles is applied to both similar as well as different items. These qualitative and quantitative conditions are not applicable to the transactions of different goods. However, the confusion may arise from the terms used in the various versions of the *hadith*. Most of the well known versions of the *ahadith* use the terms *mithlan bi mithlin* (like for like) *sawa'an bi sawa* in (equal to equal) or *aynan bi'aynin* (same for same), *yadan bi-yadin or haa' wa haa'* (hand to hand) or all of these aspects. Since, these axioms are built on the assumption of similarity in kind or genus or homogeneity of species the three axioms or principles recommended by the Prophet (saw) are strictly observed by the Muslim Ummah through out the history. However, for the similarity in kind/species is already cited therefore, these additional conditions must convey a more meaning and elaborations different from mere similarity in kind. In order to understand the true meaning and demonstrate the conceptual implications of these principles we examine, one by one, their logical sequences in reference to their linguistic interpretations on the light of objectives of relevant Shariah injunctions. And in the coming subsections we exclusively discuss the first two principles. While a brief outline of the basic concept suffices for the quantitative principle the situation is different in the case of qualitative aspects. With this reality we will concentrate on the second principle and try to demonstrate certain neglected facets of that principle.

4.2.1 Principle of Quantitative Equivalence

Any difference in quantity of the exchange items can be discovered by using a standard unit of measurement. The first axiom *sawa'a bisawa'a* (equal for equal) implies there must be equality in the exchange which necessitate that a standard unit of estimation to be used for both articles. Given that the concerned items are homogenous or similar in kind, there is a logical necessity that they should be used for the same scale of estimation i.e. measurement, counting, weighing,

volume, if they are physical goods. Or per unit of time, if they are services, rent, etc. So whatever the unit of measurement might be according to the physical nature of the two articles the quantitative equality must essentially be observed such as 2 kg of wheat for 2 kg of wheat, one meter of cloth for one meter of cloth, three sheep for three sheep, 100 kw for 100 kw of energy, 6 hrs of work for 6 hrs of the same work or 3 minutes of phone call for the same duration of telephone call. All these must be the same in quantitative terms and as far as this axiom is concerned it is sufficient if arithmetic equality of the two items are observed for any quantitative discrepancy of either consideration constitutes *riba*. According to the *ahadith* of the Prophet (saw) as Abu Said al-Khudri reported that the Prophet (saw) has said " date for date ...barley for barley ... hand to hand like for like, and there should not be excess or decrease, whoever increases or decreases has verily committed *riba* (this applies to) every thing weighable or measurable"²⁵. Thus, the general axiom of *riba* may be derived from this quantitative context could state that;

1. *Any quantitative discrepancy which might arise from a direct exchange of homogeneous articles measured by a common standard unit of estimation amounts to riba.*

But, obviously this condition alone is not sufficient to determine a complete equivalence of the two concerned goods. As this condition fulfills only the physical aspect or magnitude of the items, it is clearly inadequate to compare the qualitative aspects of things. Therefore, as we will see in short, the other two conditions are also extremely important and indispensable for understanding the essence of *riba*.

4.2.2 Principle of Qualitative Equivalence

The *Fiqh* literature does not give this principle a separate explanation than that of the quantitative equality. Although the Prophet(saw) have separately emphasized these two principles, large misinterpretations and unnecessary mixing among the usage of the terms of genus/kind (*jinsi*), similitude (*mithli*) and equality (*musawat*) have been maintained in the *Fiqh* discussions. Most of the Islamic juristic literature presents the equation of these notions. Accordingly every commodity

²⁵ Al- Baihaqi, *al-Sunan al-Kubra*, vol.5, p.282. see also, *al-Mustadrak*, vol.3, p.42.



of a homogeneous kind or genus is regarded as a *mithli* with respect to the other commodities. Thus, if the seller is to sell a specific amount from a class of goods, he must receive an equal amount from the same class or its market value. This confusion arises from the general view of mixing *mithl* sometimes with *jins* where, species of items and their qualitative attributes have no separate considerations and sometimes with *musawat*, where the first two principles are considered to be the same. As a result of this interpretations, it is envisaged that all dates to have the same price or all wheat to have the same market value as they are one kind or a class. So that their quantitative equality must be observed. Justice Taqi Osmani also tried to elaborate the true meaning of the condition of *mithli* and asserted that the required *mithliya* in loan transactions is the equivalence in the numerical amount or quantity rather than its (intrinsic) value".²⁶ Sayyid Tahir has rightly observed that *mithlan bimitlin* comes in the *ahadith* texts after the clause of "gold for gold" which signifies that one is already talking in the framework of a like-for-like exchange.²⁷ Thus, as we have noted above *mithlan bi mithlin* should mean something more than like-for-like it cannot be translated in to similarity in kind. But, the question arises from here which its answer is extremely important for our investigation of the economic rationale of these axioms is, what message or more meaning conveys by the phrase "*mithlin bimitlin*" rather than traditional interpretation of same genus or species.

S. Tahir has noted down why it cannot be translated into the like for like, such as; gold for gold? If they are identical in every respect their spot trading would become meaningless. and the decree in the *ahadith* is redundant. For this last thing is not possible. S. Tahir explained this condition of *mithlan bi mithlin* in the context of the similarity of the unit of exchange, which is required to be one and the same for both buying and selling in like for like exchange. That is, it should not be the case that one sells, say wheat by some measure like *sa'a*, but, buys it by a weigh like kilograms. Moreover the chosen measure or weight must be the same for both buying and selling.²⁸ Emphasizing on this point S. Tahir's arguments are based on the lack of uniform standards for weights and measures in Arabia during the early Islamic days. The difference of *sa'a* of Madina and that of Makkah was the evidence, and according to him the relevance of *mithlan*

²⁶ Taqi Osmani, *Ibid.* p.174.

²⁷ Sayyid Tahir, *Riba al fadl*, Hikmat-e-Qur'an p.8

²⁸ *Ibid.*, p.9

bi mithlin condition/restriction even today is noted, for the existence of difference scales of measurements i.e. US Bushel and UK gallons.²⁹

However, with close scrutiny and examination of the above reasons and arguments on interpreting the phrase of *mithlan bi mithlin* to similarity in the unit of estimation or uniformity of standards of measurement may not solve the problem, according to this explanation the difference between the first axiom and the second one will disappear and *mithlan bimithlin* axiom would eventually indicate only equality in quantity which is not the case. For whatever the standard unit might be. The objective behind the selection of the unit of estimation is one, that is the two articles must be equal in absolute terms. So no matter whether you buy in measure *sa'a* and sell it in kg if they are equal when they are converted to each other. The majority of classical *Fiqh* scholars are on the view that estimating a countable or measurable thing in weigh or volume is permissible for the purpose is to know the exact amount of the exchange amounts without any dispute. So no matter if one purchases cloths in meters and sell it in yards or purchase milk in capacity\volume but the milk man tells in weigh (kgs) there is no *riba* if the equivalence of these units of estimation are observed with consideration of their standard conversion. There is no harm if certain amount of oil which is bought in gallons be sold in kgs as long as their standard conversions are taken in to account. For instance, there is no problem if weather forecaster tells the temperature level in centigrade, fahrenheit or in environment scales, they are various scales and numbers but indicate the same level of temperature. What is important is not the number or the scale as such but the subject matter which must be closely monitored is the real substance and the actual amount of exchange items which is to be reciprocally transferred must be perfectly equivalent in quantity.

4.2.3 Linguistic Reconsideration

In search for the actual meaning of this axiom let us refer to its literal comprehension according to the classical Arabic usage of the term *mithl*. The contemporary Arabic dictionaries presented almost similar explanations of the term covering its broad linguistic usage and its derivative connotations. However, in the connection of investigating the association of the literal meaning of the term *mithl* with quality concept, we find the matter is far stronger than could be expected.

²⁹ Ibid.

The consulted material reveals that term *mithl* primarily indicates the qualitative dimension of things. The author of *al-Muhidul Muhid*,³⁰ noted that the term *mithl* means "shabah" resemblance, or likeness, similarity and qualitative attributes of the thing. Similarly in *Alfara'id of Arabic dictionary* is noted *mithl* to mean; to liken another thing to, to copy it or match it. The author of *An Advanced Learners Arabic Dictionary* also confirmed that the linguistic interpretations of the term *al-mithl* to include: resemblance, likeness, similarity, correspondence or equivalence. The grammatical derivatives of the term i.e *al-mathal* also implies comparatively preferred qualitative attributes like; excellence, superiority, merit, more perfect, complete, eminent, and better or best.³¹ Comparing the lexicographical implications of the terms *al-mumathala* (similarity) and *al-musawat* (equivalence) the linguistic scholars clearly illustrated the literal difference of the two terms and they have come up with the conclusion that the term *mithl* exhibits the qualitative aspects of things, while the *tassawi* indicates the quantitative aspects. In *al-Mujma'* it is noted that *al-mumathala* does not apply except to identical things, but *al-mussawat* applies to both identical as well as different things in kind or genesis, for *tassawi* implies only quantitative equivalence neither less nor more.³² Ibn Mansur has also mentioned in *Lisan al Arab* a similar interpretations of the term *al-mithl* quoting Ibn Barri who expressed that "the difference between *al mumathala* and *al-musawat* is that *al-musawat* is used for both similar and dissimilar things because *al-tassawi* is equivalence in estimation or in (arithmetic) numbers which means that they are equal to each other no more no less. But "*mumathala*" is not used except for similar (alike things) i.e. similarities in colour, taste, knowledge and so on.³³ If someone says "one is absolutely like the other". It means "he can do whatsoever other can, or covers whatever the other can. He can replace the other or absolutely be fitted for the place of the other. If it is said that he is like another in particular respect, it means he is similar and equivalent in that respect only. Ibn Barri also expressed that the term *mithl* indicates quality, such as a fitness, suitability and status or condition.³⁴ As Allah said about Himself: "There is nothing like Him and He is the All-Hearer the All-Seer" (42:11). Allah (saw) also said: "So if they believe in the like (similar) of that which you believe, then they are rightly guided but if they turn away then

³⁰ Btrus Bustani, *Al-Qamus al-Muhid*, vol.2, p.1938, see also *Al-Muhidul Muhid- Tarib al-Qamus al-Muhid*, Tahir A. Razi (ed.) Darul Fikri, n.d.

³¹ H. Anthony Salmone, *An Advanced learners Arabic Dictionary.*, Al-Biruni, Lahor, n.d.

³² *Al- Mujma' al-waseet*, Ibid.

³³ Ibn Manzur, *Lisanul Arab* Vol.12, P.342

³⁴ Ibn Manzur, Ibid.

they are only in opposition..." (2:137). To the people of wisdom two things are *mithliyat* if they are completely in conformity, sharing all their attributes and essence.³⁵

Thus, it is very obvious from even purely linguistic interpretation that the term *al-mithl* implies quality and no doubt how far the quality aspects are different from physical quantity, i.e. two things to be alike does not mean they are equal: So, similarity or *mithl* indicates features, resemblance and the common characteristics shared by the two things. That is why perhaps the Prophet (saw) did not stop mentioning the similarity in kind and equivalence in quantity which are not clearly sufficient for abstaining *riba* in this particular transaction. Since the objective of purchasing things are for their usefulness, or utility the higher the quality of a thing the more utility or benefits would be derived from it, hence, the more valuable that thing might be. Ibn Qayyim observed the reason of exchanging dirhams for dirham expressing that; "When they (Jahili Arabs) sell dirhams for two dirhams they do so for the differences in their kinds either in their qualities, in their minting characteristics, or in their weigh etc. Or they do so in preferring for immediate advantage in it to advantage in future and this is real *riba*".³⁶

Although the Islamic jurists have not incorporated with this principle in the analysis of *riba al-fadl*. however, they have not completely ignored the concept of quality. In general, their view of *mithl* consists of a thing whose parts are equal in price or equal in exchange value which implies that their qualities are same or very close to each other, or there may not exist any considerable quality difference. The *qimi* in contrast to the *mithl* consists of a thing which its parts fetches different market prices which means that each individual elements has different quality from the rest. According to the above definition of the term *mithl* which is "equality of the parts of a thing in price" it pertains that each part of a thing is equal in price to every other part of the same thing. In other words, when the price of the half of a commodity (e.g. 20 kg wheat) is equal to £ 10 the price of the other half also is £ 10. Or if ten kilos of date is equal to £ 2 under this *mithli* definition any other ten kilos of that date should be equal to £2. In our contemporary world and mass production, the concept of quality is extremely important and it is more highly appreciated than quantity than in the past. For, our close examination of the term *mithl* and the

³⁵ *Al-Mujma' al-waseet*, see the word *mithl*, *Majma' al-lughat al-arabiya*

³⁶ Ibn Qayyim, *I'lanul al Muwaqi'in an Rabbil alamin*, v.2, p.137

general observation of its usage in *Fiqh* literature, we see its linkage or relation to the quality dimension of goods to be obvious fact, appropriate and at the same time economically justifiable.

The above linguistic interpretation of the term *mithl* coincides with the dictionary definition of the term quality which implies fitness, merit and excellence or standard of something when it is compared to other things like. According to this common understanding of intrinsic excellence of things, and to the choice of people, high quality in itself is desirable. Thus, it is common sense that the quantitative and qualitative standard of the goods to be observed at the same degree. And that is perhaps, why the Prophet (saw) is repeatedly emphasizing that the exchange items if they are same in kind they must be *mithliyat* (similar in quality) otherwise, the exchange would be susceptible to *riba*. For quality difference means difference in value which if it is not properly considered and justly compensated may constitute some elements of *riba*. This confirms that the Prophet (saw) struck at the root of *riba* with the imposition of the *mithlan bi mithlin* restriction. However the underlying economic consideration of this condition has been either misplaced or completely ignored.

4.2.4 Economic Consideration

The forgoing discussions compel us to examine the intended meaning of the text of Prophet's recommendations given to Bilal (r) when he brought to him certain amount of good dates. Perhaps the crux of the problem lies with the interpretations made on the basic message of the Prophet (saw). It is clear that the basic purpose of the Prophet's (saw) message related to the consideration of the quality difference in the exchange of identical goods. This implies that the quality standard of the items must be taken in to account. The disproportion of their quality must be balanced with disproportion in their quantity. That is, the quality difference of the exchange items is corresponding to the difference of their quantity. If there is a deference in their quality there should be compensating deference in their quantity. There is no logic and the Prophet (saw) has not recommended any sort of equality for this kind of exchange, but all the sayings of the Prophet(saw) regarding this issue are emphasizing one important point that is the disproportion's of identical goods must be the true reflection of the degree of their quality difference.

For the qualitative difference of exchange items, can be measured only through knowing their accurate exchange values. Hence, the exchange values of the two items should be considered according to their market prices. This exchange to take place fairly, the trade must be either

through third item according to their relative price, that is, selling the concerned item for another, then purchasing the desired one. Or referring the two items to their exchange values prevailing in the market at the time of substituting each other. The natural forces of supply and demand determine the exchange value of each good. Thus, the normal operations of market price may indicate the qualitative difference of trade items. This view can be illustrated in the following hypothetical example. Suppose two individuals A and B each of them has certain amount of dates i.e. certain amounts of superior and inferior dates respectively. Where B wants to exchange certain amount of his inferior dates for some of A's superior dates. Of course each kind of the date is fetching a certain level of market value. Let the market values of inferior and superior dates be Rs.15/- and Rs.25/- per one kilogram respectively. Suppose that B wants to buy 3kg of superior dates from A. The, exchange may take place in one of the following three possibilities according to the mutual agreement of the two individuals:

- i. Assume that two parties agreed upon exchanging inferior per superior dates in equal quantity that is at $I/S = 3\text{kg}/3\text{kg} = 1$. That is to observe the standard requirement of one to one correspondence. In this case the quality difference of the dates is ignored.
- ii. Suppose the two individuals have settled their trade according to the ratio $I/S = 6\text{kg}/3\text{kg} = 2$. Where the owner of inferior dates should pay double of the superior in order to compensate the quality difference. But ignoring the market.
- iii. The trade may take place and the deal may be concluded at $I/S = 5\text{kg}/3\text{kg}$ in direct transaction but, with the consideration of the prevailing market prices.

In these three options we want to know which transaction is clearly bearing *riba* and which one we can say it is clean from it? And which transaction the Prophet (saw) rejected it for its involvement in *riba al fadl* and which one he recommended it as a fair and justified trade? What is the wisdom of prohibition of these mutual transactions? Did he prohibit any inequality of the exchange items if so why did he recommend the exchange to take place through the market price ratio which still might preserve the quantitative discrepancy?

We see that the dominant view of *Fiqh* scholars is in favor of the first one, that is observing one to one equality of the exchange items irrespective of their quality difference. So the first case we may call jurist required condition. Islamic jurists took this condition as a matter principle where quantitative equality should be observed. However, if this condition does not work practically the third option of selling the inferior dates in the market and purchasing with

its proceedings the superior one is recommended as an open option. The second situation shows the one that faced by Bilal (ra) by selling two units(saa') of good dates for one unit of bad dates and when he told to the Prophet(saw), the Prophet(saw) severely rejected it, pointing out that this kind of exchange had involved elements of true *riba*. So, this exchange is rejected by the Prophet (saw), we may call it the rejected case or the prohibited option for it involves *riba*. When the Prophet (saw) refused this case, he recommended another way of obtaining the desired good without any *riba*, saying that " But, if you wish to buy (the superior date) sell the inferior dates against something else and then buy the better dates with the price you receive" While, the second situation according to Prophet's (saw) constitute and definitely involves in the prohibited *riba*. The third situation is free from this element and it stands for a justified transaction. Nevertheless, we see that both situations show disproportions and quantitative inequality for definitely the market will not treat inferior and superior dates alike, according to the judgement of the common sense, we expect that their prices in the market must be different, for instance the above rates are prevailing. From here we can understand that the quantitative equality is not intended by itself for this may imply in most cases total disregard of quality aspect of exchange items. Thus, the purpose of the Prophet's(saw) message is to emphasize and fully take into consideration the quality aspect of the exchange items. The quality difference of the two items for exchange must be included in the exchange value. As we mentioned above the exact degree of their quality difference cannot be judged through observation of the two items but through their market prices. Therefore, in our hypothetical example, the third situation stands for the accurate exchange ratio of these two kinds of dates. i.e. $I/S = 5/3$, which stands for the only feasible way of avoiding *riba*. Further more, the transaction of dates through a third item is the permitted trade which may give rise to profit and not subject to *riba* at all. And in fact selling for another implies sell to the market price, in monetary or real terms, it is to observe their relative price. Therefore, the relative price or exchange ratio prevailing in the market is the standard measurement and reference point for the valuation of dates, in order to determine their relative prices. Accordingly, the uncompensated divergence from the exchange rate in this respect amounts to *riba*. Taking the market price ratio as the reference point we can depict the degree of divergence of each option from the market prices in the following table.

Table 4.1 Economic Considerations of three alternatives

Various Considerations	Ratio of exchange in real terms	Terms of exchange	Deviation from market price	Percent of the deviation
Rejected case by the Prophet (saw)	Inf.dates: Sup.dates 2 saa': 1saa'	2	1/3	33%
Proposed case in the <i>Fiqh</i> literature	Inf.dates: Sup.dates 2 saa': 2 saa'	1	2/3	66%
Recommended case by the Prophet (saw)	On the basis of the going market price	5/3	00	00

After this elaboration and conceptual clarification which we hope by the grace of Allah Almighty we have drawn on the light the most fundamental point of the confusion, some one may ask why do the *Fiqh* scholars prefer the first case to the third one? Keeping in mind the foregoing discussions and interpretations the problem arises from the misplacement of the concept of quality into the quantitative consideration and they treated them same. They perceived the quantity measurement of a good will take the care of its quality aspect. Although, majority of classical *Fiqh* scholars took into the account the price difference of the goods to differentiate their similarity in kind. However, this view has not been considered in their technical interpretations of the subject. Despite, the prevailing confusion in the *Fiqh* interpretations on this topic the message of the Prophet (saw) as we have elaborated is a very simple and addressing a clear economic fact. Moreover its objectives are rationally and economically self-evident in the context of market economy. For instance, in our contemporary world of mass production, we can realize that the concept of quality is extremely important and it is more highly appreciated than physical quantity. In industrial context quality is related to suitability and cost. (i) the technical consideration of suitability, that is how well the relevant material is appropriate to its use and fulfills the intended purpose and (ii) the economic consideration of price, as in general high quality involves high cost or the market value of superior quality goods in general expected to be relatively higher than the other things. The history tells us the various kinds of units of measurement for a single aspect of quantitative estimations, i.e. weight, measuring etc. However quality standardizing has been more difficult even in our modern time. Therefore, the difference in features, appearance, contents, and even durability which all constitute in the concept of quality standard was the existing reality and commonly noted in primitive societies or mostly any period before the industrial revolution.

However the transaction to take place through third item or according to the market rates does not necessarily imply that the purchaser should go to the market to sell his dates then with its proceedings purchase the kind of dates he wants. One may argue that what is intended is the human efforts and activity of going to and back from the market, or exchanging through third item, even though the two parties know perfectly the prevailing price of the items. In our opinion this kind of effort or work is not necessary by itself for the following reasons:

- i. Because, one of the main objectives of Shariah is that to relieve the existing burden and difficulties from the people not to increase it. This is very clear in many verses of the Qur'an and general Shariah principles that Islam makes things easier for the people.
- ii. In economic point of view, going and back to the market by the concerned parties seems to be unnecessary cost or activity if the price of items are fully known to the concerned parties.

Perhaps, this was the case of selling a camel for a number of camels by the Prophet (saw), that he referred the price of the sold camel to the market value and then accordingly purchased the number of camels which the Prophet (saw) wanted, provided the *hadith* is authentic. On the basis of this view we can conclude that the objectives of the Prophet's(saw) recommendations have an enormous and far reaching implications on the microeconomic theories of value on the light of exchange of goods and the role of market operations in Islam. It is hardly to find some one accepting inequality in quantity if the two items are the same in quality, but there is every possibility that an undue quantitative discrepancy may be acquired by either party through quality difference knowingly or unknowingly and with the satisfaction of the both parties. The case of Sayidina Bilal(r) is very clear example in this regard. Perhaps, this kind of *riba* that arises from quality difference of the concerned items is that called by Ibn Qayyim a concealed *riba*. On the other hand that discrepancy which arises from the quantitative difference of identical items is very clear which may be termed as an obvious *riba* or *riba jaliyya*. From these elaboration can be concluded the second axiom of *riba* which may state that;

2. *Any qualitative divergence of exchange items of the same species, which have not been compensated by the concerned party may constitute an element of riba.*

Now, if the quantitative equality is used for internationally accepted standard unit of estimations such as kg, meter, liter, minute etc. which can manifest easily a certain given magnitude of quantity depending on the nature of the good or service. The crucial question which remained sufficiently unanswered and which generally the contemporary Islamic scholars have neglected to address its importance may be; how can an ordinary person judge the equality in quality of two items of the same kind? the answer of this question in the light of the existing authentic Islamic guidelines and in line with our above discussions we elaborate it in section 4.5 of this chapter. As we have mentioned earlier although *Fiqh* scholars have ignored the concept of quality in sale transactions for fear of *riba*, they clearly incorporated both quantity and quality concepts in the context of loan. Perhaps, the negation of any excess in terms of value and quantity is more obvious in case of loan than sale transactions.

4.3 TEXTUAL STUDY OF LOAN TRANSACTION

Keeping in mind the above discussions related to the role of these two conditions in sale transactions, and having sorted out the above difficulties and misconceptions about the basic message of these fundamental principles, we may now able to illustrate analogously how these two principles are employed in the loan transaction. And it seems that this task is relatively easier exercise. To expose the significance of these principles in the loan context we examine the following points, nature and meaning of loan literally as well as in the context of technical juristic interpretations, the essential conditions of loan transaction and the prohibition of advantage that may be derived from loan contract by either party.

4.3.1 Nature and Meaning of Loan In Islam

The term *al-qard* literally is to cut off. *qaradahu* means he cut off for him a portion to be required or compensated for it.³⁷ It is what someone puts forward or gives to another, in order, to receive it back latter.³⁸ Technically, it is a thing that to be paid of which its similarity be received latter. It is a specified contract of giving payments of money to someone with the

³⁷ Adullah Alwi Haji Hassan, (1994) Sales and Contracts In early Islamic Law, Islamic Research Institute. HUI. p. 117.

³⁸ Omer bin Abdul Aziz' Mutrik, '*Al riba wal Mu'amat Al Masrafiyya*', Ist. ed. H.1414, p.33

intention of its repayment in similar.³⁹ Loan in legal context is defined as a contract whereby one of two parties transfers or passes the ownership of a definite amount of his property to the other party, so that the other party returns to the lender what is equivalent thereto in respect of quantity, kind and description.⁴⁰ If the return of the equivalence is impossible he (the borrower) gives the price (of the borrowed property) on the day of payment or contract according different opinions. In Islamic law, it is a contract by which the lender transfers something to the borrower in return for the latter's liability to give back the same thing, or its equivalence, or price/value in the market.⁴¹ It is also defined a contract by which the lender transfers the ownership of something in return for its real equivalent or consideration. Thus, loan transaction in Islam is not motivated by profit oriented drive. It is not investment by nature it is only as we have discussed in temporary inter-temporal exchange of economic means: goods and services. Loan is permissible in the Qur'an, Sunnah and the consensus of the Muslims. In the Holy Qur'an Allah (swt) says: "Who is he that will lend to Allah(swt) a goodly loan so that He may multiply it to him many times. And it is Allah (swt) that decreases or increases your (provision) and unto Him you shall return" (2.845). Ibn Mas'ud reported that the Prophet (saw) has said that: No Muslim provides a Muslim a loan for two times, if he does so, it is like charity of once". And the Muslims are in unanimous agreement on the permissibility of the loan.

4.3.2 Necessary Conditions for Loan Transaction

The dominant view in *Fiqh* literature shows that the loanable property should be one of *mithliyat* - those assets which have standard similarities. This condition implies that the object of loan should be an asset which its individuals have no difference in exchange value, such as currencies, industrial products which have standard measurement and absolutely identical things⁴². So, loan is not subject to things which have no similarity for their impossibility of knowing its like or its value in the market. Therefore, the permissibility of loan is confined for those things or properties which have *mithliyat* (equivalence) in qualitative respects. Hanafis asserted that lending is permissible only in liken things (*mithliyat*)⁴³. In this connection, exchangeable items which their

³⁹ E. W. Lane, Arabic English Lexicon. Vol. II, p. 2515

⁴⁰ Nabil Saleh, Ibid, p. 46

⁴¹ Nabil Saleh, Ibid.

⁴² *Al Mausu'at al fiqhiyah. Qard.* vol.33, p.119.

⁴³ Radhdhi Al Muhtar vo.3, p.173.

individuals have different prices such as, animals and properties/houses etc. are not permissible for lending. Al-Kassani of Hanafi jurist recommended that in lieu of avoiding any dispute in value, the payback of loans must be strictly similar or identical to the principal. And Ibn Abidin also said that, it is not permissible for loan in non alike things, similarly Ibn Qudama also expressed in al-Mughni that all those knowledgeable people are in consensus on that the loan is permissible only in those goods or things which have similarities (*mithliyat*) in equivalence and quantity with the same standard unit of estimation i.e. metering and weighing and there is an obligation of returning of the borrowed thing itself or its similarity⁴⁴. If it has no similarity, it should be paid its value, however in this case if the borrower returns itself the lender has no obligation to accept it because it was to return its value. This implies that if the borrower takes a loan of something which have similarities he should return a similar thing otherwise its value, where according to him the value of the day of contract should be considered.⁴⁵ According to the views of Islamic Jurists *qard* can be outlined as below: For Hanafis *qard* entails a guarantee that the like (*al mithl*) should be given back. Thus the subject matter of *qard* should have a like, with a same standard unit of estimation by measurement, weigh, or number. there are two conditions for this purpose;(i) an standard unit of estimation and (ii) an standard similarity of the two items.⁴⁶ As a result *qard* is not applicable to any commodity which has no like or similarity at the place of payment while Abu Hanifa is very strict to this condition even if payment of the like thing become difficult⁴⁷, Abu Yusuf is of the view that the value should be given back.⁴⁸ According to Hambalis when the borrowed article is a measurable or weighable properly, the like (*al-mithl*) should be paid back. If the like not being available the borrower is indebted to the extent of the value, irrespective of its fluctuations.⁴⁹

In the view of Malikis the borrower has two options either to give back the like (*al mithl*) of that which has borrowed or to give back the very property lent to the lender, provided it has kept its essential features. If this proviso is not fulfilled and the borrowed article undergoes

⁴⁴ Ibn Qudama, *al-Mughni*, vol.4, p.53

⁴⁵ Ibid.

⁴⁶ Al-Kasani, *Badai*, vol.7, p.395

⁴⁷ Al Kasani. Ibid. p.395

⁴⁸ Ibid.

⁴⁹ Ibn Qudama, Ibid., vol.4, p.360

transformation, then the borrower is under obligation to repay the like (*al mithl*).⁵⁰ However, according to Shafi'is, both fungible and non-fungible commodities, provided they are in circulation, may be the object of *qard*. In this case of fungible commodities the like (*al mithl*) should be given back whether currency or otherwise. There are two views on how to discharge the contract of loan. First it is acceptable to give back the value rather than the like.⁵¹ The second view suggests that the borrower should give back an article similar to the object of the *qard* in characteristics and appearance.⁵² But if the borrowed article being currency which becomes obsolete, he should return the value nearest to that obtaining at the time of claiming back the debt. According to Ja'faris view any property which could be determined either by description, measure or weigh is considered as an acceptable subject matter for *qard*.⁵³ For any fungible article the borrower is under obligation to return the like (*al-mithl*) of the borrowed article regardless of whether its value has increased or decreased.⁵⁴ But if the borrowed article is a *mal-mutaqawam* i.e. Jeweller, it is enough that its value be known at the time of the *qard*, and repayment would be based on the assessment of the value at the time of the *qard*⁵⁵ or at the time of returning the article whichever the two parties amicably agree on considering the difference in value in the two periods also. If the value of the subject matter for *qard* is unknown the *qard* is void for the impossibility of returning the like (*al-mithl*).⁵⁶ For Ibadis the rule is that the object of the *qard* should be well defined and ascertainable so that when the time comes to discharge the *qard* repayment shall represent exactly what was remitted to the borrower in the first instance with no uncertainty (*gharar*) or fear of *riba*.⁵⁷ In principle, the borrowed article in specie (*al-'ayn*) may be given back or the like (*al-mithl*) or the value in exchange (*al-iwad*)⁵⁸. From these lengthy discussions in the treatise of classical jurisprudence with respect to the conditions of loanable properties and exact obligation of borrower towards the creditor may be briefly summarized in the following lines.

⁵⁰ Ibn Juzy, *Qawanin*, p.316, Jaziri, *al Fiqh ala' almadahib*, vol. 7, p.343.

⁵¹ Jaziri, *Ibid* *Ibid.*, p.342.

⁵² al Shirazi, *al Muhadhdhab* vol.1, p.318

⁵³ Abu al-Qasim N. *Ja'far Ibn al Hassain al Ali, Sharai al Islam fi' masail al Halal wat Haram*, p.68

⁵⁴ Al Khumaini, *Tahrir* vol.1, p.655

⁵⁵ Al Bahrani, *al Hadaiq*, vol.20, p.136-39.

⁵⁶ Al Khumaini, *Ibid.*,

⁵⁷ Al-Salimi, *Jawhar al Nizam* p.385.

⁵⁸ *Ibid.*

The obligation of the borrower is to return to the lender the equivalent of the borrowed property or its price no more no less. For instance if the borrowed property is fungible (*mithli*) such as wheat, barley, gold and silver, the borrower must return the equivalent of the borrowed property which is similar to that in all qualities regardless of the increase or decrease of exchange value or market price in contrast to the time of borrowing. This is the case in all things of industrial products or made from factors under certain specified standards. Such as dishes, processed food items, electronics, etc. If the borrowed property is non-fungible (*qimi*) such as animals, due to lack of uniform standardization then its market price must be returned. This is the general view of classic jurists in all schools of thought..But whether the borrower must pay the price of the thing when it was borrowed or the price of the time when it is returned seems to be controversial. The discussion on this issue is based on time value which will be elaborated in chapter 6 of this research. The issue relates to the criterion for determining which commodity is fungible and which one is non-fungible, in other words, which commodities are considered as a *mithli* and which are classified to *qimi* goods may be important to be noted in this context. However, there is no evidence illustrated or shown in *Fiqh* literature to provide for the division of commodities into fungible and non fungible, this division is treated as it has no origin and root either in the Qur'an or the *ahadith* of the prophet(saw). It has been underlined by Islamic jurists in order to facilitate the discussion about the claim of the creditor.⁵⁹ The criterion of dividing goods into *mithli* and *qimi* seems to be dynamic changing overtime with the change of standardization of commodities. For example, clothes were *qimi* in earlier period but now the industrial revolution and computerized standards have brought that they are *mithli* because each category can be woven in similar standard in absolute likeness and identical to each other, so they are equal in price.

4.3.3 Prohibition of a Loan that Gives Rise to Benefits

The above discussions of *Fiqh* scholars on the necessity of the similarity between the principal lent and repayment is based on the Shariah principle of rejecting any advantage being stipulated on the loan contract. In Sunna we find the Prophet (saw) expressing that "Any loan that brings about utility is *riba*"⁶⁰ He also said "O' Every *riba* of *Jahiliyah* is abolished, for you, is your principal

⁵⁹ Nabil Saleh, *Ibid*.

⁶⁰ San'ani, *Subul al Salam* vol.3, p.53

of your assets, you will neither wrong nor you will be wronged"⁶¹. Ibn Taymiyah reported that the Prophet (saw) said "It is not lawful that a loan and sale or two condition to be in one sale contract and there is no profit if not guaranteed (capital) and one should not sell what is not in one's possession" Imam Ahmad. The *Fiqh* schools have common opinion on this matter which would be better to mention here in brief; For Hanafis a *qard* should not in principle is to provide the lender with any advantage stipulated in the lending contract for otherwise, it is deemed to be *riba*.⁶² Hanbalis asserts that *qard* is a charitable act and it should remain so, if an increase whether in quality or in the quantity is stipulated that would alter the objective of *qard*.⁶³ For adherents of Maliki school, it is unlawful that a *qard* agreement should stipulate conditions to the lenders advantage such as lending defected wheat with the proviso that a commodity of good quality shall be given back⁶⁴ or accepting a gift from the borrower in connection with the loan contract. According to Shafi'i school a *qard* which gives an advantage to the lender is unlawful such as giving back more in quantity or a better quality⁶⁵. in case of repaying less than the principal to the lender, some of Shafii scholars disallowed while others dissented on the ground that accepting less does not change the *qard*'s purpose, which is to assist the borrower.⁶⁶ If the borrower willingly and not as a pre-requisite of the *qard* or out of custom gives back more or better than he has borrowed or writes a bill of exchange (*Suftaja*) or sells his house to the lender that is allowed for the Prophet (saw) himself discharged a loan of an animal by giving back a better one.⁶⁷ Ibn Munzir writes that they (*Fiqh* scholars) agreed on that the loan once conditioned on that the borrower to increase or pay gift and accepted by the borrower, this increase or benefit which the lender is to receive is *riba*. Ibn Qudama, Ibn Hazm, and others also reported the same view. Mutrik (H.1414) has observed that there is a complete consensus of Muslim scholars on the prohibition of the loan on *riba* (increase or addition), without any contrary opinion throughout the Islamic history except negligible voices in post colonial era.⁶⁸

⁶¹ Sunan Abi Dawoud, vol.2, p.219

⁶² Al-Kasani, *Badai*, vol.7, p.395-6

⁶³ Ibn Qudamah, *al-Mughni*, vol.4, P.354-7

⁶⁴ Ibid.

⁶⁵ al-Shirazi, *al Muhadhdhab*, vol.1, p.306.

⁶⁶ Ibid.

⁶⁷ Ibid.

⁶⁸ Omer bin Abdul Aziz' Mutrik, 'Al *riba* wal Mu'amalat Al Masrafiyya', 1st, ed. H.1414, p.34

4.4 AN INTEGRATED CONCEPT OF RIBA

Having seen the textual analysis of the basic message of the Prophet's sayings related to the sale as well as loan transactions, it is very clearly observable, the significant relationship between these two transactions *ribawi* transactions. In abstaining *riba* element while conducting these particular transactions we see that similar rules are applicable to them. Therefore, the sale of identical goods and loan transaction constitute the basic sources of *riba*. And similar principles or same rationale is considered by Islamic injunctions in both transactions for the prohibition of *riba*. Departing from the traditional classifications of the subject into *riba al-fadl* and *riba nasi'a* This understanding gives us a general integrated view of the concept of *riba* by reducing it into a single entity or doctrine. To substantiate this generic comprehension we discuss the following points: The common features and principles applied to this particular kind of sale and loan transactions in exchange context. We briefly refer this view to the literal context of the subject, the efforts made by certain Muslim scholars in developing this similarity of the two transactions. Then, we reconsider the effective reasons and *illats* presented by *Fiqh* scholars in order to formulate from their views a consistent in legal point and rational in economic sense.

4.4.1 Common Features

Examining the above discussions we realize that these two transactions are actually the same in substance. Both of them constitute a special kind of exchange, which when it is to be conducted necessitates the transaction to take place in equal balance and absolute equivalence in terms of quality and quantity. In this respect the concept of exchange implies to both the exchange of different goods as well as to homogeneous ones. What is inherently characterized the nature of exchange is that two goods are given one for another and nothing more. Therefore, as for established linguistic usage of the term exchange conveys, the transaction in which the same kind of goods are given one for the other irrespective of time element in which they may involve is known as also exchange. This transference of the same good is considered as an exchange in its broad sense both in the common usage of the term or in jurists' technical interpretations. In this sense, the loan transaction represents a credit sale of this particular exchange, while the sale in identical goods may represent its spot form. From the forgoing discussions we may conclude certain common principles of loan and sale. In the context of exchange of identical goods, we see that both sale and loan transactions are subject to certain common conditions which must be

observed for abstaining *riba* element. These conditions in the context of this peculiar exchange contract establish the following fundamental common principles;

- a. Quantitative equivalence: both exchange items must be absolutely equal in magnitude, according to common standard unit of estimation.
- b. Qualitative equivalence: they must be *mithli* items which are completely identical to each other by having common standard similarities.
- c. If the above conditions are not fulfilled due to the existence of the difference in quality they must be evaluated through their market prices or exchange value and accordingly the items of the contract be settled with one another.

4.4.2 Consideration of Literal Evidence

This phenomenon of homogeneity in goods has a significant evidence in the *Fiqh* literature such as the literal meaning of the word *riba* shows growth of the same thing, analogous to that growth of the living things i.e. plants and animals. It implies an automatic physical expansion of the things or swelling and surrogate increase related to the value of an asset. The root of the term from which *riba* is derived is used in the Qur'an twenty times and the actual word *riba* is used eight times where the linguistic usage of the term as we have noted in chapter two, holds the following meanings; to grow (22:5), to increase (30:39), to swell (13:17), to be greater and bigger in power (16:19). All which appear to have one meaning in common: increase or excess in a qualitative and quantitative aspects, almost all Muslim scholars are in consensus that *riba* is excess which can be evaluated or observable to the concerned parties⁶⁹. The specific kind of increase intended by Shariah may be understood when the root of the term is referred to the context of charity, a numerous verses and *ahadith* of the Prophet have clearly demonstrated the literal meaning of the term *riba*. For instance ; The first verse of the Qur'an on *riba* uses this kind of meaning stating that; "That you give as a *riba* to get increase in people's wealth increase not with Allah" (30:39). "Allah deprives *riba* from all blessings and increases (*yurbi*) charity in manifold, He loves not ungrateful sinner" (2:276). Aisha (ra) reported that the Prophet (saw), said that "Verily Allah (swt) accepts charity only which is good and He makes it to grow (*tarbuwa*) for its owner as one of you grows his young horse or a seedling until a *luqmah* (mouth

⁶⁹ Abdallah Said, Interest and Banking, 1996 p. 40-48

fill) turns like the mountain of Uhud"⁷⁰. According to another source The Prophet(saw) said "It (charity) increases in the hand of Allah or arm of Allah (swt) until it becomes like *Uhud*, give charity". The growth in both charity and *riba* as we come to know that *Fiqh* scholars are in complete consensus on a single conceptual meaning that is growth out of the same good

4.4.3 Contemporary Attempts

The similarity of sale and loan in this respect is pointed out in the current literature, however, the implications of this fact has not been substantial demonstrated. It is noted in al-Muhalla that *riba* does not occur except in three cases; sale, loan and credit transactions (Salam, Mu'ajjal, etc) and there is no difference among scholars on this, because the Shariah injunctions did not bring except these. The author of this book further elaborated this point and mentioned that the difference between sale, Salam and loan is that the sale and Salam takes place in two different things or in a thing for its kind. But, the *qard* does not take place except in similar things".⁷¹ Nevertheless, the Islamic scholars have acknowledged that *riba al-fadl* signifies the excess charged in the exchange of sale of things of homogeneous nature or similar and the same species".⁷² According to Hamud (1985) as far as the reciprocal possession is concerned for avoidance of *riba* in selling of identical goods, except in Sarf case (gold for silver), the problem becomes simply nomenclature not more, that is the possibility of switching the operation from a sale to a loan so long as the discharge of the liability is equal to the principal sum. Where, if a seller tells to a purchaser: I have sold you one bushel of wheat for the same of which, you must return to me (seller) after certain period of time say a month, he would be actually saying to him, I have lent you one bushel of wheat, the similar of which you must return to me after one month. Shafi'i also considered this kind of transaction valid and it would constitute neither increase nor delayed payment *riba*. We examine the features of this similarity in terms of the ruling common principles, according to the literal meaning of the term *riba*, the current studies or contemporary work and on the light of the basic common effective cause of *riba*. Convergence of *qard ribawi* to *riba al-buyui* Rafiq al-Misri has extensively attempted to demonstrate the convergence of these two concepts of *riba* saying that: *riba qard* implies *qard ribawi* which means gold for gold, or wheat for wheat etc. With

⁷⁰ Agreed upon, also reported by Ahmad al-tarqhib wa al-tarhib, vol.2, p.19.

⁷¹ Ibn Hazm, *Al Muhalla*, vol.9, p.502-5

⁷² M. Muslihuddin, *Banking and Islamic Law*, Islamic Research Academy, Karachi, 1974, p.1 See also the writings of *riba al-fadl* of Sayyid Tahir, Ibid.

increase (in quantity or kind.) and deferment or delay, and this would fall under the meaning of the prohibition mentioned in the *hadith* of *riba al-buyu'* for the excess in quantity confronts with the condition of equal for equal" the increase in kind/quality confronts with the condition of "mithl for mithl" and deferment is contradicting with the condition of hand to hand. Because, the *riba* is not except trading of loans the traditions of the Prophet (saw) are sufficient by themselves alone for the prohibition of *riba* on loans⁷³. According to Al-Misri the *ahadiths* in the context, of *riba al-buyu'* do not cover loans without *riba'* for they conditioned hand to hand transaction and loan cannot be concluded in this spot transaction, for it necessitates a delay.⁷⁴

4.4.4 The Common Effective Cause

This apparent phenomena is considered as the common effective cause of *riba* in both cases of sale and loan transactions, that is the similarity in kind, the likeness or the exchange items being identical constitutes the central fundamental reason and *illat* for the existence or involvement of *riba* in the business transaction. This concept serves as the guide-post of differentiating between the most important basic economic elements of our concern i.e. profit and *riba*, hence the criteria of similarity and dissimilarity or homogeneity and heterogeneity has a very tremendous economic implications in whole business and financial activities. Other criteria mentioned by the classical *Fiqh* scholars have no separate significance or economic implications, but, they are the implications of this fact and mainly they reinforce this principal criterion or they are simply the common features of the six items considered under the investigation of this reason such as: being monetary, foodstuff, storable, needed for nourishment, or estimated with the same standard unit of measurement, i.e. volume, weighing and counting. There may not be economically significant peculiarity in the considered reasons, for *riba* being part of devouring a property of people in vanity i.e theft or robbery, it is not confined to food, particular commodities or monetary items. But, we find the general agreement among majority of *Fiqh* scholars that any valuable good that can be used for transaction is subject to *riba*. And all standard unit of quantitative methods of measurement merely serve as the indicators of *al-fadl*- excess rather than to be the underlying reason of the excess.⁷⁵ Moreover, we know that many things which were to be estimated in measuring or counting in the past are now estimated in weigh. Therefore, these criteria cannot be

⁷³ Rafiqi, al-Misri, 'al-Qurud wa adillatu Tahriimihi', 1987, p.5

⁷⁴ Rafiqi Ibid.,

⁷⁵ Sami Hamoud, Ibid

independently determined the nature of *riba*, but they may associate with the basic *illat* of the prohibition.

It is juristic prerequisite that the *illat* should be based on *hikmah* without which the extension of a rule through *illat* has no meaning. While the *hikmah* of the similarity\ homogeneity of exchange items is glaringly clear, the different kinds of *illat* arrived by the classical *Fiqh* scholars in the case of *riba al-fadl* may not serve the objectives and intended purposes of the rules of Shariah. The homogeneity criteria has important distinctive rationale to explain the wisdom of the prohibition of *riba* and permission of profit. From these discussions of classical jurists and in cooperation with the literal usage of the term *riba*, it may be very obvious that the common *illat* - an effective underlying cause of *riba* prohibition - to be the homogeneity of exchange items. The majority of *Fiqh* scholars are of the view that the principal underlying reason of the prohibition of *riba* is based on the similarity of the exchange goods. Ibn Qudama asserted that all knowledgeable people from whom we learned are in consensus on that *riba al fadl* does not applicable except to identical goods.⁷⁶ Therefore, the basic *illat* of *al-fadl* without which there is no *riba* associates with selling something for its same kind. According to Hamoud *al-mithliyya* and *al-maliyya* constitute the effective reason of *riba*. So any financial item which has similarity in kind, if it is sold for itself or its same kind with increase it would involve *riba*⁷⁷. Ibn Screen argued that 'the similarity of the specie is the cause' and all that is of the same kind is vulnerable to *riba*, this covers every fungible or non-fungible property or any good .i.e. cloth for two clothes, camel for two camels or egg for two eggs. This view is followed by Abibakar al-Awdhani of Shafi'i jurists. Said bin Jubair also opined nearly a similar view saying that "every goods which their benefits are closely related their direct exchange is not allowed", in other words ..."they must be equal in exchange"⁷⁸. But, Ibn Qudama rejected this view that it does not appropriate or applicable. The *Fiqh* scholars have recognized the generic and comprehensive nature of this view in the context of loan contracts Imam Malik noted in his *Mudawana* that "any thing you provide in fixed term and you were paid back itself with additional amount is *riba*".⁷⁹ Ibn Rushd also expressed that It is not lawful (exchanging) one thing for two of its same kind in

⁷⁶ Ibn Qudama, *Ibid.*, p.58

⁷⁷ Hamoud, *Ibid.*

⁷⁸ Ibn Qudama, *Ibid.* p.5

⁷⁹ Imam Malik, *Mudawana*, vol.4, p.25

all things".⁸⁰ According to Ibn Taymiya "It is the consensus of scholars that he (lender) has no right to stipulate excess (over principal) in all properties or assets".⁸¹

A significant question that may arise from the nature of this kind of transaction is that, What is the motive of conducting this kind of transaction that is devoid of any economic benefit to either party?. In fact the basic deriving force is to gain benefit or advantage but, on what ground? There are two feasible factors through which an extra advantage may be generated out of this transaction namely; (i) the qualitative differences of the exchange items, this is the case of trading directly the same kind of goods but with different qualities i.e good dates for bad dates (ii) Inter-temporal non-coincidence of means and needs, that is the lack of adjustment income and expenses. Ibn Qayyim observed that "the reason of exchanging dirhams for dirham as follows: When they (*Jahili, Arabs*) sell dirhams for two dirhams they do so for the differences in their kinds i.e in their qualities, minting characteristics or weigh etc. Or they do so in preferring for immediate advantage in it to advantage in future and this is real *riba*".⁸² Given these two natural situations there is human tendencies to make profit out of these discrepancies. And Islam is clearly teaching that the transaction in the same goods are not subject to generate profit and any additional value over and above the original amount acquired by either party through this process is considered to be *riba*. Therefore, with these findings from our enormous *Fiqh* heritage and abundant contributions of the great Islamic jurists, we come up with the conclusion that the similarity or homogeneity in identity of the exchange items is the effective cause of the prohibited *riba*.

4.4.5 The Meaning of Similarity

According to the general comprehension of *Fiqh* injunctions the notion of similarity necessitates two important aspects of the exchange things Firstly, homogeneity/identity in kind or genus, which implies the similarity of species, origin or purpose of their use. Secondly, equivalence in value, that is their market price should be absolutely equal. As far as the first condition is concerned, it is very clear from the examples given by the message of the Prophet (saw) gold for gold, silver for silver, wheat for wheat, etc. The *Fiqh* scholars also have extensively elaborated

⁸⁰ Ibn Rushd (grandfather), *Muqidimat*, p. 507

⁸¹ Ibn Taymiyya, *Majmu'al-Fatawa*, vol.29, p.535

⁸² Ibn Qayyim, *Ibid.*, vol. 2, p.137.

the subject and established a common understanding about the similarity. To summarize their interpretations might be useful in this point. According to the Hanafi school two species are deemed to be similar if they belong to one genus if they bear the same name, the same origin and have the same specific use i.e. meats of the same kind of animal; goat, lamb, or camels on the other hand all varieties of dates are considered one genus⁸³. For Shafiis the similarity in origin is essential in considering them same genus⁸⁴, therefore, two species although they bear the same name but, are of different origins they are considered as two genera i.e. Flours, from corn and wheat or vinegar from dates and grapes. The purpose of their use is also taken into consideration i.e. different parts of a given animal belong to different genera. (i.e. fat, meat etc) when they are needed for different purposes⁸⁵. The Malikis emphasize on the purpose even though the names of the origins of the species are different.

However, the second condition of similarity seems to be less familiar than the first one. We find that the consideration of price as a part of similarity is not sufficiently substantiated and clearly elaborated, perhaps due to the generally held quality apprehensions. Nevertheless, The concept of similarity in the context of price or exchange value exists in the *Fiqh* literature. And as we have seen in the earlier discussions of the definition of *mithl*, *Fiqh* scholars expressed that the term *mithl* implies "equality of the parts of a thing in price" it pertains that each part of a thing is equal in price to every other part of the same thing. Some of the great Islamic scholars like Ibn Taymiyah, Ibn Qayyim, Imam al-Ghazali, Abi Yusuf and others, studied the matter seriously and came up with profound conclusions that "The difference of prices prohibits the similarity". In other words where there is a price divergence there is no similarity. Ibn Taymiyya insisted on this rule in the context of money which depreciates in value arguing that the two valuable things can be alike only if their prices are equal, but with deference of their exchange values, there is no similarity".⁸⁶ Hence, Ali Khafif deducted from the classical juristic views of money and values that the absolute similarities or likeness of things necessitate (i) similarity in features (essential characteristics that determine its kind or genus) and (ii) similarity in monetary

⁸³ Al-Kasani, *Bada'i ul Sana'i Fi al-tarib al Sharai*, vol.5, p.188

⁸⁴ Al-Nawawi, *Minhaj al talibiin translated by E.c. Howard*, p.125

⁸⁵ Al-Hythami al footway al kubra Vol:2 P:239.

⁸⁶ Ibn Taymiyya, al-Majmu' al- fatawa, unspecified, see M. Tahir Khalifi, Ibid.

value or price⁸⁷. So, these two basic elements determine the alikeness of any two commodities or monetary units.

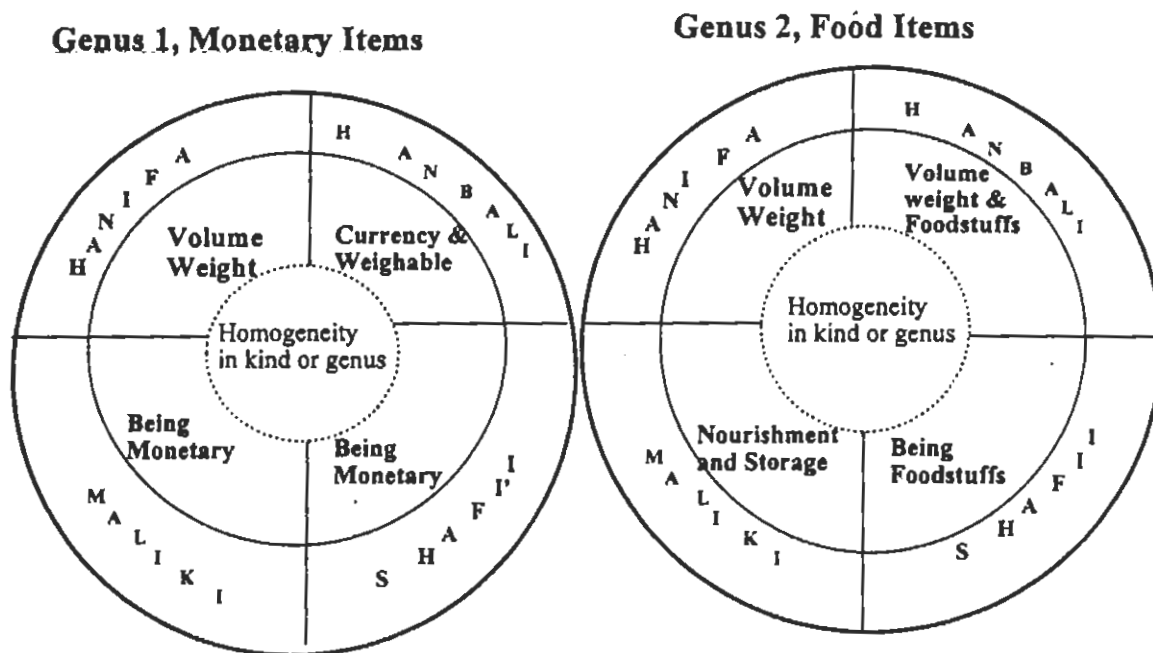


Figure 4.1 The Juristic Consensus of Effective Cause of the Prohibition of Riba

As the above diagram indicates Fiqh scholars seek the effective cause of the prohibition of riba in the context of two main genres based on the common features of the concerned items. However, they are in complete consensus that the fundamental illat in both cases is the similarity in kind or homogeneity in the specie of the concerned items. This stands for the nucleus and the subject matter of the rationale of riba.

⁸⁷ M. Tahir Khalifi, How the dollar became gold money with the rule by our fiqh scholars, *Iqtisada al Islami*, DIB. No.206, May, 1998, p.61-65.

4.5 PRINCIPLE OF EQUIVALENCE ASCERTAINMENT

In the previous textual analysis we have mentioned three principles that constitute the fundamental requirements for abstaining *riba al-fadl*, whereas we have thoroughly elaborated the first two of them such as the quantitative and qualitative principles of equivalence. However as we have briefly pointed out the fulfillment of these two principles necessitate ascertaining and assurance through standard unit of quantitative measurement and through inspection and standard specification of the qualitative aspects of objects. After, the reconstruction of the above integrated view of *riba* doctrine on realistic ground and conceivable effective reasons, it is appropriate to substantiate the role of this important principle of ascertaining. However, this is not easy task as it may seem in the beginning. For it is related to a delicate matter of highly complex concept. That is comprehending the rationale of the condition of "*yadan bil yad*" mentioned by the Prophet (saw) in various similar phrases has been one of the challenging issues of *Fiqh* literature throughout the Islamic history and as the blocking stone in the way of understanding the true nature of the concept of *riba* in its entirety. The misconception about this axiom puts a lot of difficulties in practical financial transactions. Most of the contemporary writers on this topic ask a typical question why any one would like to exchange equal quantity of the similar counterparts and on the spot too? Why exactly the same things and their immediate reciprocal payments are essentially required? Although these and similar questions and logical inquiries have been frequently expressed by the contemporary Muslim economists, unfortunately neither Shariah scholars have reconsidered them nor Muslim economists have come up with convincing proposition or practical solution. Sayyid Tahir in his scholarly work on *riba al-fadl* asserted that the said transaction would not involve any discrepancy in the give and take-back process of similar goods. The deferment of payment or delivery does not automatically amounts to *riba*, for this spot restriction is imposed by the Prophet (saw) also on the heterogeneous exchanges in all the six items as well, although he left the rates of exchange or trading ratios of these items to the discretion of the concerned parties⁸⁸. Then the question is what is the significance of this axiom of spot restriction? It is suggested that the original *ahkam* of Shariah related to this matter are not in a conditional form it is to close the doors on accidental landing into *riba* by requiring observation of this

⁸⁸ S. Tahir, Ibid p.13.

restriction. In fact this is not simply optional complementary condition, it is independent principle and practical way of avoiding committing *riba*.

The main purpose of this section is to address this conceptual problem and discuss the following dimensions of the subject; the role and significance the principle, on the basis of the kind of transaction we will elaborate our assertion that the principle to imply supervision and inspection, or identification and specification. Because the exchange according to the delivery of trading items may be two forms; spot exchange which is subject to inspection and supervision of both concerning parties and credit sale or selling a something absent at the time of the contract which subject to identification and specification. Lastly we tackle the most neglected dimension of the subject that is the economic relation of exchange items. In fact this point is extremely relevant to this discourse of identifying the nature and scope of single entity of *riba* doctrine. On the basis of this relation we divide the exchange items into homogeneous and heterogeneous ones. Then we summarize the significance of this principle by identifying the major problems that it may take care of.

4.5.1 As a Method of Inspection and Supervision

The importance of this principle can be hardly emphasized. Practically it bears comprehensive applications to all financial transactions. The role of inspection and specification which according to this interpretation stands in the context of traditions of the Prophet (saw) for the clause "hand to hand" or "give and take", is applicable to all business transaction. In general the meaning of hand to hand is conceived to imply that the transaction to take place on the spot and complete at the same session. The Prophet (saw) ordered the Sahaba to strictly observe this condition irrespective of whether it was, for example, gold for gold or silver for gold. As we have noted above classical *Fiqh* experts have taken an extreme position on this point, where some of them regarded it *riba "al-yad"* as a separate division of *riba*⁸⁹. According to them any time lag which may intervene before the delivery of either consideration contains *riba*. In other schools however, this condition is part of *riba nasia'* which arises from merely delay of either counter value irrespective of whether this delay is stipulated in the contract or not. Any how the rationale of this principle discloses a significant aspect of the subject. The central idea of this restriction is that

⁸⁹ Shafi'i School is on this view, see M. Mughni Al Muhtaj.

the objects for exchange must be thoroughly inspected and the process should take place under supervision of the purchasing party. But whether the inspection is to be carried out in *ex ante* or *ex post* is matter of concern what is essential is the equivalence of the object quantitatively and more importantly in quality according to the agreed standard. In this sense inspection is the standard way of assurance and ascertainment that the given object is exactly up to the requirement or not. With this understanding the significance of the principle is self explanatory, because the absence of this clause has a tremendous economic and legal consequences.

In any commercial transaction, it is an obligation that the seller to allow the buyer to inspect the goods prior to entering into an agreement in order to ensure that they are free from any unknown defect.⁹⁰ Such an obligation on the seller is known as in conventional law as a *Caveat Emptor*. It implies that the buyer after such an inspection or investigations of the fitness of such goods will shoulder the responsibility of any risk of that said sale and purchase agreement. The Islamic law gives such safeguard against any defected good. This is called in Islamic commercial terminology "*al-khiyar al-ayb*", under this law the seller is responsible to allow the buyer to inspect the fitness of the good and its conformity with the required standard not only before the agreement but even after its conclusion. While, the seller is allowed by the secular laws of commerce to keep silent about the commodity during the inspection, Shariah wants from the seller to disclose any hidden defect he knows about the concerned commodity to the buyer before the contract is concluded. If the buyer discovers any defect in the goods sold he has a right of option either to continue with the agreement or cancel it. Imam Nawawi defines *al-khiyar al-ayb* in the following words;

"A purchaser has a right of opinion on account of defects in the thing bought of which he become aware only after taking possession, but which existed previously"⁹¹

The product is regarded as a defective if it does not comply with the standard of reasonable safety that a person is entitled to expect it'⁹². In Islamic perspectives, the right of buyers' inspection is

⁹⁰ Mosley & Whitelys' Dictionary, 1993.

⁹¹ Al-Imam, Nawawi, *Al-Majmu'*, Ibid.

⁹² Haward Abbott, 'Product risk management', London, 1992, p.90f

considered in Islamic law as a part of general purpose of upholding justice in commercial transaction. The argument is based on the following tradition:

Uqba bin Amir said: "It is illegal for one to sell a thing if one (seller) knows that it has a defect unless one (seller) informs the buyer of that defect". Or in other version " The Prophet(saw) said A Muslim is the brother a Muslim it is not lawful for a Muslim to buy from his brother a good with defect unless he inform it" (Abi Majja, 2237).

In this way the Islamic doctrine of '*al-khiyar al-ayb*' allows the right of examination of the concerned goods (to ensure its quality etc.) and also the right of option if any hidden defect might arise after the conclusion of transaction contract. We have noted above the qualitative aspect of a thing is as equally significant as that of the quantitative aspect. From this discussions we observe that this principle is the standard measurement of the qualitative attributes for the exchange items. Thus, a complete examination and close inspection of the goods before the deal is concluded is an important way of avoiding any defected and purchase of unwanted goods. It is the most accurate way to control the quality of the things particularly when the exchange is related to two similar goods without quality standard. because as we have mentioned and we will again shortly notice that the only feasible way of checking qualitative similarity of objects is through inspection and supervision when both of them are delivered at the same session. If for instance, the buyer or consumer orders a specific quantity and quality of goods from a manufacturer the later is under obligation to prepare the goods exactly in accordance with the specifications of the order, for once the goods are delivered the consumer or buyer has a right to inspect the goods to ensure that they fulfill the required specifications, if they are not according to requested standard the consumer has a right to rescind the contract and claim any damages.

4.5.2 As a Method of Specification and Identification

While the spot sale where both things are presented at the same session of the contract is less debatable and mostly it has no harm, the sale of absent thing is subject to different opinions. The classical *Fiqh* scholars showed different opinions, some of them suggested that the sale of absent object is not allowed at all irrespective of its possibility of specification or not (Shafi'is') According to them the sale on the basis of identification is not allowed. But, Hanafi school showed in this respect a liberal view and more flexibility. Abu Hanifa endorsed its permissibility

even though it may not be subject to specification, but with inspecting option after delivery. The jurists of this school considered the option to examine the object and returning it, if it is not according to the desired standard as a legal condition. The buyer in their view always has the right to repudiate the sale once he is in a position to inspect the object of sale even if he is in a perfect conformity with the description which induced the purchaser to enter a sale contract. Although some of the Maliki jurists also agreed this sale even without the specification of the object but on optional clause⁹³, but, majority of Maliki jurists held a midpoint of these polar views. According to them the sale of absent goods is permissible if they are specified because the most of the people of Madina see that. Thus, this kind of sale is permissible subject to accurate description and specification and the goods must be reliable not subject to variation of their essential features in the mean time. Ibn Hazm also held the view of the permissibility on basis of specification. But what is non-familiar or unknown by identification is not allowed because it is subject to *gharar* which is *batil*.⁹⁴ A prior inspection is sufficient, provided that the object does not necessarily undergo a change after that inspection. Moreover, it is not necessary that the prospective purchaser sees all the subject matter, where seeing part of it, gives an indication of the remaining parts, provided that all parts of the object are alike. i.e. examining a sample of wheat by the prospective buyer he can validly buy the remaining wheat of the same quality. The pre knowledge and being acquainted with objects of exchange and its essential attributes is prerequisite for deferred transaction. And in this way the description of the exchange object would be perfect.

Hence, in the context of credit exchange the meaning of the condition of "hand to hand" does not seem to be confined to its literal context which means physical hand or necessitates the exchange to take place physically on the spot. There are many reasons to believe that the basic purpose and objective of the condition is the identification of the two trading items and assuring whether the exchange items are similar in quality or not. As we noted this axiom essentially implies to ascertainment which can take place either through inspection or specification. Although *Fiqh* experts have not explicitly elaborated this view some of them have mentioned in their deliberations. Hanafis explaining the 'hand to hand clause' asserted that what is intended is specification of the goods to be exchanged, for all commodities, unlike dirhams and dinars, can be specified⁹⁵. According to them the phrase "*yadan bil yad*" does not mean a condition for

⁹³ Ibn Rushd, Ibid p.156

⁹⁴ Muhalla, vol.9, p.277-282

⁹⁵ Al-Kasani, Ibid., vol.7, p. 319.

physically reciprocal exchange of hand to hand. The Prophet's (saw) saying "*yadan bil-yad*" as it can imply immediate and "spot reciprocal delivery" it can imply specification, for the hand is a tool/instrument of specification and possessing. They argued that the prohibited thing is the addition or excess in valuation which is known as *al-fadl* or in appointment of the right which is delayed and called *al-nasi'a*. So, spot (transaction) is not a condition as the values of spot and the specified things are the same, unlike deferment or exchange on credit for (in this case) possibly the price is less than that of the spot". Because, identifications of the two things and ability of substitution for one to another are sufficient for acquiring right on them. While in case of loan excess is created as a right of the lender or owner of the principal during the contract. There is no such an excess or right in the case of simply delaying either items⁹⁶. On the basis of these evidences there is no *riba* in exchange of specified articles. Similarly for the majority of *Fiqh* scholars the prohibited thing is a measured excess which is *al-fadl* or physical increment. They see that the Prophet's saying "*yadan bilyad*" as it can imply for immediate it can imply for specification The sold item on specified standard not conditioned on spot, if it is exchanged for its kind in deferment contrary to *sarf* is considered as a valid exchange⁹⁷. According to them this is on line with the clear *qiyas* injunction for the exchange in general is permissible, the cause of the problem is the existence of quantitative excess. Therefore, the principle of "hand to hand" does not necessarily imply that the exchange of the two items to take place immediately and on the same spot, otherwise it amounts to *riba*. for instance, the price is absent or the object.

4.5.3 The Scope and Implication of the Ascertainment

While the principles of quantitative and qualitative equivalence are strictly limited to transactions in homogeneous goods, this principle of ascertainment covers all kinds of commercial transactions, irrespective of whether concerned items are identical or different. This is very clearly stressed by the Prophet (saw) in his well known *hadith* reported by Ubada Ibn al-Samit that the messenger of Allah said "gold for gold, silver for silver, wheat for wheat barley for barley, dates for dates, salt for salt, like for like, in equal weights, hand to hand, if these species differ, then sell as you like, as long as it is hand to hand"⁹⁸. The Islamic jurists tries to find the reason

⁹⁶ A Kasani, Ibid.

⁹⁷ Omer Abdu -Aziz, Ibid.,

⁹⁸ It is reported by Muslim in (*Sarf*)

and the wisdom behind this condition in the context of the common features of six items mentioned in the text. However, the extension of the condition of hand to hand to the exchange of different goods has remained the challenging point of this crucial area. The principle of inspection and specification applied to two important cases firstly exchange in homogeneous items secondly exchange in heterogeneous ones. The meaning of these terms have been elaborated above in the context of similarity or *mithli* condition. Investigating the problem with further serious deliberations we examine it squarely in context of the economic relations of exchange goods and in this framework we divide transactions into (i) the exchange of similar or homogenous objects and (ii) and exchange of different or heterogeneous ones.

I. Exchange in homogeneous items

In case of exchange in identical goods, we have concluded in the forgoing discussions that the basic effective reason of *riba* in both *riba al-fadl* and *nasia'* is the similarity of goods. We have shown that the notion of similarity in kind represents the point of consensus among Islamic jurists on the reasons produced by the classical *Fiqh* scholars. On this ground we have made an assertion that an exchange of goods, financial assets or services for themselves is the nub and kernel of *riba*. If the exchange of similar articles is to take place, it must fulfill two fundamental conditions namely equivalence in quantity and equivalence in quality, otherwise, the transaction would not be free from *riba*. The importance of the principle of inspection and specification in this context would very clearly present itself. For it is taking care of ascertaining the qualitative equivalence of the exchange items through checking it on the spot or examining it at presence and through specification and accurate description of the deferred exchange items provided that there are standard products of similar goods. However, in case there is no standardization of products where the concerned articles are subject to quality difference i.e. *qimi* things or people have no confidence in the similarity of their quality states. There should not be direct exchange without referring them to their market prices and accordingly be exchanged. Therefore, we may conclude in these elaborations that in the context of identical goods, inspection which necessitates spot exchange is the only way of avoiding *riba* particularly if there is no standard uniform of the concerned items. That is perhaps why the Prophet (saw) stressed on this point in particular in the context of exchange of homogeneous goods expressing that as Said al Khudriyi . "Do not sell gold for gold except when it is like for like, and don't misappropriate one through the other... and do not sell things absent for those that are present". Agreed upon by both al-Bukhari and Muslim.

For this reason the Prophet (saw) emphasized that " gold for gold, silver for silver, wheat for wheat ...like for like, in equal weights, hand to hand...".

However if there is standardized goods i.e. industrial products such as; currency, or product of factory which have absolutely similar characteristics. The specification and accurate description of intended items can sufficiently serve the role of inspection and supervision. Thus, inspection or specification when it is related to transaction of homogeneous goods serves as a means of prevention against *riba*. And there may not be any *riba* involved through spot exchange or standard description. Perhaps the implications of the *hadith* of Usama and the view of Ibn Abbas indicate this meaning. "there is no *riba* in that which is delivered in hand to hand"⁹⁹. In another text the Prophet (saw) said; no problem what is in hand to hand , but what is in *nasia'* is *riba*"¹⁰⁰. These *ahadith* imply that the transaction contract in exchange of the same kind of things without ascertaining their similarity is mostly likely to involve *riba* particularly in the age of absence of standardized industrial products.

If the quality of the goods is not standard and perfectly similar to each other or certain variations is suspected the only feasible way of restraining *riba* may be through inspection and supervision which necessitate that the goods must be presented at the same session. It is almost certain as far as the exchange of identical goods is concerned that the element of *riba* would be surely avoided if the transaction takes place in reciprocal and under this strict conditions of supervising the quality and quantity equivalence principles. It follows that if after supervision and inspection one detects that the standard similarity condition is unsatisfactory the exchange value of the object would be considered through market price, because naturally objects express their exchange values not against themselves but against each other.

II. Exchange in heterogeneous items

Another very important role of this ascertainment principle as we have mentioned earlier is that it applies to exchange in heterogeneously different goods because of the *hadith* of the Prophet (saw) stated that "if these species differ, then sell as you like, as long as it is hand to hand"¹⁰¹.

⁹⁹ Muslim, vol.5, p.50

¹⁰⁰ Al-Bukhari, vol.5, p.59. see Muslim, vol.5,p. 45. see also al-Sunan al-Nisa'i, vol.7, p.180.

¹⁰¹ It is reported by Muslim in (*Sarf*)

While in this case the quantitative difference is not important but still the requirement ascertainment condition is highlighted in the context of trading dissimilar objects. In the traditional juristic treatment the meaning of this clause is taken for granted in its literal context. On the ground of this conception, the *Fiqh* scholars have extended the scope of *riba* broadly to number of normal trade transactions according to their various considerations. It is very important to note the fact that to require the presence of the subject matter and the payment of the price at the same session is undoubtedly the safest way of dispelling the perils of *riba* and *gharar* altogether. According to the deliberations of this chapter in case of the exchange in different goods, the role of ascertainment is not to take care of *riba*, for this kind of exchange is not subject to *riba*. But it is to exclude another undesired factor that is the element of *gharar*. The major factor after *riba*, that Islam has prohibited in the context of exchange or financial transactions is *gharar*. Like *riba* the safest way of averting from *gharar* would be to have the exchanged counter values in hand to hand in order to inspect them and decide whether or not to enter the proposed transaction. In this manner, *gharar* or *jahala* (uncertainty and ignorance) is surely avoided. Because, the actual presence of the subject matter and knowledge of the prices at the meeting of the contracting parties dispels all elements of uncertainty or speculation. What means that neither of the contracting parties is assuming on risk with respect to the identification of the subject matter or the price.

Some of the Islamic jurists persistently emphasized that the exchanged counter values in bilateral transaction should be present at the time of concluding transaction. Because, the contracting parties should be in a position to inspect and examine the objects in order to be acquainted with their characteristics and scrutinize whether they are exactly according to the requirements of the two parties. However, as the presence of both articles is often seen to be impracticable requirement, where sometimes either of the sale considerations may be available at the meeting of the contracting parties, but the other one is missing specification or identification is the only feasible alternative. In this case *gharar* can be dispelled by the determination of the price and accurate identification of the object during the meeting of the vendor and purchaser.¹⁰² *gharar* would disappear from the contract if the object for sale is certain in its existence, quality and quantity and it is possible for the seller to deliver in a fixed period of time. This is applicable to both object and the price. The *Fiqh* scholars pointed out the existence of the following points

¹⁰² Al-Salimi, *Ibid.*, p. 331

to indicate involvement of *gharar* (i) imperfect information regarding the existence of the exchanged counter-values and (ii) imperfect information regarding the characteristics of the exchanged counter values, or the identification of their species, quantities, or of the date of future performance if any. In this context almost all Islamic schools of law are in consensus that the period of repayment in a credit sale should be defined.¹⁰³ Leaving no room for uncertainty. When either of consideration is absent at the contract, it might come under the contract of bay' *ghaib* or sale of what is not visible at the meeting of the parties. Jurists' view ranges from prohibition of selling what has not been actually inspected or identified by the potential purchaser to its lawfulness by description of the subject matter. But, those who prohibited they did so in fear of the concerned transaction may associate with *gharar*. Shafi'is, according to their widely accepted view they regarded as an invalid the sale of what is invisible at the meeting of the contracting parties owing to the *gharar* it may involve.¹⁰⁴

A very close concept to the requirement of hand to hand is the concept of *qabd*. Similarly this concept of *qabd* is applied to the exchange of different goods for the prevention of *gharar*. There are several versions of Prophet' (saw) *hadith* which requires that the goods particularly foodstuffs should not be sold without actual possession of it. It has been noted that sales and purchases of commodities especially of foodstuffs must respectively be preceded by the actual possession of the goods. This requirement has received considerable attention in the scholastic works and writings of *Ulama* based on the hadith of the Prophet (saw) reported by Ibn Abbas ; "He who buys foodstuff should not sell it until he has taken possession of it". Ibn Abbas said "I think it applies to all other things as well"¹⁰⁵. If the goods are measurable, the seller should quantify them with standard unit of measurement i.e. weigh and volume. This view is based on the *hadith* of the Prophet (saw) as reported by Usman bin Affan " If you sell measure it and if you purchase take it with measurement"¹⁰⁶. There are diverse views of *Fiqh* scholars ranging from complete rejection to acceptance. But in any case the matter is judged from its stain with *gharar* rather than *riba*. That is why a large number of *Fiqh* scholars have maintained with great flexibility in this subject by opening it up to the influence of custom and social norms. Ibn Taymiyah is on the view that the precise meaning of *qabd* whether it is *habsi* (retention), or

¹⁰³ Ibn Rushd, *Bidaya al Mujtahid*, vol.2, p.172

¹⁰⁴ Al Nawawi, *al Majnu'* vol.9, p.301

¹⁰⁵ Sahih al-Bukhari, *Hadith # 1991*

¹⁰⁶ Al Bukhari, vol.3, p.593

takhliya (evacuation) that is the seller should make the property free from himself and make it possible for the purchaser to acquire it, but its implementation is mainly determined by its reference to the prevailing custom.¹⁰⁷ Ibn Qudama also stated that *qabd* in all things refers to an appropriate manner of taking possession. *Qabd* therefore, is required in all fungible (*mithli*) goods that are sold by weight, measurement, and counting. This is so because the responsibility for any defects, destruction or loss in such commodities would be transferred to the buyer only after *qabd*¹⁰⁸. The Malikis have confined *qabd* to food grains only. But it is the fact that the condition of *qabd* requirement is omitted altogether from at least two kinds of transactions namely; the forward sale Salam and manufacturing contracts *istisna*, and exemption here extends to all goods including food grains, on the ground of the people's need for these transactions and the utility they may derive from it or for their convenience. Kamali (1997) argued that if there is an area where the delivery is guaranteed in a way that precludes even the slightest *gharar* or uncertainty the requirement of *qabd* would not have the same meaning where its proper *illat* is no longer present.¹⁰⁹ Thus, on the basis of the above interpretations of *qabd* and the present vast advancement of communication technology and banking system. It is very reasonable to recognize the view that customary practice and prevailing business norms have an important role in determining the manner in which the legal requirement of delivery and *qabd* may be fulfilled. As long as, the basic rationale of *qabd* is satisfied which is to prevent any uncertainty and *gharar* concerning the seller's ability to deliver and the likelihood of giving rise to disputes. As this principle practically means inspection and specifications, it takes care of preventing both *gharar* and *riba* from financial transactions. Therefore, highlighting the natural difference between *riba* and *gharar* factors would be extremely important for our modern financial dealings.

4.5.4 Difference Between *Gharar* and *Riba*

From this above discussions, we conclude that there is a fundamental large difference between *gharar* and *riba* in several dimensions which may be briefly mentioned in below:

- (i) In terms of their sources; *riba* arises from the exchange of identical goods or services manifest as a discrepancy in terms of their quality and quantity or their values. While,

¹⁰⁷ Ibn Tymiyyah, *Majmu' Al fatawa'*, vol.10, p.375

¹⁰⁸ Ibn Qudama, *Ibid.*, p.124.

¹⁰⁹ M. Hashim Kamali, *Istihsan*, IRTI. IDB. 1997, p.95-101.

gharar stems from any uncertainty and risk that may associate with an exchange contract of two different goods or services in terms of the features of the contract or the characteristics of the exchange object.

- (ii) In terms of clarity and assessment; *riba* is very clear excess and known quantity or magnitude to both parties. While *gharar* is uncertain by nature and the magnitude of loss to either party is not surely known in ex ant, or its assessment may associate with significant cost.
- (iii) In terms of being the object matter of the contract; while in *riba* contract, the excess or the discrepancy that arises from this transaction is the object matter and the indigenous element of the contract, in case of *gharar* the subject matter of the contract is a permitted thing or benefit by Sharia, But, its association with undesirable elements of uncertainty and risk or *gharar* may change its legal state.
- (iv) In terms of permissibility and legal considerations. In *riba* case, Islam has strongly prohibited in absolute terms and severely condemned its practice to the extent that Allah (swt) has declared war against its users, but in the context of *gharar*, as we have seen above the situation is totally different, and Islam has shown a considerable tolerance and enormous flexibility in dealing with *gharar* element.

From this clear cut difference between *riba* and *gharar* we may discover another extremely important aspect of the subject, that is the natural distinction between *riba* and profit. We have come to the conclusion that the concept of *riba* according to this interpretation is limited to the discrepancy that may arise from the exchange in homogenous items, while the concept of profit entirely falls in the context of exchange in heterogeneous ones. Therefore, the concepts of profit and *riba* are exclusively different entities by nature. However, the first may be subject to uncertainty while the later is complete certain. And in this context we may assert that the transactions that generate profit may associate with *gharar* according to the terms of the transaction, feasibility of the profit and loss and its sharing ratios. Because, dividing the exchange transactions into these two ample categories on the basis of their economic relations we find it complies with the given fact presented by the revealed truth that "And Allah has permitted sale (profitable transaction) and prohibited *riba*"(2:276). Thus, profit and *riba* must be completely different factors of absolutely separate origins. While exchange of different goods is trade and hence it is to generate profit by nature, exchange in similar items motivated by either qualitative discrepancy of the things or by enter-temporal adjustments of ends and economic means is not

subject to profit. This is what perhaps, the Qur'anic verse of Suret Rūm has declared from the beginning and initial stage of its dealing with this matter that "That you give as a *riba* to get increase in people's wealth increases not with Allah" (30:39). As Georg Simmel has disclosed in his seminal book of *The Philosophy of Money* a rarely substantiated economic fact that "goods express their exchange values against each other".¹¹⁰ However, they are completely silent to indicate their market prices by themselves. On the light of this discussion, perhaps the most appropriate definition of *riba* could be stated as "*Riba* is a unilateral physical increase or excess in the context of an exchange in identically similar goods by the virtue of uncompensated quality and time discrepancy".

4.6 CONCLUSION

The above discussions proposes certain departure from the main dominant thinking in the contemporary studies of the subject of *riba* in which we are proposing the following points: Convergence of *riba* divisions into single comprehensive concept literally as well as in technical Interpretations of the *Fiqh* literature and establishing a unified doctrine of *riba*. *riba* is *fadl* (excess) which mainly generated through qualitative difference or time lag. There is no specific *ribawi* goods every kind of commodities are subject to *riba*. Explicit *riba* associates with quantity while implicit *riba* relates to the quality difference. The crux of the confusion about *riba* is based on the misconception in the principle of qualitative equivalence mixing it some times with specie/kind of the things and their physical sum in other times. Although this point in particular is emphasized all relevant injunctions, it seems that their central message have not been properly understood. There is no visible *riba* due to purely abstract time element, if there is no physical excess or quality discrepancy associated with it. The common effective cause of *riba* is the similarity of the goods rather than the Juristically envisaged general characteristics of the six items mentioned in Sunnah such as; being foodstuff, monetary, measurability, storability etc. As an implication of these arguments, we have asserted that there are lot of reasons to believe that exchange in heterogeneous goods irrespective of their reciprocal acquisition, whether the transaction takes place on spot or on credit, it is not subject to *riba* at all. Instead this transaction is subject to *gharar* (uncertainty and risk). Therefore, the condition of *yadan biyadin*- hand to hand is purely for ascertaining purpose. In the next chapters we will thoroughly elaborate the

¹¹⁰ Georg Simmel, *The Philosophy of Money*, 2nd ed., Routledge, 1990, p.82.

economic rationale of these findings in order to reconstruct microeconomic foundations of theories of profit and *riba* in the context of exchange economy, time value and risk element and uncertainty as well as in organizational perspectives.

CHAPTER 5

RIBA VS. PROFIT IN EXCHANGE CONTEXT

As we have seen in the earlier discussions, profit and *riba* possess common features in nomenclature, which may pose certain complexities on the face of drawing their economic distinctions. As far as the literal interpretations of both terms is concerned, we find closely related meanings; where there is a general comprehension in *Fiqh* and economic literature that both terms are treated as an increase, surplus or excess values. On one hand *riba* in Islamic terminology is increase or excess over principal or more *precisely*, it is called a stipulated surplus on a debt.² Under various justifications and rationale modern economic theory also considers profit a surplus or residual value over contractual payments or simply the difference between revenue and costs. Even in the domain of risk and uncertainty profit is considered as a surplus amount arises from the difference between actual and expected incomes. And in the context of their sources as we have noticed in the preceding chapter, there is a general agreement among *Fiqh* scholars that *riba* is based on exchange. Precisely, to classical juristic interpretations *riba* is an incremental magnitude or additional value over its original principal stipulated in bay',³ which implies that *riba* is exclusively based on exchange.⁴ Similarly, the available juristic teachings reduce profit to its literal context as a growth or increase to a thing by trading. In more technically profit is defined as the increase in the value of assets actually realized in exchange.⁵ Therefore, both *riba* and profit fall squarely in the context of exchange or sale and purchase. On the light of these evidences, it is very pertinent to carry out a rigorous work on this perplexing phenomenon inquiring for resolving certain fundamental questions, i.e., to what extent this similarity goes? What is the point of their divergence? What is the economic rationale of their distinctions? Because, despite these seemingly similar features we have a given fact presented by the revealed truth that "And Allah has permitted sale (profit) and prohibited *riba*"(2:276). Thus, profit and *riba* must be completely different

¹ Usama A. Uthman, Debt and Equity Contracts in the Theory of Social Economy. Review of Islamic economics Vol.3, No.1, (1994), p.1

² Kharofa, Ibid.

³ Al-Mabsut, Ibid.

⁴ Nabil Salih Unlawful Gain and Legitimate Profit, Ibid.

⁵ Amin, Ibid, 1985, P.15

elements and necessarily have exclusively original roots on the ground of this Qur'anic teachings. The question is what kind of excess each infers and what economic factors originate each of them?

And in this connection we try to formulate a solid microeconomic foundation for some logical separations of the concepts of *riba* and profits. In this work we propose certain departure from the main dominant view presented in the contemporary studies, which is in favor of concentrating *riba* interest relationship versus profit. In this study we directly focus on *riba* versus profit, by doing so, we illustrate the underpinning logical principles of the prohibition of *riba* and the permission of the profit in the context of exchange theory. Exploring this problem, it is necessary to freeze all other influencing factors for a while hence, we may take into consideration of the following assumptions, i.e., a competitive market, constancy of general price level, consumer rationality, perfect foresight, and no time value. Given this circumstance, we would like to examine the concept of incremental value exclusively in the context of exchange economy. The arguments in this chapter would run as follows; Section 5.1 will highlight the nature, scope and importance of the exchange economy. It explores the underpinning philosophical comprehension of the subject. Section 5.2 presents classifications of transactions, providing certain economic assessments on the incremental value and the concept of counter value in juristic as well as economic perspectives. Section 5.3 is a logical investigation of the economic rationale of *riba* and profit in consumer perspectives employing generally accepted microeconomic laws of utility theory. Section 5.4 will examine the problem from the perspective of trade theory and in this context argues that profit may be realized in the form of cost reduction in production activity and in terms of gain from trade. Section 5.5 outlines the nature profit seeking in the context of Islamic ethical principles which are governing the market operations.

5.1 THE NATURE AND IMPORTANCE OF EXCHANGE ECONOMY

Exchange is considered as the central problem of economics which coordinates and adjusts consumption and production. It is the core concept of the discipline of business activity and fundamental characteristics of market economy. In this modern world exchange is extremely important & indispensable to human existence for a simple fact that no one can produce all his

necessaries of life.⁶ Due to the specialization constraint each individual or group of individuals engages in one type of work or service and every one's needs depend upon the economic activities of the others. To elaborate the nature and role of exchange economy we will discuss the meaning and scope of the term exchange and the conceptual foundations of exchange economy in the next subsections.

5.1.1 The Meaning and Scope of Exchange

The term exchange in Islamic context is usually translated as a sale, however, it has a comprehensive meaning and broader applications than might be commonly thought. It covers any economic activity falls under the shade of *bay'*, trades, substitutes, preference or choice. In practical the act may take place in physical or even in moral sense. In the context of business activities any contract in which there is an exchange of two counter values is considered to be *bay'*. Exchanges of any two kinds of benefits are known as a trade in *Fiqh* context that is in the form of trading utilities, as this in its tangible form is the transfer of one commodity in return for another or one commodity in exchange for money. Furthermore, we find that in the Qur'an the terms of sale and *Tijara* are used interchangeably and in broad implications "these are they who have purchased error in exchange for guidance their *Tijara*(trade) has brought them no profit" (2:16). In this connection any reciprocate activity that involves transfer of one thing for another by mutual consent of the concerning parties is considered as a sale or exchange. This comprehensive scope of the notion of exchange is recognized as a part of human interactions rather than its traditional confinement to economic context as observed by Simmel "It should be recognized that most relationships between people can be interpreted as forms of exchange. Exchange is the purest and most developed kind of interaction, which shapes human life when it seeks to acquire substance and content."⁷ He equated exchange with interaction and accordingly argued that "every interaction has to be regarded as an exchange including, conversions, affections, games, or even glancing at another person. The difference that seems to exist, that in interaction a person offers what he does not possess whereas in exchange he offers what he possesses, cannot be substantiated.

⁶ W. S. Vicierey: *An Exchange of Questions Between Economic & Philosophy*. Economic Justice (1973) Ed. and S Phelps.

⁷ Georg Simmel, *The Philosophy of Money*, [English Translation, David Frisby (ed.),] 2nd ed., Routledge, 1990, p.82.

Nevertheless, it is true that interaction is more comprehensive concept than exchange; however, in human relationships the former appears predominantly in forms that may be interpreted as an exchange."⁸ In the constraint of that every individual is a specialist in a given field in order to satisfy his unlimited wants, exchange becomes the only feasible activity for anyone. In the modern age wants have increased to the extent that it is practically impossible for a man to produce all his necessities himself alone. Therefore, almost all our wants are satisfied through exchange. Islam places a great importance in exchange and encourages it, for exchange as we mentioned earlier generates income. And it is the major vehicle of increasing real income. Shariah wants people to be prosperous and to avail themselves of the bounties of Allah (swt).⁹ Moreover, Shariah considers the permissibility of this profit generating exchange or trade and the freedom to exchange as the fundamental rights of each individual's choice. It is the standard rule which should not be violated except for very clear and justifiable reasons. Shariah has laid down governing principles of exchange for two important purposes (i) for increasing the gains from exchange and (ii) for minimizing the costs and unnecessary difficulties that exchange may face¹⁰. In this context freedom of economic activities is the essence of market economy which enables the economic agents to advance their money in order to acquire more money. Advancing an object for receiving more of it, is generally the underlying driving force of commercial activities. They can be actually exchanged only when their respective owners freely choose to trade them and desire so, ruling out any external regulations.

5.1.2 Conceptual Foundations of Exchange Economy

Looking into the matter from purely objective and impersonal perspectives, provided that the exchange commodities are economic goods which have their own intrinsic values or utilities, being objects of different market needs, Simmel expressed that "the fact economic exchange, therefore, frees the objects from their bondage to the mere subjectivity of the subjects and allows them to determine themselves reciprocally, by investing economic function in them. The fact that the object has to be exchanged against another object illustrates that it is not only

⁸ Georg Simmel, Ibid, p.82.

⁹ M. A. Zarqa, Islamic Jurisprudence (*Fiqh*) and Economics of Exchange, Lectures on Islamic Economics, Ausaf Ahmad, et al (eds.) IRTI, IDB, 1992, p.93.

¹⁰ M. A. Zarqa, Ibid.

valuable for someone, but also valuable independently of him; that is to say for another person. The objects acquire its practical value not only by being in demand itself but through the demand for another object. Value is determined not by the relation to the demanding subject, but by the fact that this relation depends on the cost of a sacrifice which, for the other party, appears as a value to be enjoyed while the object itself appears as a sacrifice. Thus, objects balance each other and value appears in a very specific way as an objective, inherent quality. The equivalence of which we become aware, and in which we develop an interest through exchange imparts to value its specific objectivity."¹¹

However, examining the concept of exchange on subjective perspective, it is considered as a purely human activity directed by satisfying needs and wants through substitution processes. It is a natural and a part of human nature, one to long for and desire relatively more what he does not have compared with what he possesses. The consumer's desire for what they do not have and prefer those goods and products that offer the most satisfaction, according to its performance and particular attributes of the objects meeting their desires. The underlying basic philosophy behind the exchange is natural human need, which are beyond the control of individuals such as; unlimited and multidimensional wants, including physiological needs for food, clothing, warmth, safety etc. and social needs for belonging, influence, entertainment and affection, as well as the individuals' intellectual need for knowledge and self expression, which are the basic part of a human make up. When a need is not satisfied the person feels deprived and unhappy and strives for acquiring the desired object. It is observed that within coincidence of relative needs and the reciprocal relationship of exchange items the traded commodities acquire a further social quality consisting in the equivalence in exchangeability of one good for another as a realized value in their actual exchange. The great philosophers, i.e., Hegel, Simmel etc. also recognized that the commodity exchange is such that the exchangeability of goods ultimately rests on the complementary acts of will by which the commodity owners choose to trade what each other owns. Of course to be exchangeable the goods must have conventional qualities of being objects existing to satisfy specific market needs.¹² What then gives the traded commodities both the common quality of exchangeability in general and specific exchange values are

¹¹ Georg Simmel, *Ibid.*, p.83

¹² Richard D. Windfield, 'The Just Economy, Routledge, New York, 1988, p.109

nothing but the mutual acts by which their owners render them equivalently exchangeable. Therefore, exchange value is neither intrinsic to the natural qualities of the exchange goods nor rooted in psychological evaluation of them, nor determined by any thing preceding the freely entered exchange act setting them in their actual exchange relations of equivalence. "Neither the natural scarcity nor psychological attraction of the object necessarily mandates its exchange to take place. The socially specific wants of owners or their reciprocal desire or more precisely their relative demand each others' objects are considered as the main determinant factor of exchange."¹³ What makes the commodities exchangeable are the concurring decisions of their respective owners who are independent market agents, free to decide what they need and how they will dispose over their own commodities. Since, the mutual decisions of their owners determine the exchangeability of commodities, the origin of the exchange object has no effect on what exchange value it may bear. Its market exchange values remain the same, regardless of being it a gift of a nature or manufactured article as long as its owner offers it in trade and some other market agent agrees to give another commodity for it.¹⁴ In this connection the market forces of supply and demand happens to disregard the costs of the goods and services. Monetary value is simply the measuring rod of the exchange value that expresses the proportional relations of goods and services, but actual exchange is dictated by the human desire and free will of the buyers and sellers provided that they behave rationally. However, this seems to be an objective beyond the control of human capacity.

Economically progressed societies try to find or develop objects that will satisfy their needs, while, the poor people try to reduce and depress their needs to what is available. The need takes in the shape of human wants according to people's culture and individual peculiarities. Since people have almost unlimited wants but limited resources they will choose those goods which will give them the most satisfaction from the attainable resources through exchange. In general the individual who wants to acquire the products in the market has only the following options: - (i) he can produce by himself self production, (ii) through coercion or stealing it, (iii) through begging and get as a charity, or (iv) he can offer some resources such as money, another product(s) or service(s) for the desired good that is through exchange. In fact out of these four ways of satisfying needs, exchange has a great deal in its favor.

¹³ Richard D. Wndfield, Ibid.

¹⁴ Richard D. Wndfield, p.111

People do not have to prey on others or depend on alms from others nor do they produce every thing necessary, regardless of ability and skill. They can concentrate on producing things that they are efficient in their production and trade them for the required items produced by others. Through this, the society ends up producing a greater total number of products. When the human want is accompanied with ability to acquire the desired object in other words when wants can be transformed from mere wishes to practical implementations, it is known as demand.

Assuming the product or commodity is any thing that has usefulness and offered to a market for acquisition, use, or consumption that may satisfy a specific want or particular need, then exchange is the act of obtaining a desired object from someone by offering something valuable to the other in return. Hence, a voluntary exchange to take place five conditions must be satisfied namely (a) there are at least two parties (b) each party possesses something that may be of valuable and desired by the other party (c) each is capable of communication and delivery (d) each party is free to accept or reject the other party's offer (e) each party believes, it is appropriate or desirable to deal with the other party in trading. These conditions set up a potential for exchange whether exchange actually takes place or not depends upon the parties coming to an agreement. If they agree and conclude the deal according to this frame work, in general, the exchange leaves all of them better off (or at least not worse off in either party) because each one is rational free to accept or reject the offer.

In this context the relationship between Islamic *Fiqh* and economics of exchange theory goes to the heart of economic theory in Islam. It is this issue which is the very central point of the economic theory of markets and prices. The fundamental concept of earning additional income or incremental value in general is based on exchange. According to *Fiqh* scholars profit is a justified increase which is usually generated by exchange of two goods while, *riba* occurs either in a thing or a commodity to be returned with an increase; or in unjust \ inequitable exchange of one commodity against another with an increase in either consideration. Without repeating the discussions of jurists' interpretations which have been thoroughly reviewed and elaborated else where in chapters two and four it is important to note that the most precise understanding is presented by the great jurist, al-Imam Al-Sarakhsi in his book *Al-Mabsut*, which seems to be carefully devised and comprehensive one. From the above discussions of the subject we may derive certain important points which establish the

fundamental frame work of our investigations for the nature, origin and economic rationale of the concept of incremental value. Briefly summarizing the juristic studies of the subject of *riba* and profit the following three points are significantly relevant with our investigation of the theory of excess value: these (a) incremental value originates from sale or exchange this value is considered as an exchange phenomenon (b) it is a discrepancy of initial and final values of the same kind of a thing (c) the excess value (*riba*) has no counter value while profit naturally entails its equivalence.

5.2 EXCHANGE PATTERNS AND THE SOURCE OF EXCESS VALUE

Since profit is simply the difference between the revenue -the price of sold goods and its cost, it is an excess or surplus over the original principal, generally all Islamic scholars consider profit as the result of commercial activities or increase by trading as they defined it. Exchange is the transfer of one commodity in return for another. It may be exchange of one commodity for another commodity as barter system or one commodity in exchange for money or even money for money, i.e., *sarf* transaction. In this economy there may be various motives for exchange depending on the nature of the commodity, available contractual arrangements and perhaps the relative needs of concerned parties. The main driving motives of exchange may be, (1) exchange of one good for a particular one, (2) exchange of a commodity for money, (3) exchange of money for more money. In this section we outline several classifications of exchange and their operational scope, unlike the traditional divisions of listing all kinds of transactions we divide them in three ample categories on the basis of a time horizon, the nature of exchange objects and economic relations of exchange objects. On the light of economic relations of exchange we investigate how physical incremental value emerges out of their reciprocal transactions and in this connection we assess the economic realization of additional value/ income out of physical transformation of goods and services.

5.2.1 Patterns of Exchange Transactions

Exchange in its broad sense may be divided into three ample categories according to; (A) the time dimensions that it may involve in, i.e., spot and credit transactions (B) the nature of acquiring the things for exchange whether it is continuous or discrete form, i.e., sale of goods or sale of services and *Ijara* and (C) the relationship between the exchange items, i.e.,

identical or different. According to Ibn Arabi *Tijara* or trade involves exchange of commodities (including money) for commodities. The types of bay' vary according to the nature of wealth or commodities or in the sense of the usufruct to be derived from the exchange goods. In this context we may summarize each category and its subdivisions.

A. According to time perspective

On basis of the time dimension exchange is divided (i) spot transaction and (ii) credit transaction, regardless of the relations of the exchange items whether the two items are identical or different and irrespective of the nature of exchange objects goods or services

i. Spot transaction patterns

This category of exchange implies transaction of material substance for another. It is immediate exchange of give and take without any delay in either consideration. That is exchange of one commodity or money for another commodity or money at the same session, which is generally known as spot exchange or *Tijara hadira* in Qur'anic terminology regardless of being barter or monetary economy, i.e., goods for money or money for money which a pure monetary exchange (*sarf*). This kind of exchange does not involve time. Therefore, unlike credit contracts, spot transactions may not require for reducing them in written or keeping the record of its documentation. As it is clear in the following verse of the Qur'an "Disdain not to reduce to writing (your contract) for a future period, whether it is small or big: it is justice in the sight of God, more suitable as evidence, and more convenient to prevent doubts among yourselves but if it is a transaction which ye carry on the spot among yourselves, there is no blame if ye reduce it not to writing." (2:282) While any deferred transaction or exchange must be written down and documented with the presence of at least two mature witnesses for its involvement in future obligation, '*Tijarah hadira*' which is spot or cash transaction there is no obligation of writing down such contracts.

ii. A deferred transaction pattern.

Deferred or credit transaction is a sale involving delaying in delivery of either consideration.

The sale on deferment is based on immediate delivery of the commodity by the seller to the buyer on the condition or commonly understanding that the buyer will pay the agreed price at a certain future date. The deferred exchange as it falls under the term *al-bay'* it really mean deferment in the delivery of either consideration to a specified point in the future. Generally the credit sale activity covers both the exchange of one commodity for money or for another commodity, as well as the exchange of services. Deferred transaction, here it means any sale contract in which one of the trade items is absent or delayed its acquisition at the time of transaction but its payment is made obligatory on the concerning party. This category of exchange is usually applied to manufactured things or crops on the field, or credit transaction. During the pre-Islamic period the Arab where extensively practiced contracts of exchange in their daily commercial activities. There were many forms of deferred contracts of exchange practiced by the Arabs at the time of early history of Islam.

Credit sales include all transactions in which, utility of one consideration only is supplied in return for deferred counter value, such as: *al-bay' ul-mu'ajjal*, *al-Murabaha*, *Bai'al Salam*, *Bai'al-Istisna'* and so on¹⁵. According Arabic terminology the whole range of the exchange contract is encompassed within the generic term of *al-bay'* and *al-tijara* sometimes. Both of them are mentioned in the Qur'an and they stress on the reciprocity of the action, for the two contracting parties sell (exchange) with one another¹⁶. Thus, any future liability or claim which arises from the contract of exchange is usually known as *al-dayn* in both literary and Islamic juristic interpretations. This concept of *al-dayn* may cover also the deferred liability that arises from a loan which is usually referred to *qard* and that may arise from credit sale. As long as the sale of commodity or money for another commodity or money is concerned there is no large difference between *Salam* and deferred sale (*bay' al-Mu'ajjal*), for instance, the bartering with the delay in the delivery of either consideration or credit sale of a commodity for another implies both *Salam* and deferred sales, regardless of which party initiates the contract. Both of them are part of transactions involving future obligation. According to the Islamic jurists *Salam* is a sale of a commodity whose delivery will be in a future date for a price immediately delivered. This implies that it is a financial transaction in

¹⁵ Abdul Halim Ismail, *Ibid.*, p.290.

¹⁶ Abdul Halim Ismail, *The deferred contracts of exchange in al-Qur'an*, in *An Introduction to Islamic Finance*, Ghazali, et al (eds.), 1993 p.284.

which price is advanced in cash to the seller who is obliged to deliver the commodity in specified state on a definite due date. In this case the deferred thing is the commodity sold with identified description and the immediate payment is the price the opposite is the case of deferred sale (*bay al-Mu'ajjal*) where the commodity is delivered on the spot and its price is to be paid in latter. Deferred transaction is inseparable part of an exchange contract which Shariah has permitted in its general frame work. Ibn Abbas said "I witness that the sale by advance which is guaranteed to a certain period was permitted by Allah (swt) in His Book and allowed it.¹⁷ And he recited the verse." Allah (swt) has revealed the longest verse in Qur'an which lays down the basic principles and rules governing financial transaction involving future obligations. " O you who believe when you deal with each other in transactions involving future obligations in a fixed period of time reduce them to writing. Let a scribe write down faithfully as between the parties . . . If you are on a journey, and cannot find a scribe, a pledge possession may serve the purpose" (2:282). In *Madinah* the Prophet (saw) found that the people had been practicing forward sales (Salam Sales) in fruits for one or two and three years and he said anyone who wishes to make forward sale he should do so in a specified measure and a specified weight and for a specified period." It is reported from Aisha (*ra*), that she said " the Prophet(saw), bought some foodstuff on credit from a Jewish trader and mortgaged his armor to him" The consensus of MuslimUmma show its permissibility provided that the due date is known. Some Islamic scholars are on the view that the practice of deferred transaction is legalized as an exceptional case and in defiance of analogy which in fact implies that this legality cannot be made a precedent for further analogy, this view is based on the general rule laid down by the Prophet (saw) that the sale of a commodity which is not in the possession of the seller is unlawful. But, Majority of the Islamic scholars see that the deferred sales in general as an important component of the exchange or *al-bay'* with specified conditions regardless of which consideration is absent at the time of contract¹⁸ compatible with the general message of the verse that "Allah has permitted trade and forbidden *riba*" (2:275). Usually the deferred price is higher than the spot price enabling to possess and benefit from the commodity, in certain period of time. This kind of exchange is very relevant to the practical operations of Islamic financial institutions in the present time.

¹⁷ Al-Shafi'i, Al- Umm, vol. 3I, p. 93-94

¹⁸ Abdul Halim Ismail, Ibid., p.294.

B. According to the nature of an exchange object.

On the basis of the nature of the intended objects whether its possession or acquiring would take place continuously over time or in discretionary, the exchange can be divided into transaction of goods and transaction of services. The transaction of physical goods takes place within a short duration and transference of their possession could be immediately concluded. However, the transference of services normally takes place continuously and the intended benefit is acquired bit by bit over certain period of time. The exchange of goods is very simple and clear but the sale of services including all kinds of *Ijara* requires certain elaborations. As we have mentioned in section 3.3, *Ijara* is a sale of services or usufruct (*al-manfa'a*) for another material substance, i.e., commodity or money. That is when the intended benefit cannot be directly delivered or acquired at once, but it is received slowly over given period of time through the services of fixed property or labor. We have elaborated the discussions related to *Ijara* in the earlier chapter. Therefore, avoiding the repetition on the same point we emphasize now only the nature of *Ijara* as a part of sale

In Islamic juristic interpretations *Ijara* is a contract of selling determined utility or usufruct for specified and lawful compensation or efforts/ work which.¹⁹ According to *Fiqh* scholars *Ijara* is mere sale, i.e., sale of usufruct²⁰. Malik²¹ and Shafi'i²² considered *al-Ijara* as a sale, where the usufruct is the object of sale and *ujra* stands for the price of the usufruct or *manfa'a*. However, the price or rate of hiring or renting a property can be assessed and determined only when the property is known, whether by inspection, viewing or description. This must be clarified because the value of the usufruct and the condition for the value is determined by knowing the nature of the property. That is, since *Ijara* is a type of sale there should not be an element of *gharar* which can influence the validity of the contract.

Therefore, the contracted usufruct should be absolutely ascertained. However, the *Ijara* in general is part of the sale operation but, with peculiar features. For instance, according to

¹⁹ Al-Qastalani, *Irshad, fi Sharhi Sahih al-Bukhari*, iv, p.126

²⁰ Al-Zurqani, III, p.368

²¹ *Muwatta'*, The version of Yahya bin Yahya al-Layth, p.595

²² *Kitabul Umm*, vol.4,p.26

Ibn Rushd *Ijara* resembles a sale contract where by the price and the use of *Manfa'a* are exchanged.²³ The magnitude of the use should be determined either by the duration of the contract or by its subject matter. It is a contract for providing a specified work for a fixed price.²⁴ According to the usage of the term, wage (*ajr*) or rent is the price of an advantage which is concluded by the parties. Thus, for the *Ijara* is a sale of utilities of a thing. The *Fiqh* scholars pointed out that the nature of the intended utility determines which goods are subject to rent or not. The utility should not be a physical portion of that object itself. Any thing which its utilization is causing that both its usufruct and the object itself to go together and perish at the same period cannot be hired, but it can be sold. According to this view, *Ijara* is a bilateral contract where the utility of a corporeal object is exchanged for a price. The rules for averting *riba* apply to *Ijara* as well and these rules as we have previously seen varying from one school of law to another. We have also seen that with *Ijara* the subject matter would be materialized gradually by the lessee making use of a hired object and that is a tolerated exception to the requirement that a subject matter should be in existence at the time the contract is concluded. The requirement cannot be met when work or use is the subject matter, the latter is necessarily nonexistent at the time of the contract but comes progressively into the being by the graduate implementation of the contract²⁵.

C. According to the economic relations of exchange items

We have seen that exchange emerges from a desire of an individual to acquire other specific commodity belongs to another individual. Hence, the commercial activity appears to be an important form of manifestations of the economic relations of goods and services. For instance in a simple barter economy the exchange value or the relative price implies to express each commodity or services in terms of other(s). In monetary economy we acquire a sophisticated device of measuring the exchange value of any good or services to the rest of goods and services. Examining the concept of exchange from the perspectives of economic relations of commodities, two significant categories which are relevant to this study would arise namely; (i) transaction of different goods or services and (ii) the transaction of

²³ Ibn Rushid, *Bidayat al-Mijtahid*, vol.4, p.215

²⁴ Bahuti, *Al Kashaf Al Qina*, vol.3, p, 470

²⁵ Nabel Saleh, *Ibid*.

homogeneous ones. The concept of exchange is applicable to both cases for what the term of exchange inherently implies is that two things are given one for another and nothing more in both the linguistic usage of the term and its technical interpretations. Both terms of *Tijara* (trade) and *bay'* (sale) in Islam as we have mentioned above convey the meaning of exchange or trade. Hence, the generic connotation of exchange implies to reciprocal transference of similar as well as dissimilar things irrespective of their nature, i.e., physical goods or services, or the time element in which they may involve. The exchange of different things is normal commercial activity for which the term exchange automatically captures. But, a mutual transference of the same article may seem to be a strange thing. However, with a short notice we find that this kind of transaction establishes an important part of the exchange concept. Each one of these categories can take the form of spot and credit transactions. While the sale in identical goods may represent its spot form, the loan transaction represents a credit form. Both kinds of this particular exchange involve a reciprocal offer of identical goods, because loan transactions mean merely exchanging the present benefit for its similarity in the future. Hence, the economic activities of lending and borrowing establish an essential and most obvious part of the theory of exchange. Although this division of exchange on the basis of the economic relations of traded items is overlooked in conventional literature as well as the contemporary writings of Muslim economists, it contains extremely fascinating conceptual implications and demonstrates the essence of fundamental economic parameters, i.e., price and profit. It also provides a significant economic rationale for the prohibition of *riba* in Islam. In the preceding chapter, we have elaborated the issue in detail and looking into the matter from legal perspectives we have illustrated a consistent legal framework for understanding it. We have come with the conclusion that economic activity related to the exchange in homogenous items is subject to prohibited *riba* in Islam, in other words the *riba* doctrine is limited to the discrepancy that may arise from this kind of reciprocal identity, while the concept of profit entirely falls in the context of exchange in heterogeneous things.

All these three kinds of transactions share common basic features which determine their essential characteristics of being part of sale or *bay'*. All of them comply with our above definition of *bay'*, or exchange in general, as long as there is mutual consent of the two parties where the seller has something to sell and purchaser is giving its price according to the market value of that thing. In other words as long as there are two things to be reciprocally transferred both immediately on a spot or with delay, at once or over time period, there is a

sale. Suppose in case of renting price is clearly the monetary value and the utility or the benefits the consumer is to derive from it, is the intended object. Whereas one party is selling services and the other is purchasing it by giving its due price, in terms of money, commodity, or other utilities and services. Therefore, profit whether based on services or physical goods involves actual transformation processes while *riba* does not, we discuss how that transformation takes place in business activity in the next subsection.

5.2.2 Manifestations of Incremental Value

In order to figure out the excess or increase on the part of either consideration the final resultant value is compared to the initial one on the basis of the same identical asset or money. Anything produced for exchange are considered an economic good and its intrinsic or use value and exchange value are the twin factors which together determine the socioeconomic importance of that commodity. Adam Smith observed that: the word value is to be observed to have two different meanings and sometimes expresses the utility of some particular-object and sometimes the power of purchasing other goods which the possession of that object conveys. One may be called value in use and the other in value in exchange²⁶. The relationship between value and price is the problem which subsequently has continued to attract every generation of economists. In this connection we examine the physical nature of the incremental value that is the difference in magnitude arises from exchange of two items evaluated in the same standard unit of measurement, as a contractual condition of the trade, the point to be emphasized here is that the increase which we concern in this connection is that which must be observable measurable and transferable, subject to economic valuation. In economic sense, for both terms are being based on exchange we can say that they are value concepts where in both cases an exchange activity of two goods each one stand for the price of the other item is involved. But one important point which is mostly ignored in exchange concept is that the additional value cannot be identified unless the initial good and the final output are evaluated in the same original kind of commodity /item. When someone transforms his commodity into money, he compares the original amount and the final outcome of money of course after deducting his expenses of transformation. Thus, profit emerges only after the goods are transformed into their original forms whatever that original form might be. In other

²⁶ A. Smith, Wealth of Nations, p. 28

words the surplus or additional value can be quantified and clearly observable only if the original amount of the sale good and the amount of the final result constitute a similar kind of a good or an asset, for simply converting one a commodity into another of different or the same in their number or volume does not necessarily show the existence of excess or increase in either one. In this sense we affirm again that to say that profit as well as *riba* is an excess concept because any positive magnitude arises from the difference between the original value and final value is called increase or discrepancy.

Therefore, for identification of the excess, the initial and the end results of the exchange activities should be of the same kind of a particular item. It implies that the original value of an object which is for sale and the final resulting output from these commercial activities should be of the same original good. Because, the exchange of one commodity for another whether they are same quantity or different does not necessarily show excess of one good over the other, whatever their difference in volume or quantity might be. For instance, a few dinars might be exchanged for a number of tons of cotton or the thousands liters of fuel might be exchanged for one dollar without detecting any excess amount of either side²⁷. One can judge whether he received more of his assets or not, only when he converts his output to the original kind. This may arise either through direct exchange of the same thing or through transformation irrespective of how many times be exchanged before it is finally converted back to the original form of the object. The latter process shows the commercial circuit in the form of the following sequential scheme (M-C-M') where one market agent purchases from another (M-C) and next sells it at greater price than he paid (C-M') so that $M' > M$ which represents for the existence of positive incremental value or excess. We observe from here that M' and M are the same asset, where the final result emerged after intermediate good C, and the value of the original asset has increased. Therefore, we may conclude from this discussion that the growth or the increase of the value can be measured only in the form of the same object;²⁸ The excess value is equal to the final value or output minus the original value.

$$\text{Or } EV = M' - M > 0 \quad EV = \text{excess value}$$

²⁷ Anwar Sheikh, 'The Laws of International Exchange,' in *Growth, Profits and Property: Essays in the Revival of Political Economy*, Edward J. Nell (ed.), Cambridge University press, 1984.

²⁸ Anwar Sheikh, *Ibid.*

homogeneity which is the natural characteristic of exchange articles is the essential criterion that establishes the yardstick for distinguishing between *riba* and profit. The Islamic injunctions have clearly shown that the transformation process of objects and trading of goods one for another is itself the objective matter and it is considered as a necessary condition for seeking of profit. The most authentic and complete *hadith* of the Prophet (saw) states that " . . . if these species are different, then sell as you like as long as it is hand to hand" which show that as long as the two articles are different no equality is recommended for normally any real income that may accrue to both or either party is considered as a justified profit. The well-known *hadith* of the Prophet (saw) in the context of exchange inferior date for superior one is significantly relevant to this point. In another version of this report the Prophet (saw) asked him to sell the dates for dirhams and purchase the dirhams for superior dates. Abu Said al-Khudriyyi also reported; "An owner of a date tree comes to him with *saa'* of good date. The date of the prophet (saw) was of that kind". The negation of disproportions in an exchange ratio of the same items in both quantitative and qualitative aspects is peculiar to the direct transaction of the same articles. *Hadith* is clear that the disproportions of the dates are prohibited through direct exchange, while the Prophet (saw) clearly permitted but recommended if the exchange is taking place through intermediation of third objects either through money or another commodity. Perhaps, this is the basic point separating between *riba* and profit. Acknowledging this fact, Islamic jurists viewed mentioned that the excess or addition value that may stem from the physical transformation of an object from one state to another is profit and this transaction is naturally the profit generating process which is not subject to *riba*. Some *Fiqh* experts argued that provided the nature of the good remains the same as its original form no profit can be derived. Naqvi quoted from Sayyed al-Fiqqi that the extra money generated from the use of money without any transformation whatsoever the result of such use which may leave the commodity in its initial stage is not called profit it would be a wage, rent or fee in consideration of an advantage where the revenue generated was the result of a natural increase or generated from the original it would be a yield or advantage²⁹

Production is considered as an indirect exchange: No matter, whether the transformation takes place in trading where initially a monetary asset is transformed into

²⁹ Naqvi, Saffer. R., (1993). 'History of Banking & Islamic Laws' p. 43

merchandise goods and these goods are transformed into a larger sum of money or in production process where organized efforts/services and goods (raw material) are channeled into producing (in the future) a new object. This kind of operation is virtually commercial activity. However, it may take in the form of transformation through production process. Generally the object of exchange is to increase the sum of value, where each party offers to the other more than he possessed before as Simmel expressed "every enjoyment of values by means of attainable objects can be secured only by foregoing other values, which may take the form not only of working indirectly for ourselves by working for others, but often enough of working directly for our own ends."³⁰ This clarifies the point that exchange is just as productive and value creating as in the case of production itself. In both kinds of transformation process, one is concerned with receiving goods for the price of other goods in such a way the final situation shows a surplus of satisfaction as compared with the situation before the action. Perhaps, this process conforms with purely natural physical theories, that we are unable to create either matter or force; we can only transfer those that are given (in terms of goods and services) in such a way that as many as possible rise from the realm of reality into the realm of values through exchange.³¹ Thus, both exchange and production have almost the same economic implications. Individuals feel that they have produced the objects they acquired by means of exchange. In other words, normally the individuals feel that they have produced the goods they accepted in return for their services.³² Therefore, equating productive activity with exchange has a wide recognition in historical experience, legal treatment and linguistic usage of the terms in various human civilizations. It is predictable that producers would experience the manufacture of objects, i.e., X and its exchange as the continuation of the operational process the creation (acquisition) of a new object, i.e., Y. One implication of this view is that there is no conceptual problem (as an) "alienation" inherent in the process of exchange.³³ Our great *Fiqh* scholars have recognized this fact and considered both kinds as transformation process which is necessary for generating profit. In the form of the circuit transaction, we may precisely write this view as follows;

Monetary asset → Merchandise goods → Larger sum of money.

³⁰ Georg Simmel, *Ibid.*, p.84.

³¹ Georg Simmel, *Ibid.*

³² Moris Silver, (1989) *Foundations of Economic Justice*, Basil Blackwell Inc. UK. p.44

³³ Moris Silver, *Ibid.* p.48

In more precise form

$$i) \quad M_0 - C = M_1 \quad \text{Profit} = M_1 - M_0 > 0$$

This simple case of a transformation circuit consists of two items and two transactions and one opportunity of realizing gain or profit. Islamic jurists are almost in a consensus that the additional value or profit is either earned through the repetition of this commercial operations sale and purchase activities, keeping the original nature of the good unchanged or transformation of the good into more valuable form through value-added process and then selling it at higher price. The first case shows simply a pure exchange economy, where the existing goods are traded among households through which some extra values are created which in turn may result a real income. While the second case stands for a chain transformation process of productive functions and series of exchange activities, which may give rise to a higher value added. During the process the goods undergo different stages of transformations, slight either modifications or complete conversions from one state to another. For instance, initially an asset of monetary form might be converted into labor services, fixed capital and raw materials that is a complete transformation of liquid money into totally different kinds of inputs, again these inputs may be converted into output or intermediate goods which will be further processed into final goods for selling them in a higher value or larger sum of liquid money.

Therefore, the production process is not desired for itself, but simply is a necessary intermediate activity and complex multistage process of exchange. While, the trade is a simple and straightforward kind of exchanging produced goods, endowments or services, the production process is considered indirect exchange of goods and services³⁴. However, in commercial activity, although the essence of the goods does not change, the transference of the ownership over individuals gives brought to additional value which is nothing else except profit.

Monetary asset → Inputs → Intermediate goods → Final good and services → larger sum of money

³⁴ See Traut Rader, (1989) Production as an Indirect Exchange, Palgrave dictionary of Economics.

In the form of notations, i.e., I=inputs, G=Intermediate goods and services and F=final goods and services as an output of the process. We may write more precisely.

$$\text{ii) } M_0 \rightarrow I \rightarrow G \rightarrow F \rightarrow M_1 \quad \text{Profit} = M_1 - M_0 > 0 \quad \text{Real production}$$

$$\text{iii) } M_{R_s} \rightarrow M_s \rightarrow M'_s \rightarrow M'_{R_s} \quad \text{Profit} = M'_{R_s} - M_{R_s} > 0 \quad \text{Money exchange (sarf)}$$

The two cases are multi-steps transformation process which consists of four and three objects. It consists of a several transformation stages with similar number of opportunities for earning more value or income. However, the transformation processes can take theoretically infinite number of intermediary exchange activities.

$$\text{iv) } M_1 \rightarrow C_1 \rightarrow M_2 \rightarrow C_2 \dots\dots\dots M_n \rightarrow C_n \rightarrow M'_1 \quad \text{Where } M_1..M_n \text{ Stand for Money}$$

and $C_1..C_n$ Stand for Commodities

$$\text{Profit} = M'_1 - M_1$$

The accepted main task of economic activities is the allocation of resources which comprises production and exchange as essentially important two processes of transforming commodities and transferring the control. In another process of producing excess value arises from exchange of an object for itself that is

$$\text{v) } M_0 \rightarrow M_0 \rightarrow M'_0 \quad \text{where, } \textit{riba} = M'_0 - M_0 = \Delta M \neq 0$$

In this strange exchange of a single commodity for itself clearly manifests the existence of excess or not, in simply comparison of the two parts of the same object. Suppose, a given number of dirhams are to be exchanged for a similar amount of the same dirhams or certain amount of dates are traded for another certain amount of the same dates or a given amount of wheat is exchanged for another amount of the same wheat that is exchange of wheat for wheat with excess. This excess is very visible and it clearly shows whether there is excess or not, for very simple comparison of the two parts of the good.

Whether there are some logical reasons of exchanging two scales of the same good which will generally contain excess over the other would be the subject matter of the coming investigation, but it is to depict the arguments in the shape of the following table.

Figure 5.1

Endowments of Individual A & B.

B\A	Xa	Ya
Xb	Xa # Xb	Xa # Yb
Yb	Ya # Yb	Ya # Yb

(a)

B\A	Xa	Ya
Xb	<i>Riba</i>	Profit
Yb	Profit	<i>Riba</i>

(b)

Exchange of X for Y, is trade irrespective of whether they are same in value or different and any discrepancy arises from a fair transaction of two different goods is very legitimate profit. On the other hand if there is exchange of identical goods which are the same in quality takes place, i.e., Xb for Xb or Ya for Yb they must be equal, in value and number. This is *riba* involved transaction. If they are different in quality, but the same in kind no direct exchange is justified, as the degree of quality difference might be captured only through their market prices.

5.2.3 Conceptual Implication of the Counter Value

To paint the picture of dividing a conceptual factor of incremental value into *riba* and profit arises from simple fact that is an excess or increase in one commodity without existence of corresponding equivalent value. It is an exchange of one item for itself, where the selling and purchasing take place directly on the same and similar specie of a thing. This will be particularly interesting points in this research. And we would like to find out the rationale of *Fiqh* interpretations related to this important point of discussion.

The classical Islamic jurists were aware of this conceptual predicament, but without elaborating its economic and rational implications they held a general belief about the issue. They defined clearly the term *riba* in Islam to be "Every increase that has no counter

value"³⁵. In this context the concept of *riba* is precisely interpreted as an increase or excess value (*fadl*) which in an exchange or sale of a commodity, accrues to the owner (lender) without giving in return any equivalent counter value or *iwad*. Perhaps this is the fundamental principle that differentiates *riba* from sale (profit). Because sale is virtually an exchange of value against another value, the *Fiqh* scholars held general view and all of them are addressing one common thing, according to them *riba* arises from an exchange which has no counter value. Hanafi school clearly expressed that "*riba* in Shariah is the stipulated excess without counter value in *bay'*".³⁶ The Shafi'i school teaches almost the same opinion, but with more elaboration that "*riba* is a contract of exchange of a thing for a specific thing with unknown equivalence according to a legally standard unit of measurement at the time of the contract or delaying both or one of the counter values".³⁷ According to Maliki jurists "Every increase which is without an '*iwad*' or an equal counter value is *riba*".³⁸ Elaborating this point, he stated that." And *riba* literally means an increase and in the Qur'anic verse, *riba* is meant every kind of increase ' *ziyada*', in an exchange which is without an equivalent counter value or return *iwad*".³⁹ This means that if in a sale transaction in one commodity is without an equivalent return (*badal*) it will be contrary to the requirements of valid *bay'* ⁴⁰. Badr Al-Din al-Ayni referred the term *riba* in the terminology of Shariah as an increase on the principal sum without any equivalent payment in the contract. Ibn Haytham says that both *bay'* and *riba* share common attributes and individual operations of each are the same each comprises a '*mu'awadah*' (Mutual exchange) of goods for goods but one exchange is just permissible and perfect and other unlawful perverse and noxious and falls in the category of gravest sins.⁴¹ According to San'ani *riba* literally means any *fadl* or excess which by stipulation does not bring any *iwad* or any equivalent return to the other party in a contract of *mu'awada* barter or exchange of commodities and services.⁴² The exchange to have equivalence or not, embraces the theory of value and falls under the market mechanism. There is a common

³⁵ Al-Sarakhsi, *al-Mabsut*, vol.12, p.109.

³⁶ Al-Sarakhsi, *Ibid.*,

³⁷ Al-Sabaki, *Takmilatu al- Majmu'*, vol.10, p.22.

³⁸ Ibn Arabi, *Ibid.*

³⁹ Ibn Arabi *Ibid.*

⁴⁰ Dr. Ziaul Haque Islam and Feudalism: *The Economics of Riba, Interest and Profit*

⁴¹ Badr Al-Din Al Ayni *al Muhalla* vol. VIII 183 : 351.

⁴² San'ani, *Subul al-Salam*, *Ibid.*

opinion when goods are different the concept of excess is irrelevant as two different goods can take different quality with different market values. Because, it would be very difficult to specify or demonstrate whether they have equivalent values or not. For instance, gold and wheat or silver and cotton exchanges are completely mute in showing any clue of excess in one side or another as long as their market values are concerned. The jurists thus, clearly hold on this position that while *riba* transaction has no counter value, *bay'* activity entails a corresponding value accordingly, this is the basic principle which separates between *riba* and permissible sale (profit). Thus, according to the general view of juristic and Qur'anic commentators, such an inequitable exchange or sale is obviously unlawful from the legal/moral point of view.

Despite the above general conclusions, neither the classical *Fiqh* scholars nor the contemporary Islamic scholars have substantially elaborated the rationale of the notion of equivalence. Without paying efforts to illustrate the central message of the above juristic conclusions, the contemporary studies in general have raised confusing opinions and left unanswered the following questions; why there is no equivalence in case of *riba* while, always there should be a corresponding counter value in case of sale? Does that hold even when either party sells his goods at loss in sale operation?, or does counter value mean equal value? .Then, what is the rationale of the existence of profit? Or does, high rate of profit necessarily, mean inequitable or unjust? .

Number of contemporary economic writers have equated the notion of counter value to equitable and justice price. And accordingly, they have argued that the exchange must necessarily take place in equal values, so any transaction that deviates from this condition involves *riba*. The argument is built on the notion of just price in trading articles where neither party gains nor losses, and any departure from it imply gain to someone at the expense of the other for the price represents the intrinsic value of articles traded. On the line of these arguments we confront with the jurists' interpretations and realize a gross misunderstanding of their central arguments. There may be reasons to believe this notion of counter value by the contemporary economists. Because, the modern Muslim economists are largely influenced by either Aristotelian philosophy of Chrematistic or moneymaking, which gives equal treatment to loans on interest and simple sale operations, or exploitative theory which equally rejects profit and interest under the utopia of socioeconomic justice. Sometimes

even the Islamic thinking on this problem get lost in the middle of conventional theoretical ambiguities between interest and profit, as we have presented in chap.3. For instance Ziaul Haque (1985) in his book 'The economics of *riba* interest and profit', it is very difficult to find any difference between *riba* and profit. And nearly similar arguments are expressed by Naqvi (1983), Choudhary (1992), Aqdas (1997-8) and others. Large number of the Islamic economic writers feel uncomfortable with a high rate of profit for they see as a sign of exploitation and excess without counter value. While, the *Fiqh* injunctions endorse any rate of profit as long as the transaction is concluded under complete *gharar* a free situation and with mutual consent.

i. Counter value in exchange for a single commodity

The only areas, as we have seen in the preceding sector where detectible discrepancy arises or equivalence of counter values is clearly recognizable falls under the exchange in identical goods. Because as long as the two items are identical in every respect one thing is very easy to be pointed out their quantity/number should be equal and the same. Any difference or discrepancy how small or large it might be is termed as an excess which has no counter value. As the principles of exchange shows at a given price level in the market a physical increase of a commodity should accompany with an equal proportional increase of its exchange, then identically homogeneous goods should be equal in exchange provided that their qualities are the same. Any discrepancy or difference arises from a transaction of two identical goods with same qualities is considered as an excess without counter value. This kind of excess usually emerges from either credit transaction or loan contract. Both of which involve time concept. The question arises from here is that whether time difference matters as one of the items in the contract delayed or only quantity difference/excess in the amount of exchange goods is sufficient? Mainly the term counter value occurs on not time delayed but the discrepancy in quantity on one scale over the other. In this connection we would like to focus on the rationale and economic implications of exchange in single commodity analogy to the conventional assumption of a homogeneous commodity used for consumption, saving, investment and production, i.e., Ricardo's corn, Fishers' sheep, Crusoe's fish or Samuelson's rice (1981, 22). We want to examine what will happen when these same commodities are used in exchange for themselves. If we use it for exchange in place of input and output for production may not create a problem. But does it keeps so in case of using a single object in exchange for

itself.

Examining the matter in price context, it is very clear that the concept of price implies exchange of naturally various things where the objects exhibit their exchange values against others. Basically objects express their exchange values reciprocally. However, as far as the price of a particular object against itself is concerned the situation is totally different. Any object however valuable it might be being completely mute in respect to itself. But, the exchanges of two similar things remain the same. In other words the price of an article in respect to itself is equivalent to itself only nothing else. In case the counterparts have different characteristics, presumably due to the existence of visible qualitative disparity, neither consideration will directly indicate the exact price of the other. Although the concept of exchange as we have mentioned above is still applicable to the transaction that involves in homogeneous goods, the objects are silent to express their own exchange values, hence the notion of price whether 'absolute' or 'relative' terms, is irrelevant to these counterparts in exchange of reciprocal identity.

ii. Counter value in case of two goods

Perhaps the most familiar kind of excess that has no counter value arises from the deferred transaction. This emerges from two stage exchange contracts of the same considerations. This contract starts in the first stage as an ordinary exchange of two different articles except that one of the considerations mostly the price in monetary economy is delayed, while the intended object is delivered on the spot. There may not be harm and the exchange goes smoothly if the future obligation of paying the agreed price of the commodity is fulfilled according to the contract. But problem starts when the buyer could not fulfil his obligation and seeks extension from the creditor who accepts only with the increase of initial the debt at certain amount for a given period. This practice as prevailing in the pre-Islamic era, the people used to exchange sales and practice it, i.e., a man used to sell to another with delayed payment for a term, and the maturity of the debt the creditor used to ask the debtor to pay or to increase with some proportions. This ex-post increase after the terms of the contract is mutually concluded and ownership is reciprocally transferred represents for excess without counter value. This increase seems to be a sale of liability to more of itself. In this context of exchange economy in a single commodity the excess value without counter value arises from two ways such as

a direct exchange of the same good where the two parties are conducting a contract of exchanging two amounts of a similar good. This kind of exchange is what is known as usually loan contract, but irrespective of its time consideration it is a matter of nomenclature whether it is named a loan or sale as it will not change the nature of the contract for the actions are indeed considered on the basis of their intentions in Islamic Shariah.

Simple graphical illustrations

To depict the concept of counter value in simple graphical analysis, let us examine the first situation fig. 2,(a) where there is a single commodity endowment for two individual consumers A and B which is Y, where A possesses endowment of y_a and B has the endowment of y_b whatever their distributional sum A and B together possess the total available stock of Y, that is $y_a + y_b = Y$. Where Y may stand for any specific commodity, which have uniform and similar elements with absolutely the same features and characteristics. The two consumers may have equal proportions of Y reaching at C point of distribution or different proportions according to their initial endowments along the line of MN which stands for the opportunity space or the maximum available endowment of Y, within which each consumer will realize his share of the endowment relative to that of the other consumer. If A gets ON of Y (B gets OM of it) B (A) will get nothing, since in both sides of the diagram is depicted by the same commodity Y, OM and ON must necessarily be equal. Between these two polar points there are different proportions for each. When each one is on the point of C where A is getting OY^a_c while B is getting OY^b_c they are in equal proportions. Given this distribution no one can raise his endowment without reducing the part of the other individual. An increase to someone is possible only at the cost of the other. This is the situation of exchanging a good for itself at a higher rate. Any additional value that accrues to either party in this kind of transaction amounts to excess without counter value or prohibited *riba* in Islam. Now, we would like to emphasize on that the exchange of identical goods has no any economic use on spot transaction, but it shows a zero sum game activity where the gain of one party is directly the loss of the other one. If the exchange of this kind of trade takes place on the spot there may not be any economic benefit to be drawn from it, while there is a possibility of an increase of the welfare of both parties in the context of a time horizon intended to fulfill different dated wants (the details of this point will be discussed in chapter six). The question is how does a normal permissible trade turns into a prohibited *riba* transaction or excess value

without counter value. This will be discussed in the context of credit transaction

We take another hypothetical example, fig.2 (b). Suppose A and B are two individuals. A has endowment of good Q_A^e and certain amount of a money M_B^e . A requires to have more money and sell some of his plenty of good. While B would like to purchase some of good Q from A in exchange for money, the exchange normally takes place at a given market price. According to the above diagram there is one to one relation of the concerned good and its market price the two individuals may exchange the items on spot price but on credit transaction where individual A will give $Q_A^e - Q_A^c$ of the good on defer payment to B at price of $M_B - M_B^e$ to be paid on a fixed term up to how the transaction goes on normally and if individual B pays the debt on time the contract is complete. According to this any excess that accrues to either party is an increase of the monetary amount which is the liability of the debtor. This increase or excess has no economic justification. It is excess without counter value, for this new contract of sale is unilateral without reciprocal payment. It is very simple to depict or illustrate this idea in a diagram. The first contract is normally concluded with complete terms, at the equilibrium point of E. As a result of this mutual trade each individual's welfare has increased and reached higher level of utility. As far as the second contract or the condition is concerned. A demands for an increase without offering any thing save extending the period of the payment for the debtor. Since the debt to be paid by B is converted in money terms in the first contract, B is liable to pay a fixed amount of money not good. Then any increase takes place on this amount means increase in the same good. selling that same thing for more of itself.

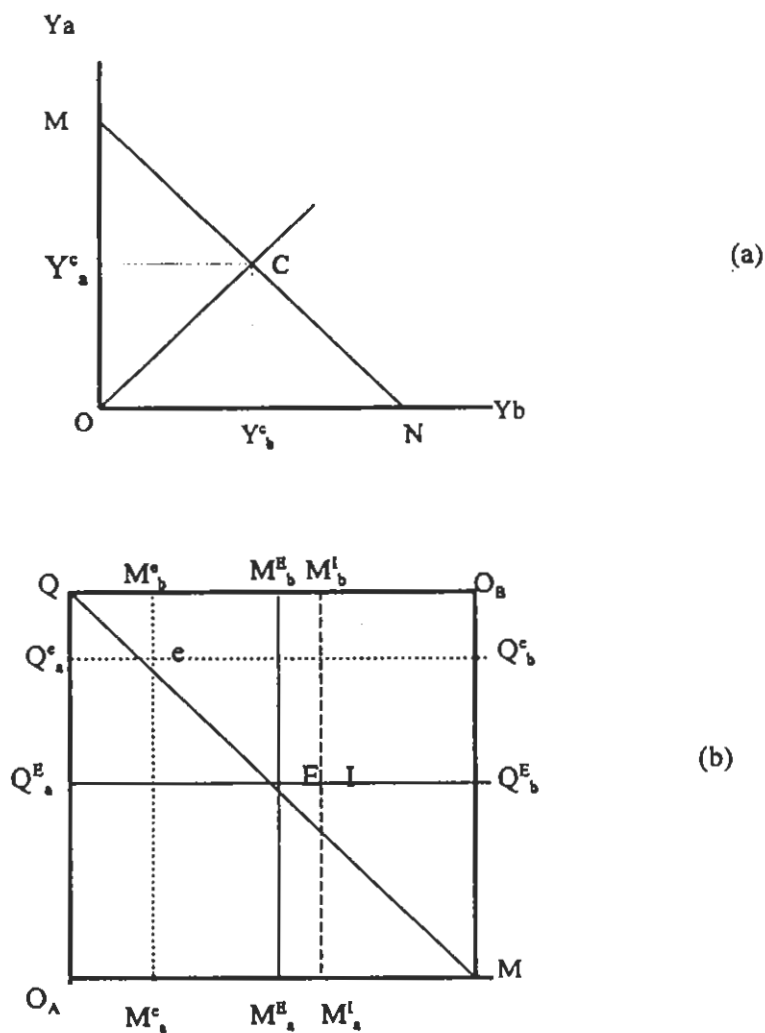


Figure 5.2 Economic Relations of Exchange Objects:

In case of exchange in single commodity Y as panel (a) shows where both axis measures the same object. The two counter values of Y should be equal, that is OM and ON are equivalents. This is because the price of an object in an exchange for itself is that object itself. Therefore, OC is a 45° line indicating the both sides of the axis are equal to each other provided that the quality of the two parts of Y to be held by A and B are equal. But, in case of two different objects as panel (b) shows, while the first transaction is normal credit sale, the second one is unjustified for it cannot draw another price. For the same amount of the object as may be indicating by the point I .

Thus, consequently the equilibrium has shifted from E to I showing that at the same amount of Q_A A increases his stock of money from M_A^E to M_A^I that is $\Delta M_A = O_A M_A^I - O_A M_A^E$. This additional amount money i.e dirhams, that accrues to A is absolutely the reduction or loss to individual B, where the stock of individual B decreases from M_B^E to M_B^I that is $\Delta M_B = O_B M_B^E - O_B M_B^I$. Therefore, $\Delta M_A = \Delta M_B$ in absolute terms, so in exchange rationale, this is one side flow which has no any corresponding value in repayment. Thus, this magnitude amounts to *riba*, for the sale has no counter value. In this context *riba* arises from multiple sale of the same transaction. That is perhaps the meaning of the *ahadith* of the Prophet (saw). It is reported that the Prophet(saw) "forbade two transactions in one". similarly as reported by Abu Dawood quoting Abu Hurayra the Prophet has said "whoever makes two sales in one transaction will end up either the lesser of the two or with *riba*". It is important to mention here that Islamic jurists took the literal meaning of these *ahadith*. They interpreted them in the context of a price increase on credit sale. Despite the fact that majority of *Fiqh* scholars are of the view that increase in credit price is permissible. The details of this issue we may postpone till the next chapter.

We have argued in detail that *riba* is an excess that has no counter value as the final conclusion which we have arrived but still certain questions may be raised in case of profit, how *riba* has no equivalence in exchange while profit might have? . And the situation may get more confusion when we incorporate with the pro-socialists Islamic economists' views, according to them any market distortions or monopolist activities or even any gain above its cost is regarded as the causes of excess without counter value so they all fall under the armpit of *riba*. They argue that if there is fair transaction there may not arise any profit only from unjust economic activity. For instance, in the above diagram there may not be excess when the exchange is readjusted from e to E point. Therefore, for no difference between the excess or surplus that arises in the first contract at E or the second at I.

5.3 UTILITY AS THE SUBJECT MATTER OF EXCHANGE ACTIVITY

It is a natural fact that goods are demanded for their utilities, the satisfaction or the pleasure a consumer derives out of consumption or the usage of a commodity is termed utility by economists. In Islamic teachings it is used usufruct (*manfa'a*) long ago the word utility had appeared in the western economic literature. But its meaning has shifted continually, Initially

it has the same meaning as its common synonym, i.e., Usefulness or satisfaction. However, the classical conventional studies defined it as "the capacity of a thing to procure us facility"⁴³. For Bentham utility mean property of any object whereby it tends to produce benefit, advantage, pleasure, good or happiness to the party whose interest is considered. However, the reduction of sufferings or relief from a pain is also considered a kind of utility. According to Gavin (1835-1882) utility is no longer to an intrinsic quality of a thing but means "the sum of pleasure and the pain prevented"⁴⁴. Economists have debated over centuries the relationship between the usefulness of the commodity and its market price. The relationship makes intuitive sense that purchaser who uses two commodities will distribute their expenditures, so that the last dollar spent on each commodity yields the same extra utility. Even the Greek philosophers recognized that two distinguishing elements are involved in the problem of value: an intrinsic quality of the object and the subjective evaluation by the user.⁴⁵ In modern understanding utility is simply catch all term for whatever it is that makes us want to consume goods or services. It indicates pleasure, satisfaction, physical comfort, welfare or well-being and so on.⁴⁶ In this sense, the utility is the subject matter and underlying motive of all exchange activities. And in this context we examine the concept of incremental value on the light of the generally accepted principles of utility theory. We discuss how the real income or profit is to be generated through simple exchange activity of consumable goods. Looking into the consumption behavior of individuals, we find the natural constraint and infinity dimensions of utility, with references to the conventional utility principles and profound comment of Imam Razi on some relevant Quranic teachings. We comparatively examine cases of single economic good and double goods in the context of exchange economy under the Pareto Optimality condition. Finally, we present briefly a monetary assessment of the incremental value from exchange in terms of consumer or producer surplus analogous to the preceding physical assessments.

⁴³ Galiani Bentham, *The works of Jeremy Bentham*, vol.1, p.ff, ed. by John Bowring. New York. 1962.

⁴⁴ Necholas Georgescu, *Utility*, International Encyclopedia of the social science, ed. by Divid L.Sills. The Macmillan Company. Vol. 17, 1968, p.237-64.

⁴⁵ Necholas Georgescu, *Ibid.* p.247.

⁴⁶ C. J. McKenna & Ray Rees, *Economics: Mathematical Introduction*, Oxford Press. 1992

5.3.1 Surplus Utility: The Source of Profit

Constructing microeconomic view of exchange theory demonstrates an important economic implication of the subject and illustrates the significant relations between the consumption and exchange. Anas Zarqa (1991) has illustrated how it will be advantageously for both parties based on the psychological tendency which economists call the law of diminishing utility of consumption. Economists assert that individuals need to exchange because they have been diminishing marginal utility and different marginal substitution for the consumption of goods, because of the disproportionate of their endowments, and the multi dimensional unlimited wants of human nature as the individual wants, not a bulk of the same good but certain amount different goods at the same time with different utility and satisfaction levels⁴⁷.

Due to these reasons the individuals want to give up part of the extra amount of a good which he has low marginal utility in exchange for some of other commodity belongs to another individual who also is facing a low level marginal utility for instance. A has plenty of apple and very small number of oranges but few of apple, assuming both goods are normal goods A's marginal utility of an apple is very low while it is very high in case of the oranges. A prefers if he would increase the number of oranges in exchange for apples. Similarly, B's Mu of oranges is very low or zero and that of the apple is very high. Therefore, B desires increasing the number of apples he has in exchange for oranges. In this way his utility would increase. If A & B exchange these two commodities both of them reap the benefit of the exchange in raising their welfare and exchange goes on until the equilibrium point is reached at the highest possible level, hence the marginal rate of substitution is equalized. Then it is very clear that exchange has a potential of benefitting each party even though in some circumstances it enables one party to reap most of the advantages. But the general principle is that when normal exchange takes place among individuals some extra real income is generated and shared by both parties which is called "profit"⁴⁸.

Zarqa concluded that this process has raised advantage from trade as real income asserting that "real income is nothing but generation of utilities. It is not, the goods which accumulate in stocks in the yards of companies are basically required, as the production of goods in large scale has no use unless it is aimed for exchange and generating more income

⁴⁷ M. A. Zarqa, Ibid p.94.

⁴⁸ M. A. Zarqa, Ibid, 98.

in terms of utilities/welfare derived from the consumption of final users".⁴⁹ The idea that the exchanging parties are trying to increase their income or their welfare in general may be examined in two dimensions. The vertical (single good) and horizontal (basket of goods) dimensions in the pursue of raising welfare or utility.

A. Vertical Constraint

The assertion that goods are characterized by diminishing marginal utility as consumption rises is an empirical one. This principle is widely believed despite the absence of generally accepting measuring device for utilities. It corresponds to our common notion that first orange or apple gives more satisfaction than the second or third one. The law diminishing marginal utility is valid even if utility were to be measurable on an ordinal scale. The law conveys that with every increase in the stock of a commodity its marginal utility diminishes with every increase in stock that we already have. In other words the Law states that "As the consumer increases his or her rate of consumption of a certain good, the consumer's total (psychological) utility increases but after a certain point the extra (or marginal) obtained from additional units tends to diminish". This law plays a crucial role in the theory of consumer behavior. In fact it is considered the underlying theory of law of demand or the downward-sloping demand curve, as such, it holds true as long as the negative phenomenon of the demand curve holds⁵⁰. In case of ordinal utility theory, perhaps, this law is implicitly the underpinning concept in diminishing marginal rate of substitution between the two goods, and hence the convexity of the level curve. On the base of this natural law of demand theory, the objective of a rational consumer is to maximize his total psychological utility that he can obtain according to his resources. If the consumer is access to single commodity, he may increase his total utility by consuming it more of it. However, after certain level of consumption he must reach where he cannot increase his utility by consuming it anymore. The main defects or the short coming in this law is that it only explains the behavior of the consumer regarding a particular commodity at each time that is a vertical increase of consumption where, the consumer concentrates only on using a single good, and spending whole of his income on the same commodity. It does not explain the consumer's behavior as

⁴⁹ M. A. Zarqa, Ibid.

⁵⁰ Miltiades, Chacholiades, 'Microeconomics', Ibid., p.88

whole. But this principle in general visualizes that as the same enjoyment continues over time, the magnitude (intensity) of pleasure continues decreasing and ultimately tends to negative welfare or disutility.

B. Horizontal Infinity

The principle equi-marginal utility illustrates this aspect. This is used for maximizing total utility, where the household will allocate his income among various commodities so that the utility of the last penny spent on each good is equal. This law does not mean that a prudent consumer substitutes one item for another in order to satisfy the same want, i.e., tea, coffee etc. It means that the consumer demands different items within his purchasing power and derives maximum utility from them. Marshall says there are an endless variety of wants but there is a limit to each separate wants. Thus, the total utility of a thing in anyone increases with every increase in his stock of it but not as fast as his stock increases. The law of equi-marginal utility allows the consumer to distribute his means among the gratifications of different wants. That is to consume different commodities at the present the same period of time the more consumer satisfies different needs or wants the greater well-being he may attain this we may call horizontal increase of utility, as mostly economists pointed out that the human want is unlimited and multidimensional there is a greater scope of increasing the welfare or utility of the consumer by spreading and spending his resources over purchasing different kinds of needed goods rather than holding or concentrating in consumption of a single commodity. This is what equi-marginal principle is going to address, that the consumer can maximize his utility or satisfaction by allocating his resources among various goods in such a way that the marginal utility of the last unit of his resources spent on one commodity is exactly equal to the marginal utility of the same unit spent on any other commodity⁵¹. The modern version of equip.-marginal utility principle presented this concept as follows " the objective function of the consumer is to maximize his utility subject to the budget constraint of his fixed endowment or income. Together these two fundamental principles of consumer theory establish a very significant foundations for our search for developing a theory of additional value in microeconomic foundations. We can learn from these elementary concepts that the vertical consumption or concentration on utilizing a single good implies ultimately

⁵¹ M, Chacholiades. *Ibid.*, *Ibid.*, p.94

decrease in total utility, while allocation of resources over large normal commodities in general is a rational way of increasing total welfare. And this is, perhaps, the driving force of exchange activities between individuals and nations all over the world.

Graphical illustrations

A more convenient way of illustrating this exchange possibilities is to assume that the two consumers have different two goods, fig.5.3 (a) and (b). Suppose A has X endowment and nothing of commodity Y while B has only Y. In this situation there is every possibility of exchange to take place raising the well-being of both individuals. Suppose for simplicity that A has an endowment consisting only good X shown in fig. 5.2a. Suppose in the initial situation he cannot engage in exchange he will have to consume his endowment which gives his utility level u^a_0 . Similarly, B has a single commodity endowment which gives him a utility level u^b_0 . Both of them in this situation are facing a low level of utility due to diminishing marginal utility in consuming each good alone and both of them desire if they can improve their well-being through trading.

If A can trade and faces a relative price of good x in terms of good y as given by the absolute value of the slope of the budget line passing through x_1 , he will choose to sell $x_1 - x^a_1$ units of good x in exchange for $0^ax^a_1$ units of good y and achieve utility level u^a_1 . By facing A with different relative prices of good x we can trace out his offer curve, labeled OC^a . This offer curve tells us the amount of good x that A is willing to exchange for a given amount of good y at any relative price. The absolute value of a budget line from point x_0 to a point of offer curve is the relative price of x for y or the terms of trade. The highest indifference curve available to A at each relative price is tangent to the budget line at its intersecting point with the offer curve. More generally A's endowment may consist of part of both goods that is any point on fig. 1. Given the relative price his budget line must pass through the endowment point the offer is obtained by rotating the budget line through the endowment point and drawing the locus of equilibrium points chosen. We can depict a similar diagram for B, and suppose that he receives an endowment consisting only good Y. His diagram may not be different from that of A except the original point of the two diagrams as we see in Fig.5.3

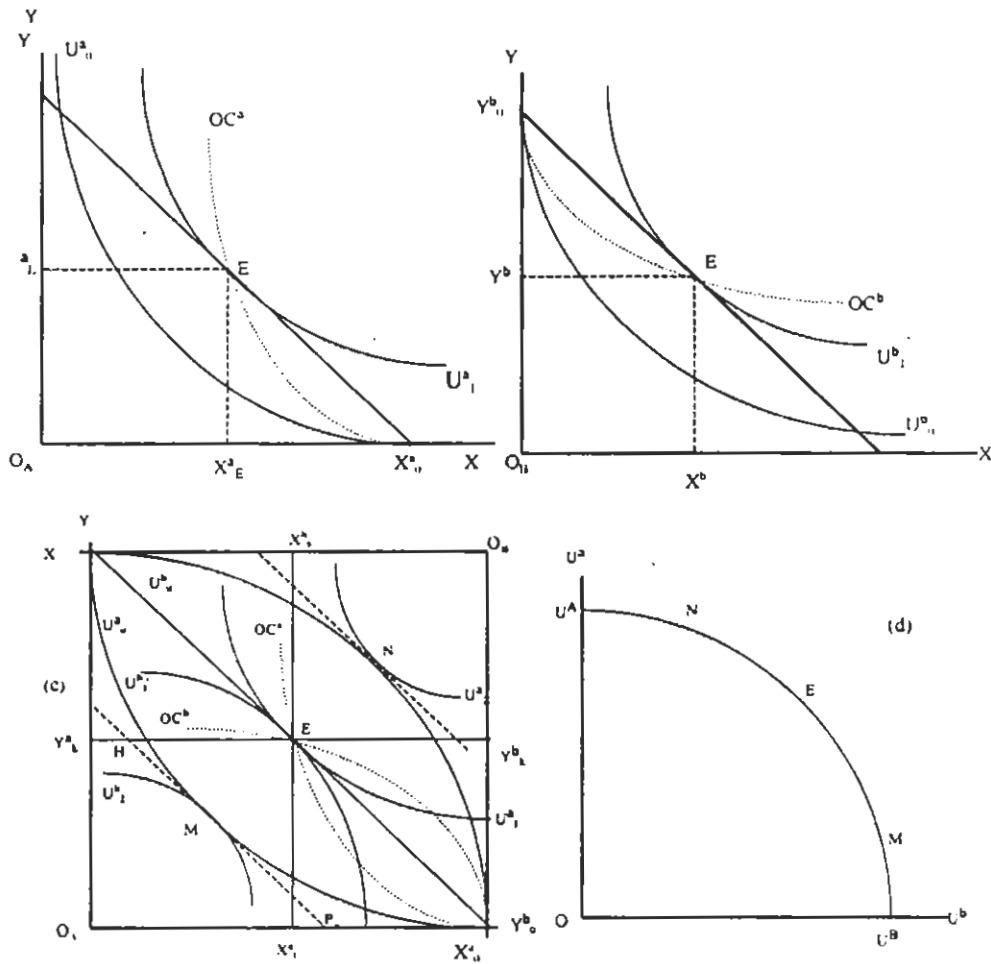


Figure 5.3 Benefits from Pure Exchange Economy.

Suppose A has X endowment and nothing of commodity Y while B has only Y. In the initial situation no one can engage in exchange so each one by consuming his endowment will obtain low level of utility u^a_0 and u^b_0 as shown by Fig. 5.3 (a) and (b) due to diminishing marginal utility. If they agree on trading according to their expected budget lines. For instance A will choose to sell $x_1 - x^a_1$ units of good x in exchange for $0^a x^a_1$ units of good y and achieve utility level u^a_1 . By facing A with different relative prices of good x we can trace out his offer curve, labeled OC^a and ultimately he reaches the point IC that is tangent to his budget line at its intersecting point with the offer curve. The similar will be the case of B. Then imposing the two diagrams as shows by c panel we can find the efficiency of exchange process by raising the welfare of both individuals. Before the exchange A and B would end up at M and N respectively but through exchange they may agree any point between these two points . But the most equity one is at E and rthey aise their welfare equally. Depicting the this distribution of texchange gain we have show n it in panel (d) Where along the contract line one can gain only at the cost of the other.

It is noteworthy to refer this principle to the context of the story of Bani Israel when they tired of eating the heavenly food *manna* and *salwa* and they said that they could not keep satisfied with one type of food only. They requested that they would prefer the food crops of the earth. One may wonder and ask whether they were so foolish and irrational to exchange such excellent food as *manna* and *salwa* for such an ordinary things as garlic lentils etc., more over they were getting gratis but were asking for that thing for which they would have to till the land with toil⁵². The Qur'an exposed this event as historical evidence and reality of the human nature, Allah (swt) stated in the holy Qur'an speaking to Bani Israel:

"Remember when we caused the cloud to over shadow you and provided you with *manna* and *salwa* for your food saying eat of the clean and pure things we have bestowed upon you. Remember, you grappled, O! Moses! we cannot endure one and the same sort of food, pray your lord to bring for us the products of the earth: green herbs, vegetables, corn, garlic, onions, pulses, and the like" (Moses replied) what ! would you exchange that which is meaner for that which is nobler?. Well go and live in a town and you will get there what you demand" (2:60-1)

They were told to eat this fine and delicious food and be satisfied - but do not hoard for the future and do not barter it for any other food. But they did not obey this, in contrary they began to store them out of greed. And they demanded for a low things cultivable from the earth / soil.⁵³ They said we cannot endure one type of food only, because the food was the same in all days without any change. Al-Imam Razi elaborated the interpretations of the above Qur'anic verses and perhaps examined the subject in its economic perspective saying that "there is no harm in their request for more kinds of food". He mentioned that the question for variety may have one of several purposes: Among them he mentioned; When they used to eat one kind of food for 40 years they tired of it and they desired for its change or to get others (in addition to it).

Then, Imam Razi came up with a profound conclusion stating that "in general regularity or repetition of a single kind of food is the main cause of losing the appetite as it weakens the

⁵² Maududi, The Meaning of the Qur'an, vol.I 5th ed. 1980.

⁵³ A. Sh. Osman, The Noble Qur'an

digestion and reduces the desire or taste. On the other hand the diversifying of the food determines the stimulation of the appetite and increases the pleasure or utility. So, the substitution of one kind of something for another is the objective of sound minded/rational people".⁵⁴ On the basis of this scholarly thoughts and penetrating understanding he argued that as long as the demand of Bani Israel is falling in this context they did not commit sin and no blame on them for their request for variation of the meal in particular. And the response given to them is clearly supporting this view⁵⁵. The given answer affirms this implications, it has been put in this form, it does not mean that you are not satisfied with *manna* and *salwa* which you get freely from the heaven but you are asking for low quality and costly things! Then they were told that, if they wanted/desired those trivial things, they should dwell a city/town where they would find their desired things, and so it happened.⁵⁶ With close examination in this revealed fact one may draw from it an extremely significant lessons. Despite the fact of incomparability between the heavenly given meals and what they wanted of earth crops in terms of quality and cost, yet they insistently opted for the latter for the sake of variation. Thus, this shows on one hand the welfare or the satisfaction of the people depends on the variety of consumption goods not on a single commodity howsoever its quality may be and it manifests the wisdom of Allah (swt) in the variety of his bounties and human taste, and it crystalizes that the nature of human taste is stronger than the cost considerations on the other. The cost and taste differences are underlaying motivating forces of trade and business operations and both of them are naturally given factors. Where cost difference arises mostly from the difference of natural endowments and similarly taste is inherited character of human nature. In this context to elaborate the essence of the concept. We may analyze it in a simple microeconomic tools we assume that consumers have two different goods suppose A have the endowments of X only and B possesses the endowment of Y only. In the light of these assumptions we would like to examine the possibilities and opportunities for exchange, in other words which situation is probably to generate benefit to either one or both individuals or economically is subject to advantageous exchange to someone without inflicting loss to the other one.

⁵⁴ Imam Razi, Tafsir al-Kabir, vol.3, p.91-95.

⁵⁵ Al-Imam Razi, Ibid.

⁵⁶ Imam Razi, Tafsir al-Kabir, Ibid. 94

5.3.2 The Economic Efficiency in Exchange.

At the turn of the century Vilfredo Pareto, a great Italian economist, was the first to define concepts of ordinal utility theory by recognizing that the laws of consumer demand do not require declining marginal utility of income and the implied cardinality measurement. The criterion is simply focusing the comparison of two stages of utilities obtained by an individual or a group of households whether the latter situation is better off or worse off than the former. Accordingly, if two situations are given T and G, a person is said to be better off in situation T than in situation G once he or she moves to higher position such as T. In other words if state T allows a higher level of utility than state G the state T is called Pareto superior to state G and state G is Pareto inferior to state T. If all households enjoy the same level of utility in both state's T and G, then T and G are Pareto indifferent. If state A is neither Pareto superior nor inferior nor in indifferent to G, then these two states are Pareto non comparable⁵⁷. Although the concept of Pareto optimality is considered a weak, it does establish some useful guidelines necessary for the maximization of welfare in households. Pareto optimality is an efficiency condition. A Pareto superior change simply shows a move to a more efficient allocation of goods and services. If the action is Pareto superior, we can unambiguously say that the household on that state is better off. Thus an infinite number of resource allocations can be said Pareto optimal in the sense that no one can be made better off without making someone else worse off. Applying this principle of Pareto optimality in the pure exchange economic analysis, suppose, two individuals A and B, and two goods x and y provided that the consumers' preferences and general price levels are constant so that the main ideas can be given a geometric interpretations. We can illustrate how benefits or advantages arise through exchange allocations to show which situation violates this Pareto condition.

By combining the two figures 5.3a and 5.3b and constructing Edge worth box diagram 5.3c we can examine how both individuals approach to Pareto optimum through trading in this simple model of two- person two-commodity exchange⁵⁸. The dimensions of the Edge worth

⁵⁷ Robin W .Boadway & Neil Bruce,, 'Welfare Economics', Basil Blackwell Inc. USA. 1984, p.62-67, 196-213.

⁵⁸ Robin W .Boadway, Ibid, p.66.

box are equal to the endowments of good x (horizontal) and good y (vertical). The origins for a consumer A and B are O^a and O^b respectively. Assuming that A has claims on the entire endowment of good x and B has claims on the entire endowment of good y . We can identify the initial endowment point at the lower right-hand corner. Moreover, the endowment point can be any point in the Edgeworth box. The contract curve O_aEO_b . It is the locus of all allocations of the two goods such that the indifference curves of A are tangents to those of B . Thus, at each point on the contract locus the marginal rate of substitution between x and y for A is equal to that for B . At any point that is not on the contract curve including our initial endowment point the marginal rates of substitution (mrs) of B and A will be different. As generally market exist in an economy because individuals have different marginal rates of substitution between goods, this opens the possibility of mutually beneficial trade. For instance, the indifference curves reached by A and B when they consume their endowments (u_{a_0} and u_{b_0}) form a lens-shaped area within which lie points that are Pareto superior to the initial endowment and which can be reached by A and B if they trade their claims on the commodities. At any point that is within this lens-shaped area but which is not on the contract curve segment MN , there exists a possibility of still further Pareto improving trade options. Once A and B are on the contract curve no further Pareto improvements are possible so one household can gain a utility at the expense of the other.

Thus, any point on the contract curve is a Pareto optimal allocation of the endowment. In an exchange economy a competitive general equilibrium can be established by assuming that an auctioneer calls out the relative price of goods x and y . In response, A (B) supplies good x (y) and demand goods for y (x). These offers are given by the offer curves OC^a and OC^b for A and B respectively. If the goods' supply and demand are not equal, the auctioneer calls out another relative price. The competitive general equilibrium is established at the point of intersection of the offer curves labeled E . Where A offers $X^a_0 - X^*_a$ in exchange for y^*_a and B exactly reciprocate. Trade takes place and A and B enjoys at higher levels of utility u_{a_1} and u_{b_1} respectively. Which constitute an increase in their real income. If each one of them remains at the original level of utility, they can transform this increase of utility into real income which amounts to $O_aE - O_aM$ in case of individual A and $O_bE - O_bN$ for individual B that is the difference between each individual's budget line from their common budget line after trade. At every point on the offer curve the marginal rate of substitution between the goods is equal to the relative price called out by the auctioneer, so it follows that E must lie on the

contract curve. From the shapes of the indifference curves at the endowment point it should be clear from geometric reasoning that a price line must exist so that A and B trade to a point such as E on the contract curve within the segment MN. Thus, a gain from trade must exist even under competitive market and the resulting allocation of goods is Pareto optimal. The Pareto optimal is one in which any change that makes some one (people) better off makes another (others) worse off. Thus, every point on the contract is Pareto optimal and the contract curve is a locus of Pareto optimal points. To summarize the economic behind these graphical analysis, it simply says that people will trade only if the trade makes the participants better off. If each person's mrs, is the same it is impossible to make both parties better off through trade⁹⁹.

As stated above each point on the contract curve O_1EO_2 , stands for a Pareto optimal allocations of the endowment X and Y. Converting these endowments in to a single concept analogous to the single endowments which we have discussed in the preceding analysis. The combinations of the two endowments stand for a certain level of utility, that is, each point on the contract curve there is a corresponding point of utility level for A and B. An alternative representation of these points along the contract curve is depicted in specific diagram known as the utility possibilities curve labeled UPC. Where, the utility of A is measured on the vertical axis and that of B on the horizontal axis. This curve is representation of the contract curve in this space. It bounds a set which contains all of the utility distribution levels of A and B that can be attained given the fixed endowment of goods. Without making the cardinality assumption about utility it is not possible to assign the property of convexity to this set. However, the utility possibilities curve must have a negative slope clearly showing that on the contract curve any increase to the utility of either party implies absolute decrease to the other party. The competitive equilibrium allocation of point E in fig.5.3a corresponds to a point e on the utility possibilities curve in fig.5.3c. It is apparent that e is just one among an infinite number of Pareto optimal distributions on the utility possibilities curve. However, it is also apparent that e is superior to the sub optimal utility distribution levels at MN in fig.5.3d, which directly corresponds to "M" and "N" in fig. 5.3c. That would be the situation had the two parties not been able to engage in exchange at all. Therefore, as the second theorem of welfare economics states that any Pareto optimal distribution can be attained by competitive

⁹⁹ Robin W .Boadway, Ibid, p. 67.

market system for some distribution of claims on the commodities, which presently, in this exchange economy grows out of the ownership of commodity endowments. It is asserted that any point on the contract or the utility possibilities curve which is in fact a kind of Pareto optimal point can be reached by engaging in exchange in a competitive market from some endowment point outside the contract curve⁶⁰. At any point on the contract curve there is a single relative price. The absolute slope of this price line is equal to the common marginal rate of substitution, where the exchange process of the distribution claims of endowments stops. And any further readjustment would be possible only at the cost of either party.

5.3.3 Monetary Assessment of Surplus Utility the Increase in Welfare

From the law of demand based on the above principles the concept of consumer surplus could be derived which is perhaps the best conveyed by Marshall's common sense definition for being the excess of what a person is willing to pay for a thing over the amount that he actually pays⁶¹. This notion is depicted in fig. It purports to measure the change in individual's or social welfare under certain conditions. It is the money measure of quantitative magnitude of utility (benefit) that consumers derive from consuming a good. Consider a Marshallian demand function for a good i.e.

$$X = D(p). \quad (5.1)$$

But, this follows in any consumption level x_0 . Now if the consumer is paying the $p(x_0)$ for all that x_0 units he consumes it, it follows that he is consuming or enjoying a surplus of total benefit over expenditure given by him

$$S(x_0) = B(x_0) - p(x_0)x_0. \quad (5.2)$$

In this analysis it will be of great convenience to measure the consumer's surplus some times

⁶⁰ Robin W .Boadway, Ibid.,.

⁶¹ J.M. Joshi, et al, 'Microeconomic Theory, An Analytical Approach', 5th ed., Division of Wiley Eastern Limited, 1994, p.64

in terms of a good, i.e., Y. in particular in the two dimensions we employ, y can be regarded either as a single good in a two-good economy without money which stands all goods at fixed prices other than the good X. We may assume that there is no matter whether the consumer's surplus is expressed in terms of good y or in terms of money as generally understood makes no difference to the particular conclusion to be drawn⁶².

In retrospect the derivation of these concepts of consumer surplus following the Allen Hicks analysis (1934), seems almost unavoidable. Let us recall one variant of the following diagrammatic features of the well-known familiar analysis of the fall in the price of a good x. after opening of trade. This exposition is useful to know and illustrate the idea that if the prevailing market price measures the value of the marginal unit the consumer buys. There, may in general be a surplus of total benefit over expenditure accruing to the consumer. In this connection we would like to put this discussion in a sounder and more rigorous footing.⁶³ Suppose the consumer has endowment of two goods x and y with a given proportions of x : y = 1 : 2 . where y is a basket of goods at given relative price of x that is $P_x/P_y = x/y$. Suppose the house hold's welfare depends on a given form of utility function.

$$U^0 = u^0(x^0, y^0) \quad (5.3)$$

Individual B has the endowment of x and y but with different ratio i.e. x:y =2. which stands for the relative prices of the two commodities where individual A has a large endowment of y and B has relatively less endowments in x, therefore, B wants to have more of x in exchange for y which he has relatively low endowments.

⁶² Ray Rees and McKenna, Ibid, p.76.

⁶³ Ray Rees and McKenna, Ibid., p.80.

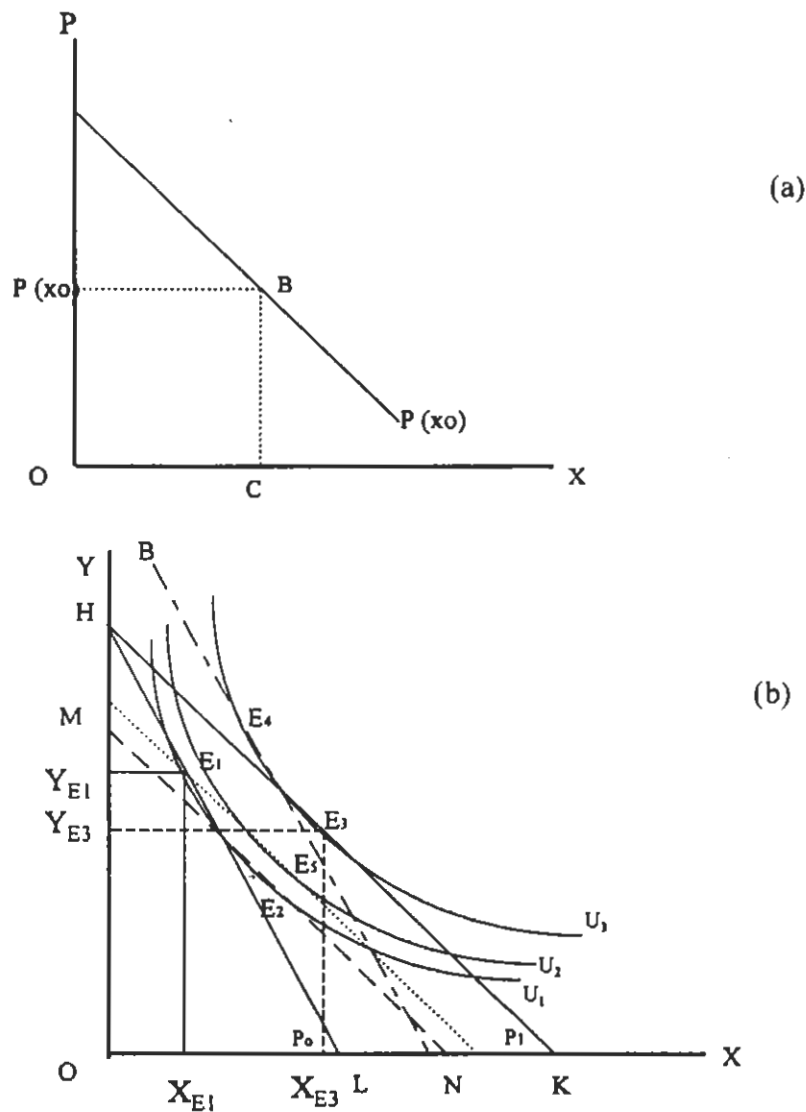


Figure 5.4 Monetary Assessment of Exchange Benefits:

Through exchange the consumers realize surplus utility mostly known as consumer surplus which nothing except a kind of gain from trade or profit pannel (a) indicates the concept of CS and panel (b) depicts it in more explicit manner. In this case we assume that the two individuals have endowment of x and y but with different proportions where A may have the ratio i.e $x:y = 1/2$ but B $x:y = 2$ These ratios stand for the relative prices of the two commodities. therefore, B wants to have more of x in exchange for y which he has relatively low endowments. Now if the two individuals exchange their endowments the welfare of both households will increase. For instance after the exchange of endowments the relative price of goods has decreased significantly, so the price line has shifted to right upward from HL to HK line. As a result consumer A is now consuming at point E_3 of the budget line which is tangent to the indifference curve at u_3 level of utility consuming yx composition of the two goods.

Now if the two individuals exchange their endowments where each individual is giving the cheaper good and acquires a relatively his expensive good. Through mutual exchange of the two individuals the welfare of both households will increase. For instance after the exchange of endowments the relative price of goods has decreased significantly, so the price line has shifted to right upward from HL to HK line. As a result consumer A is now consuming at point E_3 of the budget line which is tangent to the indifference curve at u_3 level of utility consuming y_x composition of the two goods. To illustrate the additional welfare or benefit obtained from his exchange is usually measured by the difference between the two budget or price lines. Such as MN and HK or HL and BN. Depending on the initial direction of change. J.R. Hicks demonstrated that a fall in the relative price of commodity affects the demand for that commodity in two ways; first it makes the consumer better off for it raises his real income and its effects along this channel are similar to that of an increase in income. Secondly it changes the relative price of the goods and hence, apart from the change in real income there would be a tendency to substitute the commodity whose price has fallen. The whole idea is to measure the difference between the utility levels of U_1 and U_3 . It is obvious that there are number of ways to do that. But our main task is to illustrate only that there is an increase in real income when the two individuals mutually exchange the two commodities. Without exploring various existing methods of measuring this real income generated by trade of the goods we may demonstrate the basic message of the above postulation.

An arbitrary methods of measuring the distance between the two situations of utility levels are evaluated in applied welfare economics⁶⁴. The two conventional techniques which are widely used in modern economic text books are compensation variation (CV) and the equivalent variation (EV). Briefly to illustrate how the real income that accrues to the households or endowment owners are measured, when the relative price of their goods change due to solely mutual exchange of their endowments, we use these two methods. The CV as a move from the original situation to the new situation is defined to be the income that could be taken away from a household in the new situation in order to leave him as well off as in the initial situation. That is the difference between the budget or price lines of HK and MN with slight difference between Slutsky and Hicks assumptions. In other words the CV is the

⁶⁴ Robin W .Boadway , Ibid, p.211.

amount of real income that the household may acquire if he would like to consume at the same original level of goods x and y that will be equal to the vertical distance between OH and OM . A point of our interest in this study is that the households can obtain a real income through mere mutual exchange of their endowments when their relative prices are different which is approximately equal to a certain real income that can make them reach a utility level of U_3 when the relative prices are constant that is the horizontal distance between BK and HL .

In our investigation to illustrate simply what is the amount of income that generated by the lower price level, the appropriate method of measuring seems to be relevant to both methods of compensation variation and equivalent variation while keeping the consumer at the original welfare level with the new relative price can be achieved only through the former in absolute term. And in this respect the last method gives as a positive amount of income. The EV is analogous to that obtained for CV and CS . The integrating conditions are satisfied at the symmetric condition compensated demand functions. Therefore, EV is unambiguously defined with a simple geometric interpretation can be given to each term under the integral equation (5.18). Suppose there is a reduction of the relative price in this two-commodity case. The above diagram shows EV as $Po-H$ in terms of the other good. In the lower diagram, the compensated demand curve along u_2 is drawn as $y(p, u_2)$ and Marshallian demand curve is $x(p, m)$. The EV is given by the line integration of this change or the area under the compensated demand curve. From this analysis we realize one important observation that $EV > CS > CV$. In the conventional studies CV and EV is the most widely used techniques for measuring of well-being change, for they are well defined, path independent easily interpreted through expenditure function, simply they differ only in their reference prices using the initial situation or the final prices as the reference point

This concept of consumer surplus has great similar characteristics of producer surplus, the nature of producer surplus is almost similar in nature to this important concept.⁶⁵ From purely theoretical view, however, the notion of rent as a surplus or the excess of the return to the factor-owner above that necessary to induce him to provide the factor(the services of land, capital and labor) is with the notion of consumer surplus, or 'consumer rent', for this

⁶⁵ Mishan, E.J.,(1981), 'Introduction to normative Economics,' Oxford University Press, Inc. p.145-180, 200-217.

can be described as the excess of the sum of the consumer is willing to pay above the amount he has to pay to acquire the good. Once this is recognized and precisely restated then the producer's surplus is almost analogous to that of consumer surplus. The symmetry between rent and consumer surpluses complete once we focus on the welfare effect arising from a change in prices. For just as the consumer's surplus is regarded as a measure of welfare change arising from alteration in one more factor prices, all other prices remaining constant⁶⁶.

5.4 TRADE AS THE PRIME VEHICLE OF PROFIT

On the light of the forgoing discussions, there are sufficient evidences to believe that the trade of goods and services among people in group nations or individuals to serve the principal vehicle for generating incremental or additional value that is known as profit. However, to substantiate, this believes, we will highlight, in the coming discussions, the natural forces that are inducing the realization of profit. The efficiency of exchange in production economy as well trading the services.

5.4.1 Natural Motives of Generating Profit

And from the preceding analysis we find that people conduct exchange activity for two significant reasons either one of them would be sufficient for trade to take place. The first major reason can be explained as that the people trade because they have different endowments and abilities of producing goods and services. And the second reason is because they have different taste. Precisely, the difference in resources and in preferences of the people constitute the fundamental vehicle of exchange. It is expressed that to benefit from trade it pays to be different from the others. In trading any difference is an opportunity to gain. This idea can be illustrated by practical example we may take the case of trade in similar goods. It is asked that why does it make sense for countries like USA, UK, Germany and other industrialized countries each one to produce cars for export and at the same time to import large quantities of them from other countries? Of course these countries have access to the best technology available for producing cars, and car workers of one country are surely productive and efficient as their fellow workers in Germany, USA or others. Capital

⁶⁶ Mishan, E.J.Ibid., p. 200-217.

equipment, production lines used in the production of cars are also available to any one of them. This line of reasoning leaves puzzles concerning the sources of international exchange of similar goods produced by similar people using similar technology. Why does it happen? Why do the countries like UK has comparative advantage in some types of cars and for instance Japan and other European countries in others? The first part of the answer to the puzzle is that people have a tremendous diversity of taste. In this case some people may prefer sport cars. Some of them like urban jeep, hatchback etc. There are many ways in which the cars may vary, i.e., some have low fuel consumption, some have high performance, large boot, front wheel drive, manual or automatic gears durable, flashy etc. The tremendous diversity in tastes for cars means that people would be dissatisfied if they were forced to consume from a limited range of standardized goods as the above story of Bani Israel has shown. People really value variety and are willing to pay for it in the market place, even if the sacrifice for the sake of variety is more valuable than what they receive in the eyes of others.

The second part of the answer is related to the factor of cost. That is the difference in the cost of production, someone may argue that according to the above similarity there may not be any considerable cost difference. If we incorporate the concept of economic scale of production the answer may be easy and self explaining reason, Usually the larger the scale of production the lower the average cost of production. The diversity of taste and willingness to pay for variety does not allow a highly diversified range of different types of goods. For instance car producers would not be able to reap economic scale if they try to produce every kind of car, where such level of current variety would be made available. If they try to do so the price of cars would be prohibitive and no one would be able to pay. But with the existence of trade and exchange system each firm can produce a specific type of a good in huge number on the face the whole market. This situation of market for cars is also typically applicable in many other industries, technological instruments; spare parts, computers etc. Thus it is the combination of diversity of taste and the costs of production that produces comparative advantages and generates such a large quantity of goods in international trade in even similar goods which is highly profitable activities.⁶⁷

⁶⁷ Machael Parkin, M.Powell, K. Mathews, Economics, 3rd ed. 1997.

This observation has a far reaching implication for ordinary economic implications of inter household exchanges as well as for international trade. Almost all countries get advantage from trade but those benefit the most are those whose citizens are most different from the rest of the world, by and large these are the small countries rather than big countries. Islam has recognized the endowment and human taste differences to be the basic driving forces of international trade throughout the history of mankind. Allah (swt) repeatedly reminded the people the importance of ships sailing over seas and oceans for benefit of humanity and that is the way of seeking the bounties of Allah(swt), i.e., to obtain different goods or gain profit through trade, Allah (swt) has said

"And the ships which sail through the sea with that which is of use to mankind ...are indeed *ayat* (proofs, evidence, signs etc.) for people of understanding" (2:164).

Traveling with these ships is the way of their beneficial trading as elaborated by Imam Razi the fundamental concept of trading expressing that Allah (swt) has endowed every part of the world certain kinds of specific resources and made the people of each part demand for the resources of the other part which serves as the basic motive that makes the people undertake all risks of oceans and lengthy voyages. If the endowments' differences were not, there they would not undertake it. In this operation the transporter reaps the benefit of profits and the purchaser benefits from the goods he received.⁶⁸

The great economists of 18th and 19th centuries A. Smith and D. Recardo respectively were the first in the West to recognize that the trade can benefit all parties and they illustrated the importance of comparative advantage. Smith started his discussion with a simple truth that for two nations to trade with each other voluntarily, both nations must gain if one nation is gained nothing or incurred loss it should simply refuse to trade. This law is. The message of this fundamental law is very simple. All countries of the world can benefit from international specialization and free trade. This important law is singled out as one of the greatest achievements of the classical school of economic thought and it remained unchallenged for almost two centuries. This idea finds many practical application outside the domain of

⁶⁸ Al- Imam Razi, Tafsir al-Kabir, vol.2, part 4, dara al maktaba al Ilmiya Beirut 1rst ed. 1990. p.178.

international economics. It simply states that when each country specializes in the production of that commodity in which the nation has a comparative advantage the total world output of every commodity necessarily increases (potentially) with the result that all countries become better off (save the limited case of a large country).⁶⁹

The modern economy and the very world as we know it today, obviously depend fundamentally on specialization and the division of labor between individuals, firms and nations. Though, the logic applies equally in interpersonal, inters firm, and interregional economic transactions, Because, the basic message of the comparative law in its true nature and applicability as well as its rationale is more obvious at individual level than nation level. Hence, the demand and supply at individual level are analogous to the aggregate supply and aggregate demand at country. The concept of absolute or comparative advantage would get clearer the more the size of the market is reduced. Conversely the more the size of the market increases the less would be these concepts relevant to the practical life. Naturally, individuals are different in their economic activities due to their abilities or tastes, where, one individual is more efficient in the production of certain goods or doing some kinds of services than another but less efficient in certain respects. Then both individuals can gain if each one specializes in the service or productive activity which he has advantage and exchange part of its output with the other individual for the commodity or service of his absolute disadvantage. By this process the resource available to the two individuals may be utilized in the most efficient way and the output of both products or services will rise. This increase in the output of both commodities measures the gain from specialization in producing by each what he can efficiently produce and trading the surplus to the other.

In case of countries there are large areas of similarities and it may happen that some countries may not see necessarily to trade with others but for preference or increasing their well-being, while, in case of individuals, trading is a matter of survival, where no one is expected to survive without getting the basic necessary goods or services which he cannot produce all of them by himself alone. Thus, without changing its essential message we can assert that the comparative advantage theory has tremendous implications on the economic activity at individual level. The unlimited, multidimensional human want requires different

⁶⁹ Miltiades Chacoliades, Principles of International Economics, ed. 1981 McGraw_Hill P.13.

kinds of goods and services to satisfy wants while at the same time no one can produce all what he wants. Due to the limited capacity of the individual he can efficiently produce only single good or a service at a time, so specialization is inevitable. As the specialization increases the concerned commodity or service displaces the other goods on the part of its producer and creates a situation that necessitates for him to seek exchange. Hence, there is a strong relationship between specialization and trade. Specialization on one hand improves the quality of production which increases the degree of satisfaction to consumers. On the other hand specialization increases the quantity of output in those goods or services. Moreover specialization increases the variety of the output in general as different sectors of the society specialize in different kinds of goods and services the general welfare of that society will increase and through exchange they raise their living standard.

5.4.1 The Exchange in Production Economy

Now, we consider an economy where individuals are not only recipients, but they engage in production activity. Haberler who rescues the classical trade theory emphasized that the sole purpose of the labor theory is the opportunity cost of one commodity in terms of another in each of the two countries⁷⁰. The crucial point to remember is that once comparative advantage is defined in terms of opportunity cost which reflects forgone production of other commodities⁷¹. It makes no difference whether commodities are actually produced by labor alone or by any number of factors production. The case constant opportunity cost, need not reflect the existence of a single factor, such as labor it may reflect the fact the factors of production such as labor and capital may be used in exactly the same proportion in the food and clothing industries. Where, in the contract curve in the case of a box diagram coincides with the diagonal, and production possibility curve becomes linear, reflecting constant opportunity costs, in this simplified model in which there is only single factor of production with fixed technical coefficients. To illustrate how the gain from trade or exchange is generated in the context of opportunity cost concept, we may take here two hypothetical examples, firstly, one in the case of exchanging services of two skilled individuals. Secondly, in the case of two firms or producers who will exchange their production goods.

⁷⁰ Miltiades Chacoliades, *Ibid*, p.14.

⁷¹ Miltiades Chacoliades, *Ibid*, p.15.

I. Trading of Production Goods

In this section we assume that A and B produce something rather than having endowments. Now A and B represent producers, no matter whether the producers are firms or countries in isolation. The nature of the of analysis may not change⁷². We assume also the production of two goods such as food and cloth with different costs. Suppose A specializes completely in the production of food and B clothing, where the total production of food and clothes are O_aR and O_bR respectively. Before, the trade A can consume only that it can produce. The same is the case in B so both of them consume according to their respective production possibilities curves.⁷³

Thus, we see that A's consumption combination of food and clothing with respect to its frontier, somewhere in between RF_a^T , similarly B can consume with respect to origin O_b may consume before the trade along the curve RC_b^T curve. Therefore, according to the comparative advantage principle the trade and specialization enhance the consumption possibility curve of the two firms/countries by the shaded triangular area $RF_a^TNC_b^T$. This shaded area is in fact the source of the gains from trade. The large the divergence between the slopes of the two production possibilities curves the larger the shaded area. This absolutely amounts to the gain from trade. In case the two lines have an absolutely equal slopes the shaded area shrinks to zero and gains from trade disappear. This confirms the fact that in the case of equal advantage there is no basis for trade⁷⁴ . . .

⁷² Miltiades Chacoliades, *Ibid.*, p.16.

⁷³ Miltiades Chacoliades, *International trade theory & policy*, 2nd print 1985, P.50-53 McGraw_Hill Book company.

⁷⁴ Peter H. Linder & Charles P. Kindleberger, *International Economics*, Irwing Publications 7th ed. 1982, P.36-52.

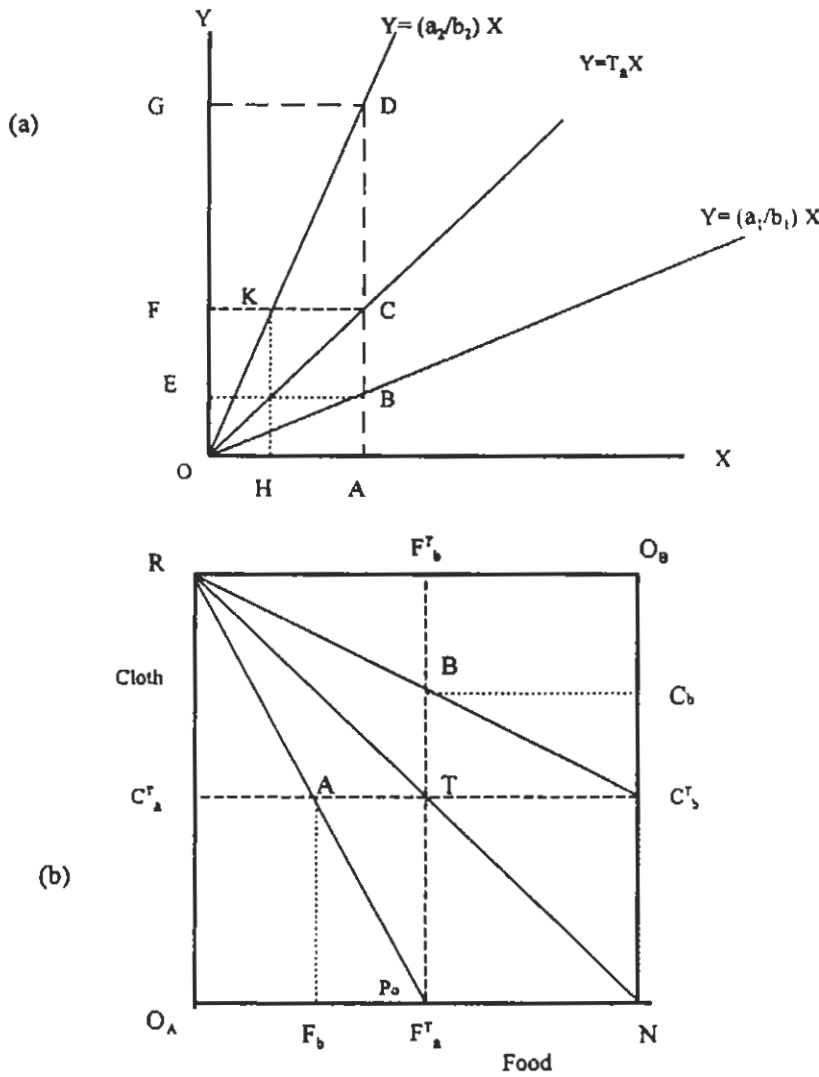


Figure 5.5 Gains From Exchange in the Form of Services Trade

In panel (a) illustrating in simple diagrams the comparative costs of the two individuals' services with different skills. Let the X axis denote the amount of cloth and Y the amount of food and L the amount of labor services per hour. With a given level of labor it is possible to obtain a certain levels of cloth and food at the ratio of $y = (a_1/b_1)x$ here (a_1/b_1) is the comparative cost which depicts the exchange ratio of the two commodities. The terms of trade is $y = T_1 x$ which is a straight line through the origin. at the domestic price ratio, individual 1 would have obtained $OE = AB$ of y for OA of x, whilst it can obtain $OF = AC$ by way of exchange. In case of exchange of goods directly in panel (b) we see that A's consumption combination of food and clothing with respect to its frontier, somewhere in between RF'_A , similarly B can consume with respect to origin O_b may consume before the trade along the curve RC'_B curve. Therefore, according to the comparative advantage principle the trade and specialization enhance the consumption possibility curve of the two firms/countries by the shaded triangular area $RF'_A NC'_B$. This shaded area is in fact the source of the gains from trade.

5.4.2 Trade in Services

Imagine in the first case, two skilled individuals: electrician and carpenter, each of whom wants his house rewired and his den paneled. Each one is relatively efficient in his major skill. Thus, their relative cost in each task in terms of service hours spent on each works are given in the following tables.

Figure.5.6

Electrician		Carpenter	
Rewiring	10 hours	Rewiring	20 hours
Paneling	15 hours	Paneling	8 hours

(a)

In terms of Opportunity Cost			
Rewiring	2/3 paneling	5/2 paneling	
Paneling	3/2 rewiring	2/5 paneling	

(b)

As shown in the above table the electrician requires 10 hours to rewire his house and 15 hours to panel his den. The carpenter knows relatively little how to do his own rewiring. But, because he is less skilled at it than the electrician. It takes him 20 hours instead of 10 hours. The electrician can panel his den in 15 hours comparatively less efficient in paneling than the carpenter 8 hours.

Without Trade		With Trade	
Electrician	25 hours		20 hours
Carpenter	28 hours		26 hours

(c)

The electrician can produce a rewiring job more cheaply than the carpenter can, because he rewires a house at a cost of 2/3 of a paneling job. Where as the carpenter rewires at a cost of 5/2 paneling jobs. We express this that the electrician has an absolute comparative advantage at rewiring. This simply means that he can do the job at a lower cost

than the carpenter can. Another way to say the same thing is that the electrician is more efficient at rewiring than the carpenter is. The concept of comparative advantage here implies the ability to perform a given task at a lower cost. We have chosen to define efficiency in such a way that the most efficient producer of a good is the one who produces it at the lowest cost. This follows from the definition of cost as the forgone opportunity⁷⁵.

We can now show in simple diagrams to represent the theory of comparative costs. Let x denote the amount of cloth and Y the amount of food and L the amount of labor services per hour⁷⁶.

With a given level of labor L_1 . It is possible to obtain an amount of cloth. $X = (1/a_1)L_1$. Where a_1 is the unit cost of the product food. Like wise with the same amount of labor it is to obtain

$Y = (1/b_1)L_1$ of cloth if we divide Y and X we get.

$$y = (a_1/b_1)x. \quad (5.4)$$

In this manner we could have arrived at the same result where the ratio (a_1/b_1) is the comparative cost which depicts the exchange ratio of the two commodities. Similarly we find in an analogous way that for another individual or a country.

$$y = (a_2/b_2)x. \quad (5.5)$$

For simple graphical representation of the above equations as two straight lines starting from the origin. The elementary straight lines tell us that, comparative costs are given by the slopes of the straight lines. The slope difference of the two line is obviously showing the their difference in comparative costs. That is, $(a_1/b_1) \neq (a_2/b_2)$ If the two slopes were equal the two lines would coincide. Therefore, the necessary condition for the trade to take place is represented the non coincidence of the two lines. The terms of trade can be represented as the

⁷⁵ Steven E. Landsburg, *Price Theory and Applications*, 2nd ed. The Dryden Press.

⁷⁶ Giancarlo Gandolfo, *International Economics*, Springer-Verlag B. Heidelberg 1986. P.57

slope of straight line, which may be denoted by T_s .

Then, $y/x = T_s$,

Where $y = T_s x$ (5.6)

Which is an straight line through the origin with the slope T_s . This, perhaps presents a sufficient condition for trade by assuming that line falls strictly between lines (5.1) and (5.2). This implies that having assumed $a_1/b_1 < a_2/b_2$, the following inequality

$$a_1/b_1 < T_s < a_2/b_2 \quad (5.7)$$

Similarly, if $a_1/b_1 > a_2/b_2$ then the condition would be the reverse, which may have obvious graphic representation. Assuming this condition to hold a profitable trade will take place and it would be advantageous for individual 1 to specialize in the production of X and of individual 2 to specialize in the production of Y. In terms of the above diagram, this proposition in fact amounts to saying as follows; (a) that individual whose line representing its comparative cost line lies between the line representing the terms of trade and the horizontal axis will find it profitable to specialize in the production of the goods measured on this axis and (b) that the individual whose comparative cost line lies between the terms of trade line and the vertical axis will find it profitable to specialize in the production of the good measured on this axis.

To further illustrate this point, let us suppose that a given the terms of the trade T_s , a quantity O_A of X is exchanged for OF of y . It is very obvious that the amount of OA is given by individual 1 (and so received by individual 2), while, the amount OF is given by individual 2 (and so important by country). In proof of this proposition, we shall measure the gains from this trade accruing to each individual. In this example, let us consider that at the domestic price ratio, individual 1 would have obtained $OE = AB$ of y for OA of x , whilst it can obtain $OF = AC$ by way of exchange. It is therefore, profitable for individual 1 to engage trade operation in the above described a pattern. And the gains from trade accrued to individual one may be measured for instance in terms of y , they are given by the segment BC . In the same pattern the analysis of individual 2 may be illustrated, that is the domestic price ratio, would be $OG = AD$ of y to obtain OA of x whilst it has to give up $OF = OC$ by way of exchange. It is therefore, profitable for individual 2 to engage a trade in the way we just

described above. And the trade benefit accrued to this individual 2 measured in terms of y is given by the segment DC. An alternative diagram of this trading model the theory of comparative costs is based on the concept of transformation curve or (production possibility curve) used in microeconomic text books. In this simplified model, in which there is only one factor of production and the technical coefficients are fixed, the transformation curve is linear.

5.5 THE QUALIFYING ASSESSMENT IN THE PURSUE OF PROFIT

Islamic injunctions do not only clarify what is prohibited and what is permitted in business dealings but beside laying down the fundamental principles for all financial activities. The Qur'anic verses clearly encourage the people to use the day for profit-making activities. Most of the verses which are reported to have been revealed in Makkah demonstrate that the commercial activity of shipping and transporting the goods through the sea as the bounty bestowed by Allah (swt) on mankind. We find in this connection numerous verses of the Qur'an that clearly indicate the importance of the trade across the seas and oceans and Allah (swt) linked the travel on ships through the seas to that of seeking His bounties in trade, which is actually the profit and benefits gained from transporting goods from corner of the world to another.⁷⁷ Further more, the Qur'an stated that Allah (swt) made the earth manageable for men to traverse through its tracts and enjoy the sustenance which he furnishes.⁷⁸ Moreover, Islam placed the spiritual and material requirements at the same footings Muslims are ordered to observe the prayers specifically Friday's one for its particular importance and stop commercial activity when the call for the prayer is announced, but to resume engaging trading after that.⁷⁹ However Islamic commercial principles establish a comprehensive framework and fundamental building blocks for smooth functioning of the business activities. In this section we concentrate two of them namely; the role of mutual willingness of contracting parties and evaluation assessment or proper measuring of exchange objects.

⁷⁷ See the verses of the Qur'an, 16:14, 17:66; 45:12; 10:12; 23:22;26:119; and others

⁷⁸ Qur'an, 67:15.

⁷⁹ See Qur'an, 62: 9-10.

5.5.1 The Principle of Mutual Consent

In Islam the additional value of trade is linked with exchange in mutual willingness. The Qur'an and Sunnah have shown that the essential basis and the fundamental functions for the transaction contracts are the mutual willingness of the involving parties. The *Ayat* in this context express two things, firstly the prohibition of devouring the people's properties or money (*bil batil*) wrongly, secondly the exception from this prohibition *Tijara an taradin*- that devouring them through trading with mutual willingness is permissible. Ibn Taymiya noted that the willingness should come from both parties, but, in case of charities the willingness of either party is sufficient. As far as the literal message of the term *Illaa* is concerned, the Islamic scholars mentioned two interpretations; in the meaning of exclusion "but"- which implies that "but the *Tijara* in mutual consent is permissible".⁸⁰ Or in the sense of continuous exception that is "even though it is in the form of *Tijara* in mutual willingness".⁸¹ The last interpretation covers the prohibition of various unlawful business behaviors for they are subject to *riba*, *gharar* etc. This means that the said transactions are prohibited even though you may conduct them in mutual willingness.⁸² However, the mutual willingness is a necessary condition for all financial transactions without which contracts are considered as invalid.⁸³

In any case what is clear from the principle of mutual willingness is that while, eating up each other's property in vanities and faulty way is strictly forbidden by Islam, the eating up each other's property through *Tijara*- trade is allowed in the Qur'an, provided that such *Tijara* must be concluded "by mutual willingness or with good will". The contract of *bay'* takes effect with the offer and acceptance of the two concerned parties.⁸⁴ And there is a unanimous view of the essence and requisite of "mutual willingness" in any form of *Tijara* or contract of exchange whether cash or deferred - is fulfilled when the contract is dully concluded by the offer (*ijab*) on the part of contractor and the acceptance (*qabul*) on the part

⁸⁰ Syed Nash'at Ibrahim al-Darini, *Al-Tradin fi al-Uqud al-Mu'amalat al Maliyya*, Darul Shuruq, 1982, p.58

⁸¹ Syed Nash'at, Ibid.

⁸² Syed Nash'at, Ibid.

⁸³ Syed Nash'at Ibid., p.59

⁸⁴ Malghani, Ibid.,

of the contractee⁸⁵. This is the essence of the above phrase in the verse. The *ahadith* of the Prophet(saw) also confirms this view "Indeed exchange is based on mutual agreement".⁸⁶ and "someone's property will not be lawfully acquired by another unless it was given to him willingly".⁸⁷ Abi Sa'id al-Khudriyi reported from the Prophet (saw)that Ibn Hajjar also mentioned in this context that the *Ayat* confines the permissible trade in mutual willingness.⁸⁸ Hence mutual consent among parties to exchange is considered as the central principle to the juristic view of exchange and foundations of their opinions on the issue. Therefore, any attempt of forcing them to exchange or to prevent them from exchanging may raise the question of injustice. Ibn Taimiyah observed that "to force people to sell their objects which are not obligatory to sell, or restrict them from selling a permissible object are injustice and therefore unlawful"⁸⁹. In *Fiqh* context the bay' or sale is an exchange of commodities for other commodities, it is a pre agreed contract of exchange with the mutual consent of the parties involved. Every contract of exchange is *Tijara* no matter in what form of market the commodities or services exchanges are. Hence *Tijara* encompasses both in spot and various types of deferred transactions. The wisdom of Shariah in imposing the rule of mutual consent is demonstrated by jurists to be based on consideration of fair play in the market. Assuming that the parties are sufficiently rational in their preferences and decisions, we rule out where there is no benefit to either party or exchange benefits of one party to the detriment of or even harm to the other party, or an exchange where neither of the parties benefits. For any mutual trading between rational parties must have certain beneficial objectives of either accruing more benefit to one or both parties or reducing kind of pain or difficult of either party without reducing the benefit or increasing the difficult of the other.

Perhaps the wisdom of this permission is taken into consideration that trades activity may not always generate profit, it may probably get into losses where either party in the contract realizes decrease of his original capital, an amount which could be translated - regardless of the real cause of the loss -as a profit reaped by the other party. Hence, Islam

⁸⁵ Abdul Halim Ismail, *The Deferred Contracts of Exchange in the Qur'an*. Ibid., p.310

⁸⁶ *Fathu al-Bari* vol.4, p.230

⁸⁷ *Fathu al-Bari* Ibid.

⁸⁸ *Fathu al-Bari* Ibid, p.230

⁸⁹ See Abdul Adim. I., 'Market Mechanism in Islam: A Historical Perspective', *Journal of Islamic economics* vol.1, No.6,(1995), p.10..

teaches that not to assume the loss of either party in trade contract to be the gain that might be realized by the other. So that this kind of gain might not be thought to fall under the above prohibition. Usually one commodity passes over many traders and each one obtains certain amount of profit. For instance, the last trader incurs loss, this loss should not be considered due to the gains obtained by the preceding traders. In another aspect, when the two parties are conducting the business, it is very difficult or probably impossible to figure out the exact amount of profit/benefit that goes to either party. Only through bargaining they conclude the deal without concerning who take greater profit. And perhaps the satisfaction of each is the best indication of their equity in the distribution of trade benefits. This idea, in fact, has great implications in international trade policy, and it has been intensively debated in international trade conferences how to share the benefits and gains of trade.

In this connection three rules are pointed out⁹⁰ such as mutual consent, contract fulfillment and fairness in exchange. Therefore, in Shariah injunctions mutual consent constitutes a centerpiece of exchange and financial transactions, while, exchange that confirms with the rule of mutual consent is considered by the jurists as valid. They recognize some invalid cases such as that contracted under coercion or misrepresentation, violating the rule of knowingly mutual consent. So, taking into account all these aspects, Islam establishes a very important and transparent principle of permitting the benefit that may go to either party or both from a trade concluded in mutual willingness and complete consent of the concerning parties. This is the essence of what Islam has declared its permission provided that the trade must be completely clean from the undesired elements such as; *riba*, and *gharar*. While *riba* could be avoided when the transaction involves the exchange of different goods and the transaction is not characterized in features of two transactions in one sale, the abstinence of *gharar* requires a complete information about the characteristics of exchange items. The following Qur'anic verses reveal certain important implications on the above understanding, Allah (swt) has said:

"And eat up not one another's property unjustly (in any illegal way, i.e., stealing, robbing and deceiving, through *riba* or *gharar*) not give bribery to the rulers (judges

⁹⁰ M. L. A. Bashar, Two Aspects of Exchange in Islamic Jurisprudence; Rejoinder, *Review of Islamic economics*, vol. 4, No. 1, 1995, p.17-27

before presenting your cases) that you may knowingly eat up a part of the property of others sinfully." (2:188).

These verses emphasize on the prohibition of devouring one another's property unjustly and sinfully with full consciousness and knowledge, for this will consequently lead people to aggression and killing each other. However, Allah (swt) is merciful for those who avoid the great sins such as; *riba*, stealing, robbery, killing each other, etc. and forgives the small ones.

These Qur'anic verses contain a profound comprehension of the subject of uncertainty bearing which should have to be viewed as the source of both profits and losses.⁹¹ While Islam shows a liberal treatment toward the fluctuations of price system, it also laid down certain moral measures and general market regulations. For the relative needs of the two individuals for the sale object is the major factor that determines the price level, Islam restrained the increase of price which may harm either party under difficult circumstance. The Prophet(saw) has forbidden to deal with an individual in selling or purchasing under pressing situation. It is related to Ali (ra) that the Apostle of Allah(swt) forbade buying and selling with person who was in dire need or difficulties and he forbade the selling of an article the availability of which was not certain and fruit before it was ready for harvesting"⁹² (Abu Dawud).

5.5.2 Principle of Valuation and Proper Measuring

Another important aspect relevant to business transactions associates with evaluations and proper measuring of the intended objects. As we have stated earlier the additional or excess value should be visible measurable and avoidable. If *riba* is excess or increase, it can be evaluated in quantitative and qualitative assessment. Islam has extremely emphasized the importance of measuring and has made obligatory that a perfect measuring must be observed in transaction or exchange dealings. A numerous verses of the Qur'an are clearly demonstrating the great importance attached to this principle. Allah(swt) says that;

" Verily a clear proof (sign) from your Lord has come unto you: so, give full

⁹¹ Abdul Halim Ismail, Ibid., p.298.

⁹² Ma'arif Hadith (524) vol.1v, p.358.

measure and full weight and wrong not men in their things, and do not do mischief on the earth after it has been set in order, that will be better for you, if you are believers."⁹³

The basic purpose of this principle is to observe a fair transactions in business activities and there should not be any unjustified increase accrued to either party. Usually the difference in quantity of the exchange items can be discovered by using a standard unit of measurement, weighing, or counting according to the physical nature of the two goods. For exchange necessitates the fulfillment of the agreed standard thing according to the contractual obligation made by the two parties. That is on the basis of Qur'anic verse "O ye who believe fulfill (all) obligations" (5:1), The gravest form of lack of fulfilling the obligation is that which arises from giving less or taking more than what one deserves in a way that the other party will not detect the shortfall or excess⁹⁴. Bashar (1994) observed that this kind of activity is very much and highly sophisticated in our modern time. For instance, metering devices in electricity, petrol pumps, milk bobbies, telephone calls, etc.⁹⁵ Islamic injunctions have laid down a universal standard of fulfilling measurement in an exchange contract. A large number of the Qur'anic verses are focusing and emphasizing on this important aspect. It is required provision of adequate and sufficient criteria, such as, smooth and natural operation of the market and standard unit of weighing and measurement.

But, qualitative difference or excess that arises from quality distinction of the two goods can be detected through market prices of the two items, provided that they are the same in all other respects. For instance, if the two goods are homogeneous, but they have observable quality difference, the only way to assess this difference is through their market prices. The prevailing price in the market in its normal condition can be the measuring rod of the qualitative discrepancy between any two commodities of similar kind. However, the market to exhibit the actual values of exchange items, the natural forces of supply and demand should fairly interplay and independently determine the prices of goods and services. This calls for another important rule of smooth and independent functioning of the market in such

⁹³ See the Qur'an 7:85, also see 11:84-5, 26:181-3, 17:35

⁹⁴ See the verses the Qur'an (83:1-5)

⁹⁵ M. L. A. Bashar, Ibid, p.25

a manner where there is no deliberate attempt of cheating, coercion, hoarding, *gharar*, or misinformation, misrepresentation etc.

The above two rules of mutual consent and fulfilling standard measurement are considered as necessary conditions for establishing fairness in the market. Although in the *Fiqh* injunctions that relate to exchange do not illustrate a clear separation between fair and just price, the adherence to the above rules of exchange may lead to the emergence of fair or just price in the market. Islamic jurists called such exchange value the 'price of equivalence'. However, it is observed that neither the Islamic jurists elaborated the concept of "price equivalence" sufficiently nor contemporary Islamic economists properly addressed it in an analytical manner. Since, there is no attempt to measure the 'equivalent price', we rely entirely on the *Fiqh* treatments of the subject. According to jurists prices are considered as exchange values expressed in terms of money⁹⁶. The exchange value may be expressed in many different ratios as the commodities for exchange where each commodity has a certain proportions of exchange value with the rest of the existing economic goods. However, it is pointed out that the Islamic jurists understood that often the harmony of fairness and justice in exchange is not obtained because of the divergence between price and exchange value, resulting in nonequivalence of prices. Zarqa also recorded this observation. The *Fiqh* scholars envisaged that the price at which two parties exchange is often disproportionate to the exchange value of the commodity. They called the difference *ghubn*. Obviously, the divergence of price from exchange value is the measure of nonequivalence that gives rise to the problem of identity among valid, fair and just price. Bashar has tried to distinguish between fair and just prices. According to him fair price might be described as that price which follows Shariah rules of exchange. A just price on the other hand is that which satisfies all possible legal requirements without violating any extralegal principle of Shariah. From this view it is evident that price of equivalent is likely to have loopholes with regard to fairness and justice.

It is the objective of Shariah to preserve fairness in the distribution of the benefits among parties of exchange that is to restrain the parties of exchange from taking more than their due share in the gain from the trade which may lead to *gharar* and *ghubn*. Nevertheless, *ghubn* is considered as a common element in trading and hardly avoidable element. So, it is

⁹⁶ Abdul Adim Islahi, *Ibid.*, p.10.

treated permissible Al-Ghazali named it as a part of *Ihsan*, as long as there are no deception and misinformation then taking high level of profit is not injustice itself. Islamic Scholars have shown a considerable tolerance on lofty profits that may accrue to either party through *ghubn* unless it become excessive. Ibn Rushd showed more liberal over this point and stated "let the people be in their unawareness and Allah (swt) provide *rizq* (sustenance) from one another"⁹⁷ However, if the *ghubn* becomes immoderate that is to exceed, i.e., 1/3 or 33% of the prevailing price level they expressed it necessitates option in the trade contract.⁹⁸ Sheikh Yusuf Addajor of Maliki school is in the opinion that *al-ghubn* if it exceeds 1/3 of the goods' price, the trade contract is to be commented. He mentioned that it is a permissible *ghubn* even if the price varies from the general prevailing levels, in more or less, and even if the purchaser is aware of this difference, unless the selling party commits deception and falsehood⁹⁹. Islamic business principles have shown a considerable flexibility in the distribution of gains from *Tijara*. For this area falls under *gharar* and human ignorance or *ghubn*, it is amiable and tolerable problem to the large extends. However, *gharar* may be minimized through exposing a detail information about the characteristics of exchange items and the stipulation conditions of the contract. The required information must include, the nature and the standard quantitative and qualitative aspect of the items, the time of delivery as well as the transparency of their original costs.

As far as the price determination is concerned in the context of sale and purchase process three forms are relevant firstly, *al-Musawama*- through bargaining this process the sale is concluded on the basis of negotiation irrespective of the original cost/principal to the seller. Secondly, *al-Musayada* (auctioning) where the people make bidding against one another over goods put up for sale and goods are received by whom pays the highest price. Finally, *bay'al-amana* (sale on trust)- a sale in which the seller fixes the price of goods with reference to its original price. This sale on trust may have one of three forms known as *Murabaha* (selling at cost with mark up), *Tawliyah* (selling at break even) and *Wadi'ah* (selling at discount). According to al-Kassani this contract is regarded a sale of trustworthiness or reliability, because the purchaser has entrusted the seller to fix the original price without any

⁹⁷ See Islamic economics Magazine. DIB. Nov. 1997

⁹⁸ Hamid Al-Ghazali. *Al Ihya'u Ulumuddin*, Quoted in *al Iqtisad al Islami*, DIB. Nov. 1997

⁹⁹ *Iqtisad al Islami*. DIB. Nov. 1997

evidence. Keeping the mutual confidence of the parties it is incumbent on the seller to be just and true to his word and to abstain from misinformation. These are all generally accepted transactions. However, the successors ruled that it is not permissible to purchase any good at discount from the original cost¹⁰⁰ While, the other two kinds are confined to specific business circumstances as necessary options, *Murabaha* is the usual and predominant one. Comparing to the other sale processes *Murabaha* is relatively more just and mutually advantageous. It serves the purpose of protecting the common unskilled consumers from the wiles and stratagems of shrewd businessmen.¹⁰¹

Thus, the *Murabaha*-based mode of finance in which the intermediary must disclose the original cost of the goods and profit margin that he is going to obtain to his clients is the appropriate instrument for this transparency purpose. The original cost that the intermediary agency incurred in the process of bringing or producing certain commercial items is very important for the client. Disclosing this information enables the client a bargaining position for it is the sole means of knowing whether unreasonable profit is accruing to the agent or not according to the given price, hence this method of determining the sales' price with the reference to its original cost of the goods to the seller provides the purchaser a modicum of protection against unjust exploitation by unscrupulous merchants.¹⁰² This also gives other competing agents incentive to enter the market whenever high rate of profit is noticed. In this way *Murabaha* may serve as an effective tool and distributive principle of trade benefits among participating parties, and reduce the element of *ghubn* or ignorance to the large extent.

Number of Islamic economists have expressed certain reservations over the operation of *Murabaha* transaction and the impersonal market mechanism of capitalist system and argued that market in Islam is necessarily regulated one. Abdul Mannan (1992) argued that there is a need for controlling the market prices which in Islamic context tend to be personal and human in character where as in the market economy they tend to be impersonal in nature this according to him is the essential difference between the two. However we see in the context of this framework the market is an autonomous & self managed institution provided that it

¹⁰⁰ Alwi, Ibid, p.96

¹⁰¹ Ali Ibn Abi al-Mirghinani, *al-Hidaya*, vol.3 (Cairo. n.d.) , p.56

¹⁰² A.L. Udovitch, *Partnership and Profit in Medieval Islam*. See also Alwi, *Sales and contracts in early Islamic law*, p.96

works naturally and there are no ill-will tendencies of human intervention. Nevertheless, certain measures may be needed to the extend of undesired human behavior influences the natural operations of the market and its autonomous mechanisms. Perhaps that is why the Prophet (saw) refused to fix prices even when they rose very high, his refusal was based on the principle of fair dealings in business which does not condone forcing the suppliers to sell their goods at lower than market prices as long as the price changes are induced by the real factors of supply and demand. After the Prophet (saw) and through out the many centuries of Islamic history, Muslim Society has preserved this cherished principle of freedom of choice.¹⁰³ Imam Abu Yusuf related the price fluctuation to divine will and command of Allah (swt). He states that "There is no definite limit of cheapness and dearness that could be ascertained . . . cheapness is not due to plentifulness of food not dearness is due to scarcity. They are subject to the command of Allah (swt). Some times food is very much but still very dear and sometimes very small or too little but cheap".¹⁰⁴ But, Ibn Khaldum described it in the context of supply and demand forces and illustrated the effect of increased or decreased supply on prices. He says that "When goods are few and rare their prices go up. On the other hand when they country is near and roads are safe for traveling there will be many transport of goods. Due to these there will be found in large quantities and their prices will go down"¹⁰⁵.

5.6. CONCLUSION

In this chapter we have established that both *riba* and profit are additional values which entirely fall in the context of pure exchange economy. They are outcomes of transactions by substituting one thing for another in the broad sense of term exchange. The classical *Fiqh* scholars in their explanations of *riba* and profit have built their views squarely in the frame work of exchange theory, whereas the problem with *riba* is identified to be its deficiency of counter value. However, despite this fundamental theoretical comprehension of the earlier *Fiqh* experts, the question of counter value on the light modern economic theory has not been properly addressed. We have realized that the problem requires to reconsider the nature of

¹⁰³ Monzer Kahf, 'Market Structure: free cooperation, Readings in Microeconomics and Islamic Perspective S. Tahir eta el (eds.), 1992, P.149.

¹⁰⁴ Imam Abu Yusuf (731- 798 CE/113 - 182)

¹⁰⁵ Ibn Khaldun: The muqaddimah & introduction to history. Tramze Rosenthal: Translation Ballingen foundation 1958 P. 337.

exchange itself and economic advantage as the deriving force of individuals. To do so we have come up with the fact that dividing the transactions on the basis of economic relations of exchange items reveal an extremely significant dimension of the problem. So, exploring this economic relations of exchange items, it is very important to divide economic goods into homogeneous and heterogeneous kinds. On the basis of the fundamental principles of price theory, we concluded that objects express their exchange values reciprocally against each other. However, in the case of a particular object against itself, the situation is totally different. Although the concept of exchange as we mentioned above are still applicable to the transaction in homogeneous goods, the objects are silent to express their own exchange values. For the price of an article in respect to itself would be equivalent to itself only, no more no less. For instance in case the counterparts are the same kind with different characteristics no either consideration will directly indicate the exact price of the other. Therefore, the theory of value necessitates that another item must be introduced in assessing the exchange price of the object and accurately measuring the economic relations of the considerations.

Concentrating on *riba* versus profit, we tried to illustrate the underpinning logical principles of the prohibition of *riba* and the permission of the profit. The exchange which implies total transformation of goods through production process or intermediation generates profit and this is known as trade in Islam, exchange of similar items which has no transformation is not subject to generate except *riba*. Thus, this division of exchange on the basis of economic relations of objects is crucial matter for distinguishing between these two fundamental concepts. In this connection we tried to formulate a solid microeconomic foundations for a logical separation of the concepts of *riba* and profits. Employing the relevant standard principles of modern economic theories, we demonstrated that the profit-oriented activity leads to an increase in welfare for the participating parties and economic efficiency, but, *riba*-induced behavior leads to scarcity, want or reduction in welfare. The Qur'an has precisely demonstrated the position of the two in Islam "And Allah has permitted sale and prohibited *riba*"(2:275). The rationale of this revealed fact may be concluded as follows;

- i. Trade is an exchange of two different utilities which increases the welfare of the both parties, while *riba*, in contrast, is a zero sum game phenomenon, the gain of either is loss to the other. It arises from the exchange of two identical utilities contained by the same kind of goods, then there is no way to increase the utility of one party without

reducing that of the other.

- ii. Trade is a transaction contract which takes place, once for all, where, a constant amount of a good is exchanged for a fixed level of its market price, irrespective of whether, it is in credit or cash transaction. , While *riba* in its peculiarity is implicitly a form of multiple selling of the same commodity, that is, an incremental amount acquired over and above its principal more than one time. This is the common practice of present credit system of interest based financial institutions.
- iii. The trade when its contract is concluded in mutual agreement, the ownership of sale commodities is reversed and reciprocally transferred to respective parties. But, the contract of *riba* transaction does not change the state of the ownership.

However, the permitted trade calls for certain general qualifying principles of just measurement, accurate description and mutual willingness, which means the transaction must take place with completely free consent of the two parties. The trade to be *gharar*-free the above measures must be observed and disclosure of costs and prices of exchange goods are required for the sake transparency. Comparing different kinds of trade modes *Murabaha* seems the most appropriate mode of transaction.

CHAPTER 6

THE NATURE AND ROLE OF TIME ELEMENT IN ECONOMIC TRANSACTIONS

The closely related topics of Interest, profit or *riba* versus a profit-sharing, together make the basic ingredients of the financial economics. They associate with and lie at the heart-center of what is known as in brevity "Capital theory" in the modern text books.¹ Capital theory represents an extension of economic analysis into the domain of time and uncertainty as an opposite of certainty and timeless.² Generally, capital is considered one of the most difficult branches of economics from the theorist point of view. Despite this fact it is also regarded as a branch of intense immediate concern from the practical man's point of view. There is no doubt that all fundamental economic concepts of resources, commodities, preference, and productive process indispensably involve time.

According to the literature on the subject, to invest generally means to sacrifice or exchange goods of a current date for some goods of a later date and in conventional economy the interest is considered to be an element of a price ratio (an exchange rate) between present and future goods.³ However, the economists realized the conceptual difficulties someone may face to explain the nature of time and its economic role. Understanding the nature of time and its implications in economic transactions have very great importance in Islamic points of view. Undoubtedly the time element is strongly related to the fundamental issues of Islamic financial system. Whether an abstract time entitles to economic value or not or increase in sale price on deferment imply acceptance of a time value make the traditional deadlock issues in the Fiqh interpretations and contemporary Islamic economic literature. The nucleus of the issue lies with the understanding of the fundamental Qur'anic principle that "Allah has allowed sale and forbidden *riba*" (2:275). Where, the permitted sale encompasses all kinds of credit/deferred transactions and although Islamic jurists are in a consensus that the price of a sale contract may be increased in case of deferred payment, they completely reject any increase on the borrowed principal.

¹ Herishliever, J. (1970). 'Investment interest & capital'. Prinice-Hall INC, p.2

² Herishliever. Ibid.

³ Roge Laroy Miller R. W. P alsinelli (1985) Modern Money and Banking, p.467

The rationale of this apparent duality requires to be properly addressed. The problem arises from the inconsistency between the rejection of time difference in exchange of *ribawi* articles and the time lags that is essential for the nature of a loan. Where in case of lending the period of the loan has no time value as any economic value attached with this period will amount to clear *riba al-nasia*, so, it is unacceptable. Moreover, the permission of a price increase on credit sale is categorically considered by the majority of Fiqh scholars as a permission to time value Ismail (1993), Saadallah (1994). Given these apparently conflicting considerations of Fiqh scholars about *riba* in the domain of controversial subject of time value we look into the following questions; What is the nature of time, time value or consumer time preference? What is the concept of time in Islam? Is there a pure time value of money in Islam or does, the future value of the same good must necessarily be greater than the present one? . In searching answerers for these questions, in section 6.1 we examine, the nature of time element and time value. Sect.6.2 presents debates on Consumer Time Preference in which we may discuss the conventional theories underlying this assumption the views of contemporary Islamic economic writers on the basis of their subsequent discounting postulations. In section. 6.3, we will present the critiques and alternative considerations of Consumer Time Preference in both conventional literature and contemporary Islamic economic teachings. In this connection we will examine the production preference, saving behavior, liquidity preference theory as the main evidence of the weaknesses of Consumer Time Preference. Sec.6.4 critically analysis deferred sale and time factor in Islamic perspectives reviewing the existing conflicting thoughts about the subject. It formulates a synthesizing view in its entirety. Sec. 6.5 looks the nature of a loan in Islamic points of view and it examines the role of loan transaction in Islam. Finally we come to the concluding remarks on the chapter.

6.1 NATURE OF TIME ELEMENT

The great economic thinkers of this century expressed this phenomenon in the following statement "The element of time is the center of the chief difficulty of almost every economic problem." ⁴. The Walras's general equilibrium is built on static analysis of economic theory which shows extremely difficulty to extend it and to take into account, the time dimension with all it's implications, while maintaining as a powerful tool for explaining actual economic

⁴ Alfred Marshall (1961,p. vii).

activities. Nevertheless, the modern inter-temporal equilibrium is considered as an advanced formulation of an integral economic theory that takes the factor of time into the account which partially meets requirements of the problem. In conventional enter-temporal theories of time value of money is based on the assumption that all goods and services even of the same quality and quantity are treated differently, on the point of time difference. Bohm-Bawerk (1888) emphasized on that present goods are higher in value than future goods of the same kind and number.⁵ He discussed in detail this issue arguing that present goods are as a general rule worth more than the future goods of equal quality and quantity.⁶ And this is considered the nub and kernel of the theory of interest.⁷ Following this view, Bliss (1980) also tries to justify the value of time in economic goods and points out the existence of an analogy between space and difference in geographical locations and time span which similarly distinguishes economic activities. More over time is looked upon as the essence of capital good, hence, capital is equated to time, while those who raised objections to this view simply argued that, if capital is time, more capital is not more time.⁸

Perhaps one of the greatest thoughts about the nature of time is reflecting from the Newtonian conception of time spatialized that is its passage is represented or symbolized by movements along a line portrayed as a succession of line segments(discrete) or points(contineous). In either case time is fully analogized to geographical space and what is true of the later is true of the former.⁹ Neoclassical economists held this view in theory. It is also noted that time is universally a standard unit of measurement or account for the duration of events and existing thing. Like any other unit such as weight volume and metering, time measures the length of events and activities or period of an existing thing. Secondly time appears like numerical concept it is an abstract word which gives reference to the events or things. Islamic teachings indicate the abstract nature of the time and its similarity and close association with arithmetic theory. The conceptual relation between a time and numerical notion might be grasped from the following verses of the Holy Qur'an;

"It is He who made the sun a shining thing and the moon as a light and measured out

⁵ See Bohm-Bawerk, Von, ([1888, 1914] 1958)'Capital and Interest'. History and Critique of Interest

⁶ Bohm-Bawerk, Ibid.

⁷ Maclachlan, Fiona C. (1993) Keynes Theory of Interest: Reconsideration, p.52

⁴ Bliss, J.(1975), 'Capital Theory & Distribution of Income', p.13

⁹ Gerald B. O'driscoll. JR. and Mario J. Rizzo. The Economics of Time and Ignorance, 1985, p. 3

for its stages that you might know the number of years and reckoning. Allah did not create this but in truth and He explains the *ayat* (proofs, evidences, verses, lessons, signs, revelations etc.), in detail for people who have knowledge" (5:10).

"And We have appointed the night and the day as two *Ayat* (signs etc.). Then we have obliterated the sign of the night with (darkness) while we have made the sign of the day illuminating that you may seek bounty from your Lord and that you may know the number of the years and the reckoning. And we have explained every thing (in detail) with full explanation" (17:12).

The measurement of time involves established system of standard intervals and references for specifying any event that may occur. In our contemporary world the fundamental unit of a time interval is the second, but reference time scale could be based on any phenomenon that involves change with time. Imam Razi has pointed out the similarity in features of time and arithmetic numerical concept expressing that: "It is to know that numerical series or counting of time is based on four scales hours, days, months, and years. When someone wants to mention a number more than or less than a year there will be only repetitions of the above four scales. The same like the numerical order in arithmetic units of mathematics which has also four main scales such as: Ones, tens, hundreds, and thousands and there is no after this except repetition¹⁰." Interestingly there are similar peculiar features in three fundamental things time, space and arithmetic numbers the similarity among these three factors may give us food for thought to understand more about the nature of time and its peculiar characteristics. We may mention here in four significant aspects;

- i. The continuity of divisibility: Just as a line can be divided and subdivided without end. The intervals of time and numbers can be made arbitrarily small, No matter how finely we divide and close the resultant points or instants are to each other, there is always some space between them. Hence, there is always, as far as the time is concerned, a place for increasing the speed of events. Each instant of time is separate from the others similar as the points on a line can never touch each other. Gunnar Myrdal(1993) saw this significance of mathematical continuity.

¹⁰ Al-Imam Razi, *Al-Tafsir Al Kabir, Part. 10, vol.20, p.131*

- ii. **Homogeneity:** Time intervals or equal moments like arithmetic numbers or geometry lines each instant or point of time is identical to all others except for its position, this is really representing all that constitutes a point analogously spatialized time is merely temporal position. It is an empty point or container that can be filled with changes and events. Just as the matter occupies empty space changes or events also give reference to the numbers, points, and instants of time. Since a point is by construction empty, time must in principle be independent from the events or changes. If nothing happens, the time may elapse blank according to Newtonian concept of time. So probably time passes without agents learned and did not make any improvement.
- iii. **Neutrality:** That the mere elapse of time does not produce or cause any thing is obviously just another way of looking at homogeneity of the time elements. The independence of time from its contents implies that time adds literally nothing, the same like number it remains abstract idea, if there is no any thing to refer to it, both of them seem to be vacuum space, neutral from events, matters or whatever that may occupy them. The passage of time does not by itself produce changes in the method of processing, exogenous messages or agents' economic activities are independent of the date they take place.
- iv. **Coexistence:** Just as the points on a line coexists or is simultaneously given, so too must be the time present and future instants there is no definite separation between them, hence the events can be either is spread over a long period of time or concentrated on certain moment. Thus, it is observed that there is no analytical difference between various cross sections, i.e., in horizontal and vertical dimensions which spread out over successive instants and those same cross sections being spread out over different regions at one instant of time. Shackle (1969)¹¹

6.1.1 The Concept of Time Value

As these theoretical similarities between time space and numerical concepts show, there may be a strong evidence for time being a scale of measuring events and period of existence there is no

¹¹ Shackle, 1969, p.16, 17.

logic to yield a separate value. Further more, as there is no separate price for unit of weight in normal transactions although this unit is owned by a person and time no body owns it save that it belongs to Allah (swt) the creator of the whole universe. Time and activities which take place over time are two different things, the price and marketability associate with the events and goods existing within a time. But time alone has no exchange value things and events that take place over time have their own value according to the human judgement and availability of a market for them. This neutrality of a time element is recognized by many of conventional economic theorists. For instance Samuel Bailey (1925) stated that "time, as a mere abstract word, could not add to value (to the things) we generally prefer a present pleasure or enjoyment to a distant one and therefore, prefer present goods to waiting for goods to arrive in the future."¹² Hence, as we mentioned above that time although, the values of things or price of goods & services are so connected to time, but compensating them accordingly may not have any convincing rational foundation, as a pure abstract word does not add any value to a thing. Nevertheless, there is a human tendency of preferring the present benefits for the future ones. This is natural fact and what is beneficial in the future may not be always beneficial to the same extent at the present. In this connection the concept of time value is entirely associated with the assumption of Consumer Time Preference, in the subsequent sections we may examine the nature and rationale of this assumption.

6.2. CONSUMER TIME PREFERENCE

Following Bohn-Bawerk's(1888) explanation and Fisher's (1930) contribution, the modern theory of interest was set squarely on the time preference plane. Under this dominant view of conventional economic theory, it is generally assumed that people prefer the money or goods available for current use to those becoming available at some date in future, and that the social rate of time preference as the result of the inter actions of individuals'. Time preference schedules will determine and be equal to the pure rate of interest in society. As the modern application of this theory, the market for loans is viewed as a time market for present against future not only for lenders or borrowers but, also as some certain or natural rates in all process of production. On the basis of the consumers preferences for consumption now and consumption in the future the individual decides according to his income in both periods and makes the choice

¹² Pervez, New Horizon, July 1997

of how much to borrow or lend. It is not surprise that many of the Islamic economic writers also argue that this Fisherian theory must be accepted or used as a tool of evaluation. Elaborating the essence of this popular theory of consumer preference we present the conventional views of the assumption in the next sections. The general thoughts of contemporary Islamic economic writers in connection with their justification as a method of discounting project enterprises constitute the bone of contention among them.

6.2.1 Conventional Theory Consumer Preference

Time preference, as a concept and as a foundation for the explanation of interest, has been an outstanding feature of the Austrian school of economics. Bohm-Bawerk who is considered as the pioneer of this theory offered his theory of interest which came to be recognized as a theory of positive time preference.¹³ As the economic implications of this theory the interest was justified on the grounds that the value of present goods was higher than the value of future goods. Thus, the future goods should be "increased" sufficiently to make-up the difference in the present and future ones. Frank Fetter has completely discarded productivity as an explanation of interest and constructed an integrated theory of value and distribution in which interest is determined solely by time preference while marginal productivity determines the rental prices of the factors of production.¹⁴ On the other hand leading Mises made it allocate that positive time preference rate is an essential attribute of human nature, whereas Falter viewed that people would have entered positively or a negative rate of time preference, Mises demonstrated that a positive rate is deducible from human action, by it's very nature as a goal or an end target, it is something people wish to achieve as soon as possible.¹⁵

It is generally believed that people prefer the money or goods available for current use to money and goods becoming available at some date in future, and that the social rate of time preference as the result of the interactions of individuals and time preference schedules, will determine and be equal to the pure rate of interest in a society. Economists generally believe that the long-run profit rates and rate of return on capital are considered as forms of an interest rate. The economy will tend toward a general equilibrium in which all interest rates and rates of return

¹³ Bohm-Bawerk, *Ibid.*

¹⁴ See Fiona, *Ibid.*, p.46.

¹⁵ Pervez, *New Horizon*, *Ibid* p. 7

will be equal and hence there will be no pure entrepreneurial profits or losses¹⁶. According Miller and Pulsinelli (1985) interest is the amount of money that lenders receive when they extend credit. At the heart of the interest-rate phenomenon lies the trade off between presents purchasing power and future purchasing power. According to them the interest rate is the price that must be paid for credit and like other prices it performs an allocating function. Also, like other prices it provides information. At a national level the rate of interest reflects the community's rate of time preferences. Other things being constant, a relative high interest rate indicates a community that is impatient and wants to consume more in the present time of which they called it a present oriented society and other things remain the same a relatively low rate of interest reflects a patient future-oriented society that is willing to forgo present consumption. Future oriented society tends to grow more rapidly than present oriented societies. In future oriented society national saving and investment ratios are relatively, high and an economic growth rate will reflect this capital expansion. The market rate of interest indicates the rate at which a household can trade present for future purchasing power.¹⁷ As we have note in the preceding chapter(ch.3) in this context, the controversy over the rate of interest replicated a range of rudimentary questions about the ultimate cause of interest, was it due solely to time preference? (Fetter, 1977) or to the productivity of capital? (Brown, 1913) or to both (Fisher, 1930)¹⁸. Eventually the last view was to dominate in the text books presentations.

Those who insisted that the interest rate is the result of the existence of enter-temporal exchange economy argue that the present goods are in general rule worth more than future goods of equal quality and quantity, in other words present goods have in general greater subjective value than future and intermediate goods of similar ones. Since the results derived from the ascribing of the subjective value determine the objective exchange value, present goods have in general greater exchange value and higher price than future(and intermediate good) of the same kind and number. Bohm-Bawerk has elaborated the logic behind this economic phenomenon. As he noted, from this view a number of factors determine or exert their influence in the same direction¹⁹.

¹⁶ Pervez, *Ibid.*, p.7

¹⁷ See Roge Laroy Miller R. W. P alsinelli (1985) *Modern Money and Banking*, p.467

¹⁸ Fiona Maclanlach, *ibid*

¹⁹ Bohm-Bawerk, ([1914] 1958)'Capital and Interest'. *History and Critique of Interest*. vol. 1

- i. **Lack of coincidence between demand and supply:** The difference between the relation of supply to demand as it exists at one point of time and that relation as it exists at another point of time. Lack of coincidence of demand at present and supply which may be in the future. Where, the individual may have urgent demand which cannot be postponed and hope to get supply in future. But if the supply and demand are matching each other in any given period of time. Then no preference of putting more value to the present, hence no reason in this respect of paying or receiving a positive rate of interest other things remain the same.
- ii. **Systematic under value of future needs:** We systematically undervalue our future wants and also the means of which serve to satisfy them. This is considered to be due to the fragmentary nature of the imaginary picture that we construct of the future state of our wants, in other words it's the failure of will power. Suppose, a person is facing with a choice between a present and a future satisfaction or dissatisfaction and that he decides in favor of lesser present pleasure or in case of dissatisfaction, he decides in favor of lesser present dissatisfaction. Even though he knows perfectly. According to Bohn-Bawerk there are three contributory or partial causes for the lesser valuation of future utility. (1) Erroneous valuation by reason of fragmentary imaginary of future wants (2) lack of will of power (3) and consideration of uncertainty of life.
- iii. **Roundabout:** As a general rule present goods are for technological reasons preferable means to the satisfaction of wants and for that reason, they are warranties of higher marginal utility than future goods. By experience, elementary facts time consuming of roundabout methods of production are more productive. Given equal quantities of means of production the more time a method of production consumes, the greater will be the output it produces. The natural difference in value between present and future goods the existence and causes of above mentioned constitute the fountainhead from which all interest takes its origin.

However, it has subordinated in the explanation of the role of interest. Hence, modern interest theory fails to integrate interest on consumer loans and producers return into coherent explanation

Pervez (1997).²⁰

6.2.2 Contemporary Thoughts of Muslim Economists

Despite the unrealistic nature of this assumption, the concept of time value of money has been adopted by a number of Islamic economists under various assumptions. Some of them accepted that the value of present goods is higher than the value of future goods, they keep using this assumption in justifying the discount rate Zarqa (1983),²¹ Naqvi (1983) has taken the existence of positive Time Preference for granted and strongly argued that the interest rate must be sufficiently higher ahead to offset the rate of the secular decline in the marginal utility of saving. He also asserted that "for an individual level we have to accept a positive time preference."²² The Islamic injunctions are against *riba* does not necessarily negate the Fisherian explanation for "existence" of a positive rate of interest for it might protect the rate of the "roundabout" method of production and a positive preference for the present consumption over future consumption. Similarly Prof. Shabir F. Ulgeret has first written about this tendency; "the crux of the problem for underdeveloped countries is to differentiate between interest as a surplus and interest as a factor in computing the overall efficiency of their economics²³".

Saadallah (1994) perceived that price increase when payment is deferred is specifically compensating time value. Saadallah tried to solve this conflicting reasoning, but it seems that he restated with more forceful the existence of economic value of time. He began his reasoning that any increase over principal amount of the loan is unjust. Clearly mentioned in the Holy Qur'an, then asked "from where these injustice arises?" Applying the concept of time value on loans, he argued that;

"The principle, the immediate are better than the deferred, is true in loans. In deed if the loaned money was equal in value to the repaid equivalent there would be no sense in calling a loan a benevolent contract what the creditor gives as a charity, in fact, is

²⁰ Pervez, New Horizon, Ibid p. 7

²¹ M.A. Zarqa, (1983), An Islamic Perspective on the Economics of Discounting in Project Evaluation, in Ziauddin A. et al (eds.), Fiscal Policy and Resource Allocation in Islam, IFS, ICRIE. p.204-231.

²² Discussions on the Paper of M.A. Zarqa, (1983), Ibid., p.230.

²³ Ulgener, Shabir: Monetary Conditions of Economic Growth and the Islamic Concept of Interest. IR & Arab Affairs London (55:2) Feb 1967 p.11.

nothing but the difference of the economic values attached to the immediately delivered loan and the deferred repayment after a period of time. Further more he stated that. It is not true therefore, to say that interest on loans has no counter value, but we hasten to add that it is usury without any doubt, for the reason that it is wrong and unjust. Injustice or wrong consists in fact in the unbalanced equation²⁴".

According to him time determines the price of the commodity which associates with the commodity and contributes to the price determination. The equation in such a sale consists of a commodity tied to a time frame and an increase in price is included as an element to compensate for time. Such an equation cannot be perceived as an unjust if the sale is concluded by mutual consent. Saadallah has come up with conclusion that the provisions of sales and loans in Islamic jurisprudence fall within a single concept of time where time is recognized as having on economic value. However, time may be treated differently in sales and loans for reasons mentioned above. The negation of the economic value of time in the case of a loan means that time is treated differently in loans and sales. However, the rationale of the prohibition of *riba* in this view will turn out very weak and vague.

6.2.3 Discounting Perspective

Fahim Khan(1983) inquired about the actual position of Islam on the issue of time value he expressed that if Islam does not recognize the time value of money then there would be no need for discounting or compounding for the time value money in profit evaluation and feasibility studies. If on the other hand Islam does recognize the time value of money, we need to know the principles under which such a value is to be determined and the rationale of discounting and the discount rate to be used in project evaluation. The correct position of Islam on this issue is of primary importance in the context of project evaluations where cost of capital is to be defined clearly with awareness of its time value. perhaps the first rigorous attempt was carried out by Anas Zarqa (1983). He presented two justifications for this assumption: time preference and net profit rate of investment. If positive time preference stems out of purely a systematic human tendency, it means that people naturally discount future consumption and should have sufficient

²⁴ Ridha Saadallah.(1994) Concept of Time in Islamic Economics, Islamic Studies. Vol.2, No.1, p.82-102

justification for future benefits and costs of investment²⁵. Thus, he concluded that positive time preference is neither a principle of rationality nor an empirically established predicament tendency among consumers. It is simply one of three patterns of individual choice. The arguments of those in favor of price increase for deferments are founded on the basis of the idea of opportunity cost arguing the difference between the increase in price and the time value of that commodity. Being the most proponent of this issue Zarqa argued and eloquently presented that discounting is the direct requirement for efficiency in investment at both the private and social levels. The logical and consistent basis for discounting rests on the empirical fact that investment very often is productive over a period of time (has possible expected net value). Hence resources received earlier have the opportunity to be more productive through real investment than resources received later"). Zarqa technically accepts the concept of time value of capital as it reaches the same distinction thought by an unnecessarily roundabout road. However, ideologically he rejects it for it keeps the interest rate as a reference point²⁶. Zarqa is in the opinion that a great deal of confusion may be avoided and clarity of thoughts might be achieved by keeping a clear distinction among: discounting rate- the rate of return, the rate of time preference and the rate of interest. He identified each as follows (1) the interest (i) arises out of borrowing-lending relationships among economic agents it is a contract in nature(2) the rate of time preference (p) is a psychological concept expressed by individual's relative valuation of consumption that occurs at different points of time (3) the rate of return (r) arises out investment phenomenon and is entirely independent of the institutional arrangement of economy. According to Zarqa the last two rates can co-exist normally whether economy permits or forbid interest²⁷. However, he emphasized that discounting can be squarely based on the (r) or very shakily based on the rate of time preference. While the rate of return has genuine reasons and practical implication, a pure time preference is merely matter of desire and passion any thing is based on this has no solid foundations. Discounting which is acceptably in Islam is based on expected real rate of return (r^e), this is not only permissible but even desirable, to the extend that it promotes investment efficiency in both private and public projects. From these arguments Zarqa came up with the conclusion that discounting and time values go together.

R. Al-Misri (1987) also discussed the question of time value of money concluding it that

²⁵ M.A. Zarqa, (1983), Ibid.

²⁶ M.A. Zarqa, (1983), Ibid. p.221.

²⁷ Zarqa, Ibid. p. 223.

Islam does allow time value of money. Referring to Zarqa's work he concluded that discounting is permissible in Islam and that the rate of return in project of comparable riskiness already in operation should be used as the rate of discounting. R. Azhar (1992) discussed the consumer's time preference and productivity of investment and concluded that the rate of profit not the rate of interest is to be the appropriate rate of discounting in an Islamic economics. But Fahim Khan objected his conventional assumption of perfect for sight and lack of uncertainty what according to him does not qualify the concept of profit in Islam. Fahim Khan objected also the assertion made by Azhar that money has no time value or is not entitled to a rate of return if it is in malleable form where it is entitled for profit only if it is molded into a productive asset. Here Khan accepted the time value of money but argued that the time value of money on Islamic point of view cannot be predetermined. Average rate of return on capital in the economy can be used as a proxy for the expected time value of money which may represent Zarqas' rate of return in alternative uses of comparable risk. Therefore, if it is so we will have to think of the rate of time preference as function of time as well. F. Khan justified his view on the basis of the existence of the increase in deferred payment of *bay ul muajjal* which may have the following possible reasons (i) time preference. One is not necessarily indifferent about the same value of two different point of view, i.e., \$100 now may not be equal or the same as \$100 after a year because of the time element involved (ii) supply demand conditions. One may not assume that present supply demand conditions and hence price will hold constant at some point in the future. According to F. Khan both factors may be considered in this contract. The rate of time preference can be determined as the consumers choice between present and future consumption and locating the point of indifference. Suppose if the consumer is indifferent between \$100 now and \$110 a year from now then his rate of time preference is 10 percent. In conventional economy this rate is assumed to be fixed over time. But with the reflection of uncertainty over time it may not be fixed but it varies with different periods of time.

In the above arguments what is important is not the fixity/certainty or uncertainty of the rate of return as such but, it is the concept of time value of money which is of essence. As long as the time value is dependent on the individuals preferences which usually determined or decided before the activity was carried out then time value is fixed as each period according to its length and it has a price preference like interest. Reflecting on the above discussions the following objections may be raised (i) whether the prices fixed or variable as long as it is linked with time, it seems similar to interest regardless of its pattern and practical fluctuations (ii) the pure time

preference of the individual if it is positively exists it is also applicable to loans (iii) by merely desires and wishes of an individual no feasible return takes place (iv) therefore, human being economic agents are ordered to do some thing and to choose its course of action rationally not to wait and count the time elements.

6.3. CRITIQUES AND ALTERNATIVE CONSIDERATIONS

The rationale of the Consumer Time Preference is subject to a lot of criticisms from both Western prominent economic theorists and Islamic economic writers. A number of Islamic economists also have critically shown the fallacy of Consumer Time Preference under various considerations. In this section we outline certain dimensions of the critiques. We summarize the objections of both made by the theorists of main stream economics on the ground of its irrationality and existence of production, then the observations of Islamic economist on the basis of empirical evidences, i.e., saving behavior and natural human tendency. We examine the critiques on the basis of the dominant perspective of production preference, showing that in this latter context the theory of capital productivity has almost replaced the consumer time preference. Finally we examine the matter in the domain of liquidity preference theory as an explanation for the human preference.

6.3.1 Conventional Critiques

The assumption of Consumer Time Preference has been rejected by many of leading conventional economists on the ground of its irrational implications for discounting later enjoyments in comparison with earlier ones arises merely from the individual's weakness of imagination, and that generally everybody prefers present pleasures or satisfactions to that in future is bound to logical contradictions. Ramsey (1928) has clearly pointed out that discounting later enjoyments in comparison with earlier ones is a practice which is athelia indefensible and arises merely from the weakness of imagination Pagan (1920) also argued that generally speaking everybody prefers present pleasures or satisfaction of equal magnitudes...implies only that our telescopic faculty is defective. In this context Harrod.(1948)²⁸ also asserted that pure time preference is a polite expression for rapacity and the conquest of reason by passion. Lord

²⁸ Dougherly, Theory of Profit in Capitalism Economy, 1980 .p.25

Keynes also viewed that, "individuals do not save in order to guarantee for themselves an income from investment of their savings but rather for the purpose of having capital which they can command. For this purpose trading with ones property with a view to earning profit will flourish irrespective of the fall or rise in the rate of interest and people will go on saving and building up their capital even though the rate of interest should fall to zero". M. Abu Saud (1992 p.75). Fiona (1993) writes "our quarrel with Bohn-Bawerk rule of originary interest is not that he is wrong to identify the technical superiority of present goods as a reason for the existence of what he calls originary interest but rather that he fails to demonstrate that his originary interest is the reason for the existence of loan interest. Perhaps the unnatural implication of this assumptions was illustrated by Arthur Birnie (1952) expressing asking the rationale of extra charge: Is this extra charge just? Perhaps the creditor makes some sacrificed in lending the money? This is generally assumed in theories in defense of interest. Birnie argued that this is not true. Explaining why it is not true he elaborated the matter as follows:

"If a man has wealth and wishes to consume it, he consumes it; if he wishes to use it in the production of more wealth he does so. He only lends when he has a superfluous wealth, which he wishes neither to consume or use it. There is a tendency always to regard the typical creditor as a man who gives away his dinner to another man. He goes hungry today and though he will get his dinner back tomorrow, it seems just to get some compensation for fasting today. But actually the typical creditor is a man with two dinners. He cannot eat both. The one he keeps will be cold and stale the following day. But suppose he finds another man who will consume his superfluous dinner today, and supply him with a fresh one tomorrow. This would seem an excellent bargain for him and it would strike us as exceedingly odd if he insisted that the other man should give him back a dinner and a half. But this is what happens with a loan. The creditor gives away superfluous wealth; the debtor looks after it till he (the creditor) wants it again; and instead of being paid for this service he has to pay"²⁹.

The main reason for this behavior as Birnie put it: "The creditor can wait but the debtor cannot"³⁰. And accordingly the creditor can drive an advantageous bargain depending on the intensity and

²⁹ Arthur Birnie, (1952) 'The History and Ethics of Interest', Willium Hodge & Company Limited, London, p.5.

³⁰ Arthur Birnie, Ibid.

urgency of the need of the borrower for that loan. This view suggests that people's main driving force is to safeguard their capital while they are shifting it to the future. The concept of discounting for project appraisal is also strongly rejected, for it may keep the "ghost" of interest alive and would continue providing a justification for interest. The evaluation of projects on the basis of discounted flows (whatever rate) is not a sure guide to sound decision making. The argument that interest may be used as a discount factor for appraising projects will preserve the existence of interest intact in the economy. However, it may be argued that the concept of discounting rate and the interest rate are two distinctly different things. Discounting may be based entirely on rates of return in an Islamic economy which abolishes the interest. But its distinction from the rate interest is in fact a challenging issue subject to a great ambiguity and obscurity which may lead to admitting *riba* through the back door.³¹ It is always argued that the proper discount rate is (r). This is true in the real world of uncertainty as well as under the assumption of perfect for sight in which (r) and (i) are identical. However the identity of these two terms is questionable and unconvincing statement on the light of Islamic injunction as we cannot conclude that predetermined rate of return is equal to *riba* or under perfect for sight both *riba* and profit converge to each other" As we have mentioned elsewhere, this misconception of convergence of the two terms under perfect foresight made some economists to prefer to reach the rate of return by adding a risk premium to a pure interest rate.

6.3.2 Critiques of Time Preference in Rational Perspectives

The assumption of Consumer Time Preference is criticized on the basis of the law of diminishing marginal utility. Assuming this law is valid in all the time for any certain period of time, consuming an apple today yields exactly the same utility to the consumer if he consumes it tomorrow other things being equal, hence the consumer does not necessarily prefer an apple of today to that of tomorrow, Kahf (1991). Akram Khan (1992) has launched a critical examination on the assumption of Consumer Time Preference assumption on the perspective of its contradiction to the prohibition of *riba*. He writes that it would be very difficult to argue against *riba* once we accept positive time preference as a rational concept. According to him the acceptance would allow *riba* to stay in tact in the economy of money. To argue that interest-free finance is prone to be utilized with negligence is to deny the fact that the greatest motive force

³¹ Akram Khan, *Ibid.*, p.133

for any economic activity is profit motive and not the anxiety to pay interest. On the other hand preferring the present consumption to the future one of the same magnitude and kind in general is a sign of mere irrationality of that consumer as it is very contradictory to the normal consumer behavior, provided that there may not be pressing need for this particular consumption. Rationality (*rushdi*) according to Islam is referred to integrity suitableness or sound mindedness which is very crucial in any economic activities or financial dealings. Islam made this concept as a necessary condition and prerequisite for any responsibility, in its connection to particularly economic aspects is strongly emphasized. This may be understood from the following Qur'anic verses, Allah (swt) says that; "And give not unto the foolish (feeble minded irrational etc.) your property (wealth) which Allah has made a means of support for you but feed and cloth them there with and speak to them words of kindness and justice " (4:5). Allah (swt) has clearly stated in the Qur'an regarding about economic dealings of orphans;

"And examine orphans (as regards their intelligence) until they reach the age of marriage if then you find sound judgement in them release their property to them but consume it not wastefully and hastily fearing that they should grow and whoever (amongst guardians) is rich he should abstain but if he is poor let him have for himself what is just and reasonable (according to his labor). And when you release their property to them take witness in their presence and Allah is all sufficient in taking account" (4:6).

The consumer to be rational is necessary that he must choose among available patterns of consumption in such a way to maximize his welfare not that very moment but in the whole expected life spectra, of course without harming or reducing that of the others. Therefore, any economic agent to act rationally has to make ranking and ordering of the choices open to him in order to select the best alternative option. In respect to individuals' maximization of their economic welfare (*falah*) or utility and according to the degree of their telescopic view and of rationality they may be divided into the following categories; (1) those who maximize only their present welfare/utility, irrespective of their future welfare and consumption pattern. (2) those who smooth their consumption in such a manner to maximize their welfare over their life time span. (3) those who maximize their welfare in here and hereafter and as far as their wealth is concerned uses in such a manner to raise their *falah* as highest as possible by smoothing their consumption throughout their life and spend also part of their wealth in the way of Allah (swt) to increase their *falah* in hereafter whatever their income or wealth may be "Fear from the hell

even with the split of date". This category is perhaps of those mentioned in the Qur'an. Allah (swa) says: "And in their property there is a right for the *sa'il* (the beggar who asked) and the *mahrūm* (the poor who does not ask the others) (51:19). The first category who follows the assumption of time preference perhaps suffer at the present the outcome of their excessive consumption and perhaps they would face short of resources in the future as a result of their short sightedness and irrational behavior by consuming all their goods at the moment of the present time. In this way they may turn into the poor and beggars in the next moments, however rich they might be before. The rapacity of their passion conquered their reason. Both the last two categories who are the majority of the people normally save and capitalize their income for future consumption so they have some degree of preference of the future goods to the present one they would like to transform their present commodities in to future and more goods. Therefore, they do not save only but, they invest also.

These undesirable behavior increase with the existence of the credit market particularly in regard to consumer credit where with easy availability of loans creates excessive consumption and passion for enjoyment particularly the young generation which may give arise to irrational behavior. This does not mean denial of the importance of consumer credit market and its profound implications on economy. In promoting of the sale of goods in sufficient quality in the trade network and solving a number of social and economic problems as consumers with non regular incomes can purchase their necessary goods. On the other hand this scheme reduces much of the possible costs on the part of the supplier. But its excessive use and unregulated mechanism of this scheme may produce or generate other problems. On the other hand in conventional economics the sophisticated method of advertisement through the inescapable mass media make consumers mostly to purchase more than what is needed and spend beyond their budget constraint. With the same methods and similar techniques are used to attract consumers to buy on credit using banking facilities of highly speedy credit and payment system. Thus to check human rapacity behavior Islam calls for the midway in consumption and expenses that is balancing the consumption pattern in order to optimize the general welfare level. To assure that the following two important principles are to be observed;

i. The Principle of Moderation:

With the same degree as Islam disallows miserliness also discourages extravagances both to be considered as two extreme behaviors, Islam calls for the middle way in economic dealings in this regard Allah (swt) says that "Those who when they spend are no extravagant and not niggardly but hold a just (balance) between those (extremes)" (25:67). In another place Allah (swt) says: "Make not thy hand tied (like niggards) to thy neck nor stretch it forth to its utmost reach so that thou become blameworthy and destitute" (17:29). Moderation is recommended in every thing and strongly urged in consumption by Islam even free goods. Therefore, on the personal level excess borrowing is assumed to be bad because it indicates one to live beyond his means and on the aggregate level it is also undesirable because as the consumer debt grows the country may become a nation of debtors.

ii. The Principle of Living According to Ones' Means;

Living within the reach is the basic feature of Muslim consumer rather than leading by wishes and desires of physiological passion. Within this constraint the individual plans to balance his consumption behavior rather than concentrating it on one particular period of time at the cost of the other. Given certain level of endowments or resources using this principle of balancing consumption through inter-temporal adjustment the consumer may reach at the optimum level of benefits or welfare according to the condition of Pareto efficiency where any further readjustment will never bring to him more welfare without reducing the welfare of another individual. With view on this principle there is a great difference between who wants and deserves a loan and who really needs charity. This is an important constraint that any person to plan to live according to his means not beyond his resources. So that any loan be borrowed must be paid. The importance of this principle can hardly be over

In fact these two principles serve as the main check points for human irrational desires. If the speed of credit mechanism goes without checking and unwisely used. Particularly our age of mass industrial products where enormous and various goods are entering infinitely to the market of our global village. This may most likely make the amount of credit to exceed the means of repayments and the consumer fall into debt trap and excessively becomes indebted. Then, as a result of being indebted permanently, that same debt might be passed from one

generation to another. For instance, the interest based system through various advertising methods may lead the consumer to overspend his income some times on unnecessary or genuinely unneeded goods. The problem of equity between generations becomes therefore, a dilemma their future income.

6.3.3 The Natural Saving Behavior

It is also empirically observed that the issue of the time preference itself is not supporting the above implications because there is always positive for the goods not consumed (i.e., saved) which enter into commercial transactions and further production process or transferred to the money market. It is argued that the existence of the saving as a basic nature of human economic activities is clearly demonstrating the fallacy of the assumption of consumer time preference. The basic premises of the time value of money is that present goods are of a higher value than the future goods. But the empirical evidence from everyday behavior of consumers does not confirm this assertion.³² The fact that people want to save something from the current incomes is sufficient proof that they attach higher value to future over the present otherwise they would prefer to consume all their income in the present. The saving motives are inherent nature of human behavior and fact of real life such education of children, marriage of dependents, Security against old age sickness and accident or mere mean and miserliness. Earning interest is not the main determinant factor for saving. There is a lot of evidence that people continued to save even when the interest is reduced to zero. People with extremely low income also save or desire to save part of their subsistence income. Thus, each act of saving bears an irrefutable testimony to the fact that the positive time preference is a myth so far as savings are concerned.

Perhaps there is a confusion between the individual motivation to possess and own the resources in the present and the motivation to spend them all in the present. There is a difference between a desire to acquire as much as possible of resources at any moment or, i.e., present time and a desire to use and spend all at that same moment. The desire to have command over resources has no limitation, but to utilize them has a strong rational constraint for it is beyond the human capacity as well as against its nature. The Islam teaches that this to be the inherent character of man except those of believers, as Allah (swt) pointed them out in this verse:

³² Akram Khan, Ibid.,

"Say (to disbelievers) if you possess the treasure of the mercy of my Lord (wealth in any provision) then you would surely hold back (from spending) for fear of being exhausted and ever miserly" (17:100).

From these discussions we can conclude that as long as the individual decides not to consume his resources at a present moment of time he is leaving those resource for the future and it is true if someone says that an individual has no command or choice except his future course of action for the future time starts from the very moment of your present time and pasts are irreversibly gone period, the individual's whole decisions then seem to be a future oriented activity. Moreover, the prestige name and economic status of the individual do not depend on what he is consuming or spending that moment, but what he is possessing for his future perspective.

6.3.4 Production Preference

The role of time factor is also justified on the ground of real productivity and investment decision making. Conventional literature has vastly detailed the interconnection between the physical productivity of capital and time element. However, the pattern of the output distribution entitled to the capital in lieu to its time value rather than contribution is the primary concern in this discussion. That is how the productivity is uniformly related to time an element has been the main issue for investigation. The concept of the productivity of physical capital is assumed to be based on a single commodity where the input and output of the production process are the same good, in which more of the output can be produced simply by waiting longer. Fishers'(1930) theory of inter-temporal choice maintains the rate of transformation between present and future goods as a fixed rate, assuming that PPF to be straight line, on the basis of which he argued that the rate of interest would be determined by the physical productivity to justify the reason for the rate of exchange between present and future goods. Fisher argued that the rate of exchange between present and future goods to be such that more future goods must be given up for a given number of present goods.³³ As Brown (1913) argued the productivity of capital is the originating cause of interest, this interpretation says that interest exists because of the value of productivity of capital or because by investing a given number of dollars in

³³ Fisher,(1930) 'Theory of Interest, p.194

capitalist process of production one is able to get a greater number of dollars in the future³⁴.

To identify the future output added to the stock and its value generated by the present investments. Some kinds of technique are needed for its evaluation. The available techniques use the concept of time value of money based on the perception of present goods have higher value as compared to future goods. Thus, the costs and benefits are forecast over the life time of the given enterprise. The concept of discounting was introduced (though not named) by Sraffa (1932) in his review of von Hayek's the concept³⁵ of own rate of interest on a commodity which later on was taken up and labeled after Keynes (1936) in his analysis of the role of money in the theory of employment. Sraffa illustrated this notion by means of an example of a cotton spinner who borrows money to purchase a quantity of raw cotton today (at the spot price) which he simultaneously sells it forward³⁶. The spinner actually borrows cotton for the period of the transaction, i.e., one year. Then the own rate of interest on cotton is equal to the spot price of a bale of cotton divided by the future price of a bale discounted at the going money rate of interest less one. So for instance, the price of 100 bales of cotton for delivery today is \$20 and the price to be paid for delivery of 100 bales in one year time is \$21.40 while, a money rate of interest is 5% then the own rate of interest on cotton would be 2%.

In general economic theory the interpretation of the own-rate of interest in modern time might be different from that advanced by Sraffa. (Debreu, 1959). The sets of equilibrium prices refer to commodities located at different points in time, the prices are discounted which would be paid today for commodities to be traded at a future date, while the rate of interest used for discounting is not specified. In one production period say t to $t+1$, the own rate of interest on a commodity over the time period t , is determined by the quantity of other commodities, and preferences of individuals.

The problem of showing how an economic order stems from individual's free choice and voluntary exchange, how prices are determined by the efforts of utility maximization is constrained by their original endowments of resources and technological possibilities. The serious difficult in this analysis may arise from explanation of profit in this context. B. Calark (1902:

³⁴ H.G. Brown, (1913), 'Marginal Productivity Versus Impatience Theory of Interest', *Quarterly Journal of Economics*, vol.27, p.630-50.

³⁵ Friedrich von Hayek, (1932) *Prices and Production*

³⁶ Sraffa, P. (1960), 'Production of Commodities by Means of Commodities', Cambridge, Cambridge University Press.

VIII, 123, 190, 236) pointed out that capital goods are factors of production while like all other factors of production earns rents and interest which are the return to capital and it is equal to the marginal product of capital and depends on the quantity of capital available to relative to the demand for it and available factors of production.³⁷ Reflecting on this view, Hausman (1980) observed that neoclassical theories face their sternest test when they confront the problem of incorporating interest in to price theory and try to explain how interest is determined. But identification and determination of interest depends on the theory of capital itself.³⁸

Interest and wages are equated to respective marginal products. To speak of explaining interest in terms of the marginal productivity of capital is some what confused. The capital theorists want in Bohm Bawerk words to show that "The exchange" . . . in which interest has its origin is only a special case of the exchange of goods in general. But such perception has been taken to be dubious and misleading. According to Austrian theories such a claim of neoclassical economists that capital earns interest because it is scarce and has a positive marginal products seemed naive and unhelpful and regarding capital as an input leaves the social questions unanswered. Instead, Austrian theorists argued the round about ness of capital and interest to be the marginal product of time or waiting. Austrian theory is regarded as an ingenious attempt to provide a unified explicit theory of capital and interest without introduction into the analysis what is called capital good. The role of time in production apparently provides a unified and unspecified treatment of capital and interest. Bohm Bawerk puts it as follows: "if I now prefer present consumption to future consumption then invest paid a premium to save or invest."³⁹ But from the above fragmentary aspect of theory of capital related to the domain of time Hausman raised the following philosophical questions:-

How is apparent capital accumulation related to the time intensity of production? How can one measure the time intensity of production? Or how can one find out whether the values of capital and the length of the average period of production do generally increase together? How can one test the claim that with the increase of round about ness there would be higher return? How do the market forces relate the rate of interest to the period

³⁷ Daniel A. Hausman,(1978) 'Profit, Price and Capital..

³⁸ Hausman, Ibid.

³⁹ Bohm-Bawerk, [(1888). 1952] Positive Capital Theory, p.253.

of production rather than the nature of production itself?⁴⁰

However, this theory has implicitly emphasized upon that income increases only with investment while merely abstention from consumption does not entail any yield in future then. Time Preference in real life is an investment phenomenon rather than consumption.⁴¹ In fact, the existence of productivity show somehow a contrary reality to the above Consumer Time Preference. It is generally believed as an established fact that the production process may be relevant only to any moment the existing future goods are larger than the consumption goods of that moment, for that moment the individual would prefer the future production for the present ones manifesting that in undertaking the risk process of transferring his present resources into future ones which of course he does not know as surely as the present ones. Thus, the future becomes more valuable than the present. Otherwise, those goods which are built for future use would have been consumed in the present. Each decision of saving has not been dictated by the existence of interest, but it is testimony to the above fact. No development would be possible if people preferred the present to the future. Thus to the extent of goods saved the future value is higher than the present. It may be also, argued that the confusion may arise from the fact that people may generally prefer to possess all the goods in the present than to possess them in the future. But to possess in the present does not necessarily indicate their preference for consumption will be present. To the extent of the resources which are not consumed in the present are, they saved for the future consumption the resources will be available for investment.

Those who usually observe strictly the Consumer Time Preference, they perhaps forgot one important thing that is the point of reference or marginal position of the concerned individual(s). In any given moment the people might be divided into two groups: a group which is enjoying surplus resources or a group which is facing a deficit. The first group has something more than its present needs or at least according to their individual priority criteria they feel that the future needs would be more important than the present ones, while the second group whatever resources they might still feel a deficit as their urgent needs have not yet been fulfilled. Still those who are in a deficit are not all require loan for consumption purposes perhaps most

⁴⁰ Hausman, Ibid, p.3

⁴¹ Monzer Kahf, Ibid.

of them need for production loans and hence they have future time preference, so their preference is different from those who require consumption loans to meet their urgent needs. Then relatively those who have no surplus fund for their basic urgent consumption would manifest consumer time preference in terms of seeking loan fund for their urgent need, not in terms of lending with interest. The existence of production activity negates the concept of time preferences. The second argument that the productivity of capital is the originating cause of interest this interpretation says that interest exists because of the value of productivity of capital or because by investing a given number of dollars in capitalist process of production, one is able to get a greater number of dollars at the end. There is a natural fact that any produced goods are subject to natural law of depreciation. Whether it is working or not, then the only way to keep it preserved and maintained its utility is to reproduce it again by investing it. The consumption goods in the present are not received like Manna from the Heaven their production requires investment so that the present level of consumption be maintained also in the future. Then replacement of the consumed goods requires saving and investment dictated by the consumer's need for future goods.

The differential price of the present good over the future goods is also based on the theory of liquidity preference which implies that interest rate is a percentage premium that a borrower pays a lender in exchanging a future claim denominated in the unit of account for a present claim denominated in the same unit of account."⁴² In this context the natural rate of interest is understood to be the rate of interest appearing in the real economy that lies beneath the veil of money. Thus money in this theory is argued to explain the rate of inter-temporal exchange not just between a unit of account denominated claims, but between non money goods as well. Liquidity preference theory implies more liquid assets provide one a greater range of options than the less liquid one and accordingly it determines or causes the interest rate. But it is not necessarily to be linked with future, it can take place in the spot as it can work also in future transaction with different rates of exchange. Eventually, it turns out whether one prefers the present consumption to the future depends on how well endowed one is in a different times, that is to say; it depends on the margin from which one is making the choice. The existence of liquidity preference implies that wealth holders require some payment to persuade them to give up cash in exchange for debt. Two criticisms on liquidity preference theory are; (i) the theory relies on a particular speculative motive to explain interest which refers to speculation about the

⁴² Fiona C. Maclachlan, *Ibid.* p.53

future rate of interest (ii) liquidity preference theory makes sense only in an economy with advance bond and similar security markets and which speculative trading takes place. Thus, the question is what determines the interest rate in undeveloped economy remains till unanswered.

6.4 TIME FACTOR AND CREDIT SALE IN ISLAMIC PERSPECTIVES

In dealing with the question of time as we have seen in conventional economics, it does not separate a loan from a sale, since it considers an installment sale as a dual operation of sale cum-loan. Economic units decide their current and future borrowing and lending comparing the subject of an interest rate. This uniform treatment of time in conventional economics seems contrary to the dual perception of time coming into a sale transaction governed by Islamic law. As we have mentioned earlier. The prohibition interest on loan transactions can be considered as a sort of denial of the time value of money in Islamic Economics. On the other hand the permissions of deferred sale contracts in which the price of a commodity can be different from its spot price, may be considered a sort of recognition of the time value. This apparent double treatment of time value has attracted the attention of Muslim scholars, a vast literature of Islamic economics has focused on the economic rationale and the consistency of Fiqh injunctions on the subject. Saadullah (1994) based his inquiry about the concept of time value and examined the difference between an increase in sale price of deferred payment which is permissible and rejection of any increase on a loan contract which apparently seems a conflicting duality of the concept of time by allowing the time value on one hand and completely prohibiting on the other. Whether time value is justified in Islam when time elements is involved is the unresolved issue in Islamic economy some Islamic economists have given in affirmative answers arguing that credit sale, i.e., *bay' Salam* and *bay' Muajjal* are permissible modes of trade in Islam which their deferred prices can be different from spot ones which is a sufficient proof that Islam allows and recognize the difference in value due to a time element and as a result accepts the concept of time preference. Although the jurists have allowed the difference of these two prices cash and credit prices of same commodities Fahim Khan (1995) argued that, however, this does not necessarily mean that they have recognized a predetermined time value for money they might have allowed this difference because they recognized that supply and demand forces are different at different points of time which accordingly the price of a commodity can be either higher or lower than or equal to the present price. They have never say the deferred price of credit transactions must always be higher than the present one. Whether there is accepted time value

in sale transaction by deferring either of the two exchange systems or some thing else, we will examine the Fiqh literature relevant to this perception, on two prospective the legal position of the deferment itself and of the increase of price in return for deferment. Then we reconsider the points of contention in order to synthesize the basic message of the relevant injunctions and views of Shariah scholars.

6.4.1 Increase of Price in Deferred Sale

Whether increase of price in deferred by payment, is allowed or not and whether if it's allowed is due to the consideration of compensating of setting the delayed time is the unresolved debate among Muslim scholars in contemporary time. According to Sa'adallah there is a consensus among Jurist views of an increase of deferred price to offset delayed payment, although he has not given a sufficient reasoning on this point, the arguments in favor of an increase of deferred price mostly relate to the reason of two time values. According to this view an increase is often unspecified, specially as a composition for time for evidence it is quoted the analogy which may be made between price increase and price decrease in the case of deferment and early payment respectively, as the Prophet (swa) ordered the expulsion of al-Nadir (Jewish Clan) some of them told the Prophet (swa). That there were debts due to them, and time of their payment is still away: the Prophet (swa) told them " reduce the debts and claim them before their due time"

With the above reasoning of jurists Saadallah has founded his argument on the basis of more vague ideas stating that the justification of or increasing price when payment is deferred is that the intervening time between the time of passing the commodity and the time of receiving its price involves possibilities of opportunity benefits which are waved in the interest of the buyer. On the other hand the legitimacy of a price increase establishes that Shariah admits that time has a value and recognizes the innate human preference of what is in hand to what is lent and of the immediate to the deferred. Even though the time parse may not be the subject matter of the contract it is permissible to pay a premium of time on credit sale. Accepting the time premium on credit sale forced, those who are of this view to admit that loan is an act of charity or vice versa. However, the existence of the benevolence of a loan is paradoxically supporting the view of time value. Accepting that grace period of a loan transaction is charity and kind of generosity from the part of the lender without rationalizing its benevolence seems to be misleading to shallow understanding of Islamic injunctions. The prominent early jurists such

as Malik and Shafi'i did not make an objection to higher price for deferred payment and a lower price for cash payment. According to the Hanbali scholar Ibn Qayyim when someone sells something for one hundred on deferred payment basis or for fifty on cash payment basis there is no *riba*"Baqhawi⁴³. Majority of the jurists are of the view that charging a higher price for a credit sale is the customary practice of merchants and on this basis, the jurists have permitted the higher price. In the context of Islamic injunctions several reasons have been put forward in favor of higher price in credit sale such as; (i) the Shariah texts do not prohibit it (ii) there is a difference between cash available now and cash available in the future. (iii) that this increase is not against time allowed for payment and hence, it does not resemble pre Islamic *riba* prohibited in the Qur'an (iv) that the increase is charged at the time of the sale, not the time the sale occurred (v) that the increase is due to factors influencing the market such as demand and supply and the rise or fall in the purchasing power of money as a result of inflation and deflation (vi) that the seller is engaged in a productive and recognized commercial activity (vii) that the seller is allowed to charge whatever price his commodity (ies) may fetch in the market. The contemporary financial Institutions as a matter of standard practices have accepted the lawfulness of this increase. However, some of the classical jurists seem to have refused to recognize this increase. They equated an increase in sale price to increase in a principal loan. Similarly they equated a reduction in lieu of time in a loan/debt with *riba*.

But, Abu Hanifa reportedly refused the validity of a contract in which a person says to his tailor: 'If you tailor it today you would get one dirham and if you tailor it tomorrow you would get half of the dirham'. Jassas went on the view that the second condition is null and void, according to him the tailor must get the same rate in both cases because they are one and same in both times. Shaybani, the prominent Hanafi jurist, did not approve selling things at a lower price on cash and selling at higher price on credit. Razi in his commentary on *riba* verses rejected the notion of that time allowed for payment can be a counter value for an increase, because time is not goods or a thing which could be (physically) pointed out, to make it a counter value'. In this connection we notice that many of the early authorities considered that a value cannot be assigned to time, and as a result an increase cannot be demanded from the debtor on the basis of an extension given for payment. Al-Khafif maintained that the increase against time would be *riba*.

⁴³ Shehata, Nazariyyat, Al Muzaba, p.104.

A number of the Islamic economic writers equated the increase of price in deferred sale with conventional interest on loans, i.e., R. al-Misri (1977) noted that the increase represents interest on the loan and expressed "in deferred payment sale it is not possible to equate the seller with the usurer even though the deferred payment sale in reality consists of a cash sale and a loan with interest, it combines these two aspects in single activity, that sale or commercial transaction. According to al Misri the deferred payment sale consists of two elements, a cash sale plus a loan at interest which represents the difference between cash price and deferred payment price"⁴⁴. Abdallah (1996) has shown critically to the view of Kuwait Finance House (KFH) which supports that 'increase in Murabaha is not against time, but against the goods themselves. According to Abdallah the increase in deferred payment sales against the goods themselves is untenable. If it is so, the existence of two prices, a cash price and a higher credit price would be meaningless. He further argued that goods are one in both cases and therefore, any price should be one as well.⁴⁵ According to this view the credit price reflects the cost plus a profit margin plus an allowance against credit period. In this line of thinking several scholars are of the view that the increase in deferred payment is against time given for payment, Siddiqi the prominent Islamic economist also expressed the linkage of deferred price with time value noting "The mark up would tend to be higher the longer the period of time involved"⁴⁶

Although the majority of Islamic scholars try to avoid this link between the increase in Murabaha and the time allowed for payment, but some of the religious supervisory boards, i.e., Tadmond Islamic Bank, recognize this as a permissible increase against time consideration, on the basis of the interpretations of the *hadith* of the Prophet (swa) which prohibits 'two sales in one sale' the RSB concluded: "The increase in price in lieu of time is lawful and valid. It is lawful in the Shariah that parts of the price can be given in lieu of time in financial transaction."⁴⁷ Abdallah Said in his study concluded: "This appears to be the view of all Islamic Banks whose Murabaha contracts are being studied. Thus a sort of confusion is introduced and the two positions become inconsistent. The main argument against time value of money is that this concept is valid only for the goods being consumed in the present (at this very moment) dictated by urgent need or not for those goods which are not being consumed or future goods. Therefore,

⁴⁴ Rafiq Y.. Al-Misri, *Masraf al-Tanmiyat al-Islami*, p.10-2

⁴⁵ Abdallah Saeed, (1996) 'Islamic Banking and Interest: A study of the Prohibition of Riba and its Contemporary Interpretations', p.82-3.

⁴⁶ M.N.Siddiqi, *Issues in Islamic Banking*, p.138.

⁴⁷ Abdallah Saeed, *Ibid*. p. 83

as long as there is building process of future goods and as a very urgent need it may be justified. Saadallah has tried to reconcile these long discussions and jurists' views and he expressed that "what may not be allowed separately and in itself may be acceptable as an implication and a consequence of some thing else⁴⁸." For instance, the sale of an unborn animal he argued is valid on the basis that the time is not separate from the sold article and the compensation for time is included in the price in one contract. Moreover it may not be easy to separate the exact quantity of an increase that offsets time from the amount of the price of the article sold. In fact such reparation is possible only when two prices are set one for cash and other for on credit sale and the deal is concluded for deferred payment. So the differences between the two prices in this case constitute the value attributed to time value which can be calculated only by estimation, i.e., through comparison with the price of similar articles sold on cash basis.⁴⁹

6.4.2 Reconsideration of the Issue

The increase in price in return of deferment constitutes *riba*, for time is neither susceptible to valuation nor appropriation and it is not therefore considered as an exchange of counter value. To conclude that increasing the price when payment is deferred is the same thing as increasing the amount of a loan to offset deferment would lead us into the very early fallacy that trading and *riba* is the same as claimed by Arab-nonbelievers. The logical conclusion is that if deferment justifies increasing the price it should also validate increasing the level of the loan. To their understanding there was no difference between; (a) setting a garment at 10 dinars cash for 11 dinars in deferment and (b) giving 10 dinars as loan to be repaid as 11 dinars after some time, i.e., a month. A critical analysis of the above apprehension requires the problem to be divided in two stages which have to be separately discussed (A) the increase in deferred price before the contract is concluded that is *ex ant* increase of the price (B) the increase of price after the contract is concluded that is *ex post* increase. While the former is simply as the part of a normal bargain of parties, the latter seem to be another contract or reopening clauses.

A. Increase of deferred price in the initial session.

⁴⁸ Saadallah, Ibid.

⁴⁹ Saadallah, Ibid.

Here as the exchange of two different goods is to take place the rate of exchange or the price level may not be much important as far as there is a mutual trading of the two individuals, according to their free consent, particularly if there is no fixed price level prevailing in the market. So during this first negotiation each party has its own free will to decide to enter this contract on given terms including the deferment and level of the relative price of the concerned commodities. And as we have elaborated in detail they decide only when each one of them is feeling that he is getting benefit from the contract. Assuming that the two parties behave rationally in their exchange contract the relative price ratio of the two goods will vary according to the market forces of demand and supply and on the basis of this variation the deferred price may increase or decrease according to the direction of the price change. Moreover, the increase of deferred price can be explained in analogous to the price discrimination of whole seller and retailer. Normally, in trading goods there are two or even more price levels on single good depend on the quantity of the goods that the client is going to buy. For instance the industries put the final or retail price of their products say Rs.100 per item, but they may charge Rs.60 per item as a whole sale price where the whole seller is to sell at Rs.75 to the retailer still retailer may give to the final consumers with some concession and charge Rs.95 per item. Since there is a large price gap between the final retail price and the initial factory price there is no harm any price is charged. Furthermore, each stage has also flexibility of price setting such as 15 and 25 respectively. The whole seller, may give more concession to his usual customers or those who buy larger amount at one time than the others. He may charge full price on those retailers who delay the payments. The same is the case in the retailers' dealings with different customers. The reason is that since the main goal of business is seeking profit, the level profit other things remain the same depend on the volume of the transaction and its velocity or the number of the transaction at a given period of time. Therefore, selling large quantity at a time is better and less costly than selling in retail in long period, and similarly selling on cash is better and more speedy than selling on credit. Thus, whole sale with cash payment is the most preferable and retail sale with deferred payment is the least preferable activity. Hence, the retailer may charge full price, i.e., Rs.100 for an item, while others may fall between these two extremes. On the basis of these normal business practices of setting different price levels for different situations, the deferred price would likely be higher than its corresponding cash price of similar business circumstance. On the basis of this analogy we argue that if the price differences of various commercial stages are permissible then increase of deferred price, being a part of these commercial stages and probably the least preferable one, it is permissible. The main thrust of

jurists opinion shows its permissibility on the basis of that (i) it is mutual consent of trading(ii) it is beneficial for both parties (iii) it is allowed on the ground of general acceptance of trade by Shariah.

It is very simple to illustrate this idea in a diagram. Suppose according to fig 6.1 A and B are two individuals. A has endowment of good Q_a^c and certain amount of money M_b . He requires to have more money and sell some of his very much good. While B would like to purchase some of goods Q from A with money the exchange normally may take place according to the given market price. In this example for instance there is one to one relation of the concerned goods and its market price the two individuals may exchange the items on spot price but on credit transaction where individual A will give $O_a Q_a^c - O_a Q_a^E$ of the good Q on defer payment to B at price of $O_b M_b^E - O_b M_a^c$ to be paid on a fixed term in this normal transaction may be concluded at point E if individual B pays the debt on time the contract is complete and nothing is wrong with this transaction or any harm to either party. The contract is perfectly concluded with complete terms, at the equilibrium point of E. As a result of this mutual trade each individual's welfare has increased and reached higher level of utility/welfare. However the parties have complete freedom to agree, for instance, at E with complete equity each one receiving and paying equal amounts of good X or at I_1 , or even at I_2 where individual A is receiving a large share than individual B in this exchange activity. Nevertheless, the people mostly charge full price on deferred price according to the market rates while they may give concession on spot and immediate exchanges. It is also very feasible that the seller may give a large concession to the extent he charges a price lower than the market rate due to different purposes mentioned above. For instance it may charge at I_0 and the price may vary justifiably from P_0 to P_1 or P_2 as long as there is a beneficial trade for both parties. The area between the two indifference curves IC_1^A and IC_1^B in this diagram stands for this range of variation. However, the exchange will take place only once and for all, it follows when the contract is finally concluded by both parties in mutual agreement no further increase or decrease of prices is feasible.

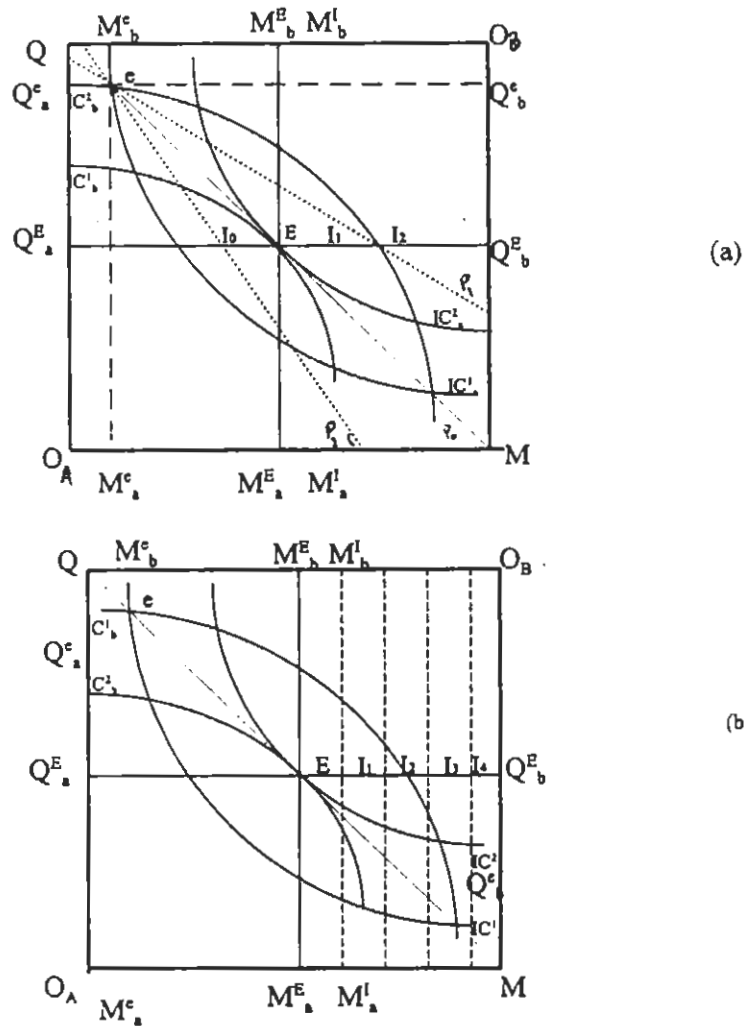


Figure 6.1 Increase in deferred price.

According to fig 6.1 (a) A and B are two individuals having different proportions of money and commodities where A has a large endowment of good Q_A^e and small amount of money M_B . He requires to have more money and sell some of his good and opposite is the case of B. In this example for instance there is one to one relationship between the commodity and its market price the two individuals may exchange on credit at spot price. A will give $O_A Q_a^e - O_A Q_a^E$ of the good Q on defer payment to B at price of $O_B M^e - O_B M^E$ to be paid on a fixed term. With Mutual agreement they may conclude the transaction at E. However the parties have complete freedom to agree, any point between I_1 and I_2 at initial contract and price may vary from P_0 to P_1 or P_2 as long as there is a beneficial trade for both parties. The area between the two indifference curves IC_1^A and IC_1^B in (a) stands for this range of variation. However, as the panel (b) shows increasing the price after the terms of trade is mutually agreed and executed has no countervalue and it not permissible as that would imply actual riba.

B. The increase of price for rescheduling

That is an increase after the terms and conditions of the contract are concluded and the most important term of the contract is the change of the price, increase or decrease after long ago the transaction had taken place and all its details had finally decided in mutual consent of the two parties. We know that as a matter of principle in Islam the option of settling price level remains open only during the negotiation where when it is agreed and the contract is concluded at a given price level this option will be closed and no further change will take place, for any change of price decrease or increase associated with this contract of exchange or include as a condition of its execution. Islam considered this kind of increase to contain *riba*. Any increase of the price after the conclusion of the contract, for instance, a monetary amount which is the liability of the debtor constitutes an excess that has no economic justification. It is excess without counter value, for this new contract of sale is a unilateral offer on the part of the borrower without reciprocal payment.

To show this in a diagram it follows that once the first contract is normally concluded with complete terms, at the equilibrium point at E in fig.6.2, as a result of this mutual trade each individual's welfare has increased and reached higher level of welfare. Suppose in the meantime or when the liability on B matured he could not pay the due debt. If individual A insists that B must pay the debt on time otherwise the debt on B will be increased with additional payment over the principal that is the terms of contract will change from the previous equilibrium point E to a new level I. In this situation the amount of the debt which was fixed quantity of a good or monetary price and has no other price except what was already paid is augmented merely on the ground of extending its maturity, for the transaction contract is the same there is no way the quantity of either to be enhanced without corresponding price. Moreover, as far as the second contract or the condition is concerned, A demands for increase without offering any thing except extending the period of the payment for the debtor. Since the debt to be paid by B is converted in money terms in the first contract, B is liable to pay a fixed amount of money not good.

Then any increase takes place on this amount means increase in the same good, selling that same thing for more of itself. This implies an increase to someone is possible only at the cost of the other or conducting two transactions on the same sale. The Prophet (swa) has Prohibited

two sale in one transaction. It is narrated from Amrin bin Shu'aib, that "the Prophet (swa) has prohibited a sale in two transactions" ⁵⁰ Abi Hurayra narrated that "the Prophet (swa) has prohibited two sales in one transaction."⁵¹ He reported also that the Prophet (swa) has Said: "Whoever makes two sales in one transaction should receive the principal only, otherwise, he commits *riba*⁵²." In a similar manner the Prophet (swa) prohibited *safqatani fil safqat* (two bargaining in one deal). Ibn Masud (ra) has Said: "Two bargains in one deal result *riba*." It is narrated from Abdillahi bin Masud that the Prophet (swa) has prohibited two bargains in one deal⁵³." And the view of the majority of Fiqh schools maintained that conducting two sales in one transaction is *riba*. Ibn Arsalan has explained the message of the *hadith* saying that "it is to sell a bushel of an oat for a dinar on credit and when its time matures and the seller asks for the oat the purchaser says sell your bushel to me for two bushels on credit for a month."⁵⁴ So it becomes selling the same thing two times'. Obviously this kind of transaction retains all features of *riba*, for it is an increase on credit, that is when the debtor could not meet his promise. So, it is simply increasing the debt for the extension of its maturity. This problem of double bargaining in the same deal may take the following forms:

a. Two Conditions in a Sale or Sale and Condition

It is reported from Abdillahi bin Omar (ra) that the Prophet (swa) said: "It is not lawful, sale and credit, not two conditions in one sale, not profit without liability, and not sale of what is not possessed"⁵⁵. Al-Imam Shafi'i interpreted this *hadith* and mentioned "It is to say that I sell to you this good for, i.e., one thousand rupees, in condition to sell to me your house, or I sell to you my house for such an amount of money provided you sell your slave boy to me for such price that when you deliver your boy you will obtain it (my house)."⁵⁶ Hanbali explained this point in this manner; "it is to say that I sell my house to you in such a price provided that you purchase my second house for such price or to sell your house to me in such price or rent it to me for such amounts of money or to wed your daughter to me or to wed my daughter to you⁵⁷."

⁵⁰ Shawkani, *Nail al-Awtar*, vol.5, p.190.

⁵¹ San'ani, *Subul al-Salam* of vol.3, p.16.or *Nail al-Awtar*, vol.5, p.161.(Ahmad).

⁵² *Nail al-Awtar*, Vol.5, p. 162.

⁵³ *Al-Jahid fil Talkhis*. (Ahmad)

⁵⁴ Yasin A. Ibrahim, (1973) '*Nathariyat al-Gharar fil Shariah al-Islamiya: Darasat al-Muqarana'*, vol.1, p. 95.

⁵⁵ (Agreed by all five except Ibn Majjah).See *Nail al-Awtar*, vol.5 p.190.

⁵⁶ Shafi'i, *Al-Umm*, vol.3, p.77.

⁵⁷ Ibn Qudama, *al-Muqhnii*, vol.4, p.176.

b. *Salaf* (Credit or loan) and Sale

The meaning of *salaf* as Baqhawī has pointed out implies loan, he mentioned that "the meaning of *salaf* here is a loan⁵⁸." Ahmad explained it "that it is to give a loan to some one provided that he has to purchase certain goods with it from the seller at higher price on credit⁵⁹." Ahmad bin Qasim also mentioned it is that a man to purchase the good from the seller at a higher price in deferment⁶⁰." Imam Malik also elaborated this and pointed out; " A man says to another I will purchase your good in such price but you give me a loan of such an amount of money."⁶¹ There is no doubt that both *salaf* and sale are lawful transactions in Shariah but separately. Nevertheless, when they are combined in one contract they are prohibited and equated to *riba*. Moreover, even if a pure sale contract is simply doubled in one contract or in the above-mentioned manners it turns out unlawful in Shariah.⁶² These principals are extremely important and very relevant in our age of market economy, Perhaps the underlying reason is the strict Shariah requirement that the economic transactions should be free from any manipulations and superfluous influences, the buyers and sellers should directly concentrate only on the goods in transaction, so that the relative price of the exchange items is determined by their corresponding scarcity and relative demands, in order the natural forces of supply and demand plays smoothly as the two blades of the natural scissors in determining the real relative prices of the goods. The Prophet (swa) also said that: "Indeed exchange is based on mutual agreement."⁶³ And in another *hadith* the Prophet (swa) has said;

"The traders have an option before they depart from each other if both parties spoke the truth and described the defects and qualities then they will be blessed in their transaction and if they told lies or concealed any thing then blessing on their transaction will be blotted out."⁶⁴

This consideration is applicable to both the decrease and increase of debt or the deferred

⁵⁸ Yasin A. Ibrahim, *Ibid.*, p.96.

⁵⁹ Yasin Ahmad Ibrahim, *Ibid.*, p.97.

⁶⁰ Yasin Ahmad Ibrahim, *Ibid.*, p.97.

⁶¹ *Tanweer at-Hawlik, Sharhi Muwatta'* of Imam Malik, vol.2,p.157.

⁶² Yasin Ahmad Ibrahim, *Ibid.*, p.97.

⁶³ *Fathu al-Bari* vol.4, p.230

⁶⁴ M. Fuad Abdul Baqi, *Al-Lu'lu' wal marjan*, vol.2, hadith 980.

price. In fact, the reduction of a debt in return for early repayment is a matter of contention among jurists the general view of classical Fiqh scholars shows opposing the reduction of deferred debt and principal loans conditional on early repayment. However a large number of Fiqh scholars allowed the reduction of the price and loan reduction and they analogously inferred the permission of the increase in the price of the deferred sale. Some companions (of the Prophet) and even some of the great scholars of Hanbali Jurists like Ibn Taymiya and Ibn Qayyim have permitted it. The contemporary Shariah experts also endorsed this view, where the Makkah Fiqh Academy of OIC adopted that "reduction of a deferred debt in order to accelerate its repayment at the request of either party is permissible under Shariah, and it does not constitute *riba* provided not agreed upon in advance as long as the creditor-debt relationship remains bilateral relationship. If however a third party is involved, it becomes forbidden since it becomes similar to the discount of bills."⁶⁵ They further argued that reduction is the opposite of *riba* both in language and in practice. It is forgiving part of the debt in return for corresponding acceleration of payment before a due date.

Despite this general acceptance of the reduction of deferred price by the renowned Fiqh academies still the general views of earlier jurists which is opposing the matter and have solid reasons. They argue as Taqi Osmani has summarized that the reduction of deferred price is not permitted. Taqi Osmani has termed the *hadith* authentically weak where he quoted another opposing *hadith* with similar degree of authenticity. It is reported by Abu-Dawoud that Maqdad bin Al Ahmad is quoted saying;

"I lent a man a hundred dinars in the mean time my name was drawn and I had to go out in expedition with the Messenger (swa) of Allah I told the man to give me 90 dinars and give a discount 10 dinar and he agreed, I mentioned this to the Messenger (swa) and he Said "Maqdad you ate *riba* and you fed it to others."⁶⁶

So the *hadith* is apparently opposite to the above one as well as the position of Fiqh Academies. However, there is a room of reconciliation between them. Examining the text of the earlier *hadith* in the context of the prevailing Jewish practices and on the basis of another relevant

⁶⁵ Resolution No.66/2/7 on Installment Sale, Seventh Session of the Islamic Fiqh Academy 1412H (1992).

⁶⁶ Al-Bayhaqi, *Al-Sunan Al-Kubra*, vol.6, p.28

reports from the Prophet (swa) we find that the above interpretation of the *hadith* is in fact misleading. There is a strong reason to believe that the amount which the Prophet (swa) ordered to decrease by Bani Nadir represented only the accumulated amount of *riba*. It is well-known fact that Jewish people used to give loans to Arab tribes with an increase (*riba*). Thus, given this historical evidence what they had to reduce according to the recommendation of that Prophet (swa) seems to be the excess due which they had made over the principal loans. This inference is supported by Haqiqi who owed to Ossayd bin Hadeer 120 dinars payable after one year. "He then reached an agreement with Ossayd to repay the principal which was 80 dinars and to discount the *riba*."⁶⁷

Otherwise, the creditor of a deferred debt has no right to demand accelerated repayment. Similarly the debtor has no right to reduce the principal for immediate payment. A creditor who resorts to such measure is in fact buying the time term for the amount of the discount which is similar to selling the time-term for the amount of an increase of the original debt and this is precisely the pre-Islamic *riba*. Therefore, the discounting in return for early repayment cannot stand as strong justification for the price increase in return of deferred payment. And this general recognition of these variations as we illustrated above does not seem sound for the above reasons. Further more when the reciprocal transference of the ownership of two items takes place and value of each item is determined in fixed proportions of the other, a fixed level of rights of each individual is finally established irrespective of being delivered presently in the place of the contract or absent on the liability of the debtor, then there is no way these rights to be amended in the context of this sale contract. This conforms with the general objectives of Shariah and the principles which the Prophet (swa) has laid down stating that: "someone's property will not be lawfully acquired by another unless it was given to him willingly."⁶⁸ Precisely, we assert that the reduction of the deferred price implies the reduction of already accumulated interest. It does not mean that one party should reduce and leave part of his very principal right for early repayment. As the decrease of ones' wealth at the cost of the increasing other individual's wealth if it is stipulated in the contract by paying early time amounts to injustice to one party, since that is a fattening of the share of one party associate with the decrease of the wealth of the other and this situation is against very fundamental purposes of Shariah. The creditor may give his right for

⁶⁷ Al-Waqidi, Al-Maghazi, vol. 1, p.374.

⁶⁸ *Fathu al-Bari* Ibid.

charity but that is something bilaterally to be decided outside the loan or sale transaction on his own wish and free will as far as the contract is related to matter of sale and transaction no outside a factor would force him to reduce part of his right if the creditors insist claiming his full amount no force can make him leave it.

6.5 LOAN TRANSACTION

We have seen above that the exchange of two different goods or distinctive items, i.e., money and commodity either on cash or over a period of time, serve to balance the consumers spending and their average income. And in this way the individuals optimize their current and expected welfare levels. Similarly the activity of lending and borrowing is induced by a very fundamental economic phenomena associated with the lack of coincidence of the human wants and available economic resources. The conversion of future goods into present goods takes place in various forms. In this section we analyze the major principal one of them that is to examine the nature of a loan, which is basically the exchange of similar assets and goods either through geographical space like Bill of exchange or Saftaja in Fiqh terminology or through inter-temporal transaction. We will discuss also the main objective and advantages of this transaction for the contracting individuals and economics at large.

6.5.1 Lending as a Pure Exchange Transaction

In this context, it is assumed that this market to be similar to a goods market which its price is interest rates the premium paid on the amount borrowed or lent over specified period. In conventional literature as we have seen above the market for loan is deemed as a pure time market for present assets against future not only for lenders/creditors or borrowers but also as natural rates in all process of production. According to Fiona (1993) interest is the premium that the seller of the future claim pays the seller of the present claim⁶⁹. It is presumed that the present claim is more liquid than the future claim to the same amount due to two reasons;(1) the present claims value in terms of the unit of account is fixed, with the result that one can feel more certain about its purchasing power than one can about a future claim (2) the transaction cost of transforming a future claim onto immediate purchasing power is higher than for a present

⁶⁹ Fiona C. Maclachlan, *Ibid.*

claim. Bohn-Bawerk made critical deliberation to explain the apparent similarity between the exchange of goods and exchange loans. He presented a robust argument for extending the concept of exchange to lend transactions. Answering the question whether a loan can or cannot be called a genuine exchange he came with the following conclusion;

"The limitation of the concept of exchange of goods of different kinds is inherent neither in the nature of exchange nor in consonance with the hitherto firmly established use of the concept. What is inherent in the nature of exchange is that two goods are given one for another and nothing more. And as for established linguistic usage it can readily be shown that transactions in which same kind of goods are given one for the other are looked upon by everyone as a genuine exchange and are so designated⁷⁰."

Bohn-Bawerk has further elaborated and clearly furnished the nature of conventional loan contract and pure loan contract according to him is a part of sale and purchase or in its broad sense it is a part of exchange activity elaborating this notion he asserted that;

"The loan is nothing more nor less than a true and genuine exchange of present goods for future goods. Indeed, it represents the purest conceivable form of that phenomenon and constitutes in some respects its ideal type, i.e., creditor A gives debtor B a quantity of present goods - present dollars, in return debtor B gives creditor A quantity of goods which are of the same kind, but are future - next year's dollars. So what takes place is a reciprocal conveyance of property in two quantities of goods one of which is given as the equivalent of the other and both of which are absolutely identical except in one respect: The sole difference lies in the fact that one belongs to the present the other to the future"⁷¹

Bohn-Bawerk's penetrated work revealed the peculiarity of this kind of transaction which goes under the name of loan and its pseudo price under the cover of usury/interest stating that: "I really know of nothing which is a purer and clearer embodiment of the concept of exchange in general and exchange of present for future good in particular."⁷² .

⁷⁰ Bohn-Bawerk, *Positive Capital Theory*, 1888, p.56

⁷¹ Bohm-Bawerk, *Ibid.*

⁷² Bohm-Bawerk, *Ibid.*

6.5.2 External Economies of Loan (*Qard Hassana*)

Usually the main purpose of conducting transaction of goods is to acquire more gain or to attain more advantage. And as we discussed in the earlier chapter the normal exchange must provide additional benefit to the transacting parties for the exchange is an economic activity induced by a perceived benefit. The advantage that is gained from trade is very clear and it is considered as an indigenous part of the contract and the subject matter of the exchange. However, the benefit that arises from the exchange of homogenous goods is exogenous to the process of the exchange as it is not the subject matter of the transaction. While the benefit in the first case is inherently the result of exchange of heterogenous goods which essentially to generate additional economic gain known as gain from trade, consumer surplus or producer surplus etc. The second kind of benefit is apparently referred to external economies of loan transaction which we present in the coming discussions. The determination of this requires a great care and cautious handling for it is always susceptible to be mixed with the prohibited benefits of a loan in Islam. These external economies may be considered as a kind of mutual benefit that goes to both the borrower and the lender at the same time. Because objects have their own economic benefits based on their usefulness or value in use to satisfy the demand of the consumers' wants, these are the natural benefits of the objects. But when the objects associate with other external factors such as time and space they give the users additional gain which may accrue to the participating parties or the economy as whole. Let us now examine two significant kinds of benefits arise from exchanging similar goods namely (A) the benefits that arise by inter-temporal exchange or loan transaction over time period this is the contract largely called *qard hassan*. (B) the benefits that stem from the consideration geographical space that is what is known as *Saftaja* in Islamic jurisprudence

A. *Saftaja* (Bill of exchange) space consideration

In general the loan contract is concluded in a place and its payment is to be made at the same place. However, if the lender agrees with the borrower to pay the loan in another place for the convenience of the borrower, it is a kind of additional benefit that goes to the borrower. But, in if this kind of contract is providing benefit to the lender also, where there is a benefit derived from the loan by the lender, is the matter of contention among Fiqh scholars. The Fiqh scholars hold different views of this issue, some of them expressed strong objections while others allowed it completely. Those who disallowed it they did so because they deny any benefit that goes to

the lender. The majority of Fiqh scholars are supporting the objection because the utility that associated with the loan is clearly against the *hadith* of the Prophet (swa) "Any loan that entails benefit is *riba*". *Saftaja* in Fiqh studies is simply the borrower to pay the debt in place other than where he received it. In the modern terms it is known as "Bill of Exchange". That is when the place of the loan contract is different from the place of payment. According to the Islamic jurists *Saftaja* arises from debt such as the deferred sale renting or loan. R. Al-Misri who extensively studied the subject argued that since the increase or additional benefit that arises from sale is permissible, then *Saftaja* in case of credit sale is also permissible without difference among jurists, even if the payment of the sale price in another place is stipulated in the contract.

However, al-Misri tried to draw analogical conclusion between the allowance of deferred price in consideration of place and its increase in consideration of time. He argued that since the increase in deferred price is permissible for consideration of time and place then the allowance of an increase in the consideration of place permits the increase in time consideration. There is no doubt in the first to serve as an analogy for the permission of the second⁷³. Nevertheless, there is no disagreement on the permissibility of *Saftaja* loans if the payment in another place is not stipulated in the contract, and if on the basis of customary any transport expense is paid by the borrower to the lender it would not be making any problem for it is considered as goodwill repayment. But if the payment of the loan in another place is a part of the contract stipulated by the lender without paying any transportation or transference cost, the Islamic jurists have different opinions about legal position of this case. Some of them rejected it like al-Hanafi, al-Shafi'i, and al-Tahiri schools of thought, while al-Imamiya and Hanbali schools are of the view of its acceptance.

The benefits which the lender may obtain from *Saftaja* may be summarized in the following two forms:(a) transport cost or the rent of its loading, some of the Islamic jurist object this contract for there is no transport cost. they ask where is the rent of transportation? .(b) guarantee against any risk that may arise during the transference. *Saftaja* seems to be technique of risk aversion in favor of the lender, where despite the length of distance or any possible risk during the transportation the lender gets the same amount of his asset or property. Then keeping the account on these potential economic benefits in general there may be three considerations in

⁷³ R. Al-Misri, *al-Qurud wa Adhillatu Tahrimihi*, 1987 p.54

conducting this kind of loan transactions according to the motivating derive of parties.

- i. Like any kind of *qard hassan*, *Saftaja* may be purely humanitarian motivated contract for temporary assistance of the borrower and relieving a difficult from him. in this case *Saftaja* gives an additional benefit to the borrower. It is also possible that the lender himself may recollect his principal from the borrower's place. So that the whole possible benefit from the transaction accrues to the borrower.
- ii. It is possible that the purpose of the loan on the part of the lender to be motivated by security factor, where the lender wants only someone to guarantee his financial asset against a potential risk expected to arise in the mean time. So by lending his property one can make it pass a given place or threat in that particular time. In this case the benefit from a guarantee of the loan by the borrower goes to the lender only. This benefit according to Al-Misri constituted the benefit prohibited by the Prophet(swa) and termed it to be *riba*. On the basis of the *hadith* of the Prophet (swa): "Any loan that draws benefit(stipulated benefit to the lender) is *riba*".
- iii. It is also very likely that *Saftaja* may become advantageous for both parties, over and above the common benefits of any loan. That is perhaps, the borrower feels better to pay the loan in his place or in a place other than where the original loan contract was concluded. On the other hand the lender appreciates if the borrower pays it in the other place without bearing any cost of transportation and with complete security. The two interests coincided and each one got his own benefit

This last kind of benefit that accrues to the lender when the borrower also gets his own benefit is the point of dispute among Fiqh scholars. In its permissibility Atta' Said that "Ibn Zubair was used to take dirhams from the people in Makka then writing for them to Mus'ab in Iraq and they were used to take from him" Ibn Abbas was asked about this and he did not see any problem with it. Reportedly, it is also asked Ali bin Abi Talib, and did not see any problem with it. Similarly number of *Sahaba* (ra) and great classical Fiqh scholars could not see any problem in this kind of activities. Al-Misri in his lengthy discussion about *Saftaja* in Islamic Jurisprudence concluded that. The repayment of the loan in another country or place other than where the contract was initially concluded may contain benefit for either party. According to him if the benefit accrues

to the borrower only it is desired, but if it goes to the lender it is not, however if the benefit of the contract will be shared by both parties it is permissible provided that there is no transport cost on either party, neither on the lender nor on the borrower. Since, a security factor associates with any loan because the loan principal must be repaid under any circumstance nothing to worry about the benefit of safety that accrues to the lender. What is not permissible may be when the transference of a loan stipulated in the contract which provides benefits to either party. For insisting on that one bear cost without compensation is impermissible.

B. *Qard Hassan* or Inter-temporal Consideration

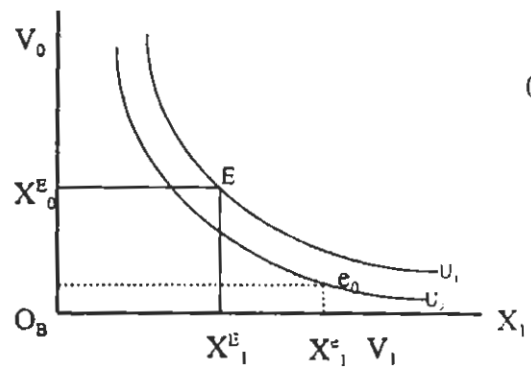
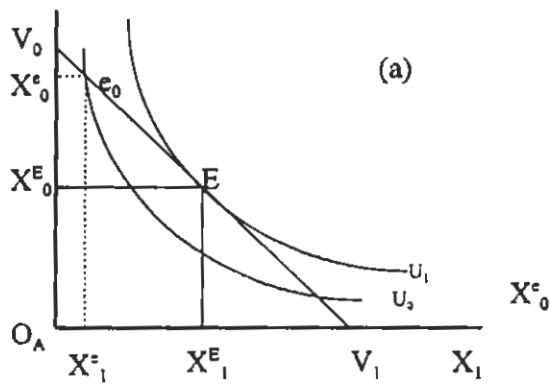
To put this discussion in the context of inter-temporal and give further analytical fashion we assume two individuals A and B, single identical good X, each individual have an endowment sufficient for the consumption of two periods, i.e., present and future periods irrespective of these two times being two days, weeks, months or years. We assume also that the two individuals get their endowments alternatively, so that at the beginning A has its two period endowments while B has to wait till the next period he receives his endowment, except that he has very little of that good for his survival only. Suppose individual A has in the present time $O_1X_0^a$ of wheat and $O_2X_1^a$ of wheat in the future Individual A might consumes all his endowment at the present period. Then he will over consume the wheat of two period and complete it in one period where as he consumes more and more of his marginal utility may turn to be zero after that stage any amount he uses further reduce his welfare as he reached in a saturation point at half of the endowment whatever he consumes after that means wasting of the resources. So, has a large amount of wheat in the present while he is in a deficit in the future. If he consumes all of his present endowments now and save nothing for the future, certainly he will face the deficit in the future period and as a result he may realize two undesired situations;

- a. By consuming all of his stock of wheat at the present time he may not increase his utility. But that may waste only his endowment or cause even disutility and increase only his dissatisfaction after he reaches certain level of a saturation point. This may be so, according to the law of diminishing marginal utility.
- b. As result of over consumption of his endowment and finishing them completely at the present period he will suffer also a shortage of resources in the future and realize lower

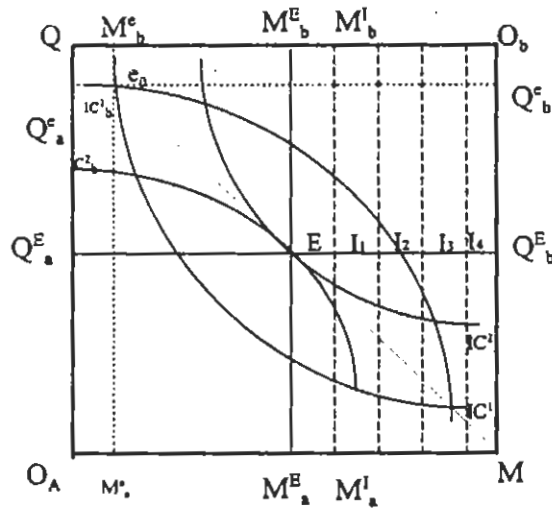
level of consumption.

Thus, in this situation he will reach a lower indifference curve for instance U_0^b for both cases which is actually undesirable state in both periods; Then individual A must save his present surplus for the future consumption if he wants to raise his utility level that is he has to seek a way to transfer part of his endowments in the present to the future use. To do so, he has to select one of several options which can give him certain benefits, before he decides any one of them he would rank the options open for him and rationally will select the best alternatives. We would summarize here the options that the consumer will face and briefly compare among them on the basis of their benefits and opportunity costs.

Costs of withholding/hoarding behavior; Suppose the individual opts to save his extra/surplus wheat and keep them with him, without lending to anybody. The implications of this behavior may be as follows; (i) he will incur some costs of storing and keeping it until the next consumption period which will reduce its actual quantity as he pays the expenses of storage from the wheat (ii) the quality of the wheat may get deteriorated, which as a result may reduce the utility derived from it by the individual in its future use. He may preserve it in paying for it at high price or costly method (iii) individual B who is seeking loans at the present time with guaranteeing its return in future. He will suffer from under consumption by getting less utility (iv) the social deadweight loss may be the combination of the welfare loss of both individuals, i.e., A and B as well as the costs incurred by individual B.(v) the difficult created by this lack of cooperation may not stop here. It will have a perpetual consequence where alternatively each time one individual will suffer from resource deficiency and loss of welfare (vi) their cooperation may suffer and they may instead of brotherly helping each other without any cost and living together in solidarity and social coherence they might develop enmity and rivalry to compete with each other over resources (vii) the problem will be further aggravated if we incorporate with the supply side where as one group is consuming less than their optimum level, inventory of output will be created, as result, fluctuation in a business cycle may be generated (viii) as this kind of self attitude shows also hoarding behavior Islam has severely abolishes and forbidden any hoarding activity and promised for those who practice this for terrible reward.



(b) 255



(c)

Figure 6.2 External Benefits of Loan Transaction and Riba

Illustrating the role of enter-temporal exchange of single commodity, we assume two individuals A and B have an endowment sufficient for the consumption of two periods, i.e., present and future periods. A depicted in fig. 6.2 (a) and (b) A holds at present $O_A X_0^e$ of wheat and $O_A X_1^e$ of wheat in the future. While B will get his resources of times in the next period. It is better for both of them to lend their surpluses to each other. Then both A and B will consume at E which shows the highest level of preference for both individuals. Now combining both figures in an edge-worth box, fig.6.2(c) and we see that E shows the individual endowments. If each one fairly exchange with the other, both will end up at E and by consuming equal proportions of present and future consumption both individuals will realize higher level of utility. However, A may not be prepared to give loan to B without Interest/riba that is A want to sell the external benefit that accrues to B and charges at I_1 instead of E level which implies that B has to pay the principal loan plus certain amount of his future endowments that is the distance between E and I_1 without any feasible counter value. This process may continue to I_2, I_3 and so on. And each time the principal loan will be increased even if that will exhaust the whole future endowment of individual B as the point I_4 shows.

Therefore, it is better for both of them to lend their surpluses to each other. If A lends his wheat surplus to B as a *qardi hassana* to return it in period, 2, in the same quantity is their reduction of welfare for A? Are there time preferences, so that A prefers present consumption to the future one? Or both improve their welfare level by lending each other or at least one of them improves its utility without affecting the benefit of the other? If A consumes half of his wheat in present period and lend the other half to B who will go repay it out at the beginning of period 2 in future. Then both A and B will consume at E which shows the highest level of preference for both individuals. Any point other than E will be inefficient where either of them or both will get less utility. But most of the time both of them is losing. If A consumes more of Q or save it as we have seen above both will realize inefficiency arising from that action.

The second alternative may be the opposite of the above one and individual A decides to lend his surplus to individual B for a certain period of time as the above diagram shows. Supposes A gives a loan amounts to $O_aX_0^e - O_aX_0^e = \Delta X_a$ to individual B who will return this same amount or its value equal to $O_aX_1^e - O_aX_1^e = \Delta X_a$ in fixed date in the future period. Individual B has very small amount of endowment (wheat) not sufficient for his survival even but he is expecting that he will be prosperous in the future period and will get O_bX^e of wheat for consumption in two periods present and the future. His endowment is O^bV of wheat in the future and of O_bX^e wheat at the present facing deficit of wheat for the present period. If he exchange in some of his future endowment for the present consumption he can increase his welfare. That is if he gets loan from A who has an extra or surplus consumption at the present. If A gives certain amount of wheat in *qard hassana* to B, both A and B can improve their welfare without reducing the welfare of anyone else. A has improved its utility by lending part of his present consumption and consuming the other part in the present. That is postponing part of his consumption in the future. Of course, this option has a different implication than the above option. We may briefly mention certain benefits that the consumer may derive from it. While, as we have seen above the spot exchange of single, homogeneous good has no any economic benefit at all and no rational individual will get interest to carry such a fruitless exercise, there are various kinds of external economies that may accrue to the concerned parties. The justifiably permissible benefits that may be derived from loan transaction may be divided into three kinds of benefits such as;

1. **Benefits of a loan that accrues to the lender:** The people mostly and overemphasize on the benefit that goes to the borrower and almost ignore the benefit or multidimensional utilities that is received by the lender without harming anybody. (i) Increase of the utility or the welfare of the lender, that is instead of consuming his resources at once he spreads his resource over certain period of time and accordingly maximize his welfare (ii) Through *qard hassan* he may avoid the above costs, i.e., storage expenses, quality preservation and securing his credit opportunity in the future. All these may turn as significantly beneficial for him and raise his welfare level economically and socially (iii) assuring the security of his assets and hedging its value against any risk which may deplete or erode its value, this requires for preserving the quality or the value of his good in the period. (iv) obtaining reward from Allah(swt) which may be more than that of the charity or at least equal to one half of the charity (v) enhancing the social coherence and promoting the feeling of brotherhood, where the lender through this *qard hassana* the lender may win to make a friend of him who will also help him during the period of difficult and hardship (vi) in case of *Saftaja* or bill exchange the asset or the loan may be delivered at his desired place without any transport cost of these benefits are carefully separated from those prohibited, i.e., *riba*.

2. **Benefits that go to the borrower:** No doubt that a significant advantage of this transaction goes to the borrower and S. Tahir observed that the loan instrument bridges the gap between a borrower and his immediate need, which he cannot fulfil on his own, Tahir (1995). Thus, when a person is seeking a loan he wants to exchange his future income for present income of equal amounts. In other words it is an exchange of same kind of goods of different dates. It provides the following economic benefits to the borrower: (i) his immediate and urgent want is met, so that his pattern of consumption may be smoothed and some potential threats of income fluctuations or living conditions are normalized. (ii) he got access to use his future assets at the present which was otherwise, impossible for him to obtain it.

3. **General Economic Benefits:** As we have seen that both A and B individual's utilities increase through this process, we can safely say that the welfare of involving parties in this loan transaction will increase and the general well-being of the society will be enhanced. Since each individual's consumption is smoothed and any disturbance which may emerge or urgent need or consumption gaps are covered through loan transaction among societies, this will

induce a smooth functioning of the economy and prevent in large extent against an economic fluctuations and business cycle. For there may not be any inventory stock in the goods market or squeezing the general production and investment level. Hence, the production will steadily grow without ups and downs. Hence, the problem transaction may arise from attempting to internalize these external economies.

All these advantages are the economic benefits of loan transaction which serves as the underlying reasons of its permissibility in Islam. However these advantages are not part of the loan itself or its magnitude. It is apparently an external economy of the loan contact. However, internalizing this advantage by selling it for part of the loan itself is unlawful and that is the benefit prohibited by the Prophet (swa) in his statement "Any loan that brings about advantage/benefit is *riba*⁷⁴."

6.5.3 Riba-based Loan Transactions

Now we turn to the situation that individual want market his economic position of having surplus at the present and sell the external benefit that loan transaction is going to generate. We analyze this irrational behavior by referring again to the above figure. In this case individual see as an economic opportunity of generating more income by providing a loan to B for his present surplus but with certain amount premium/interest to be paid by A to B for this offer or consumption. Suppose A gives a loan to B But with interest which means that A will receive a higher or additional amount over its principal. A will put the interest rate according to the degree of demanded for funds by the borrower and accordingly try to maximize the rate of interest. It is a natural fact the individual's endowments or earnings are not constant. Similarly the production or output is not smooth some times people face deficit and some times realize surplus. From here the concepts of lending and borrowing arises as a way of smoothing the consumption patterns over individuals a life span or to cope with any urgent need which might unexpectedly arise.

We can combine the two groups of maximizing utility in ordinal approach. We have seen previous in fig. 6.2 (a) and fig.6.2 (b) the behavior of each individual in maximizing their

⁷⁴ San'ani. Subul al-Salam vol.3, p.53

utilities. Now combining both figures in an edge-worth box, we can illustrate our next discussions on fig.6.2(c) and we see that E shows the individual endowments. If each one fairly exchange with the other, both will end up at C and consume an equal proportion of present and future consumption. Both individuals will realize higher level of utility at C. But If A cannot give loan to B without increase of some additional amount above the principal. B has no option except to accept this offer with interest cost as long as that rate makes him better or same level of welfare. Now suppose B has OX_0^e of X commodity in the current period while he is to get OX_1^e of X in the future there is big distortion in his consumption pattern. If he would not get a loan he will consume at e and remain in distress in both periods but if he finds someone to give a loan he will smooth his consumption and reach higher welfare in both periods at c individual B is suffering a consumption shortage at the current without getting a loan he alone will face the problem. Knowing that individual A has a surplus of X at the present he may ask for a loan and A may give a loan to B in return of same amount in the future or may lend him with some charges it is up to A which one he prefers, and even he may refuse the offer with such cost.

If A gives X_0^e to B both, A & B will in enjoy their highest consumption according to their budget constraints, i.e., at e point where individual A will consume at $O_A X_1^e$ of X at the present period and $O_A X_0^e$ of it in the future by merely changing the composition of his consumption pattern and smoothing his expenses he can reach the highest possible indifference curve without harming anybody else. In this situation B also is in the position with highest utility level where he is consuming $O_B X_1^e$ of X in the current period and $O_B X_0^e$ in the future. In this case up to now everybody is happy both enjoying the Pareto efficient point. But B has reached in this position by the help of A and without any sacrifice by lending A certain amount of his present endowments X_0 to the individual B in exchange B's X_1 in the future. Simply like A is saving the present surplus for his future consumption with more safe and secure way that is to lend the current excess to B in return of excess to B in return of B's excess future consumption. It is mutual interchange of their surpluses one in the present while the other has a surplus in the future period. Suppose now A is not prepared to give loan to B without Interest/*riba*. Because, B individual is in difficult, any slight relieve he may find even with more or additional payment to A, he will accept, as any point above his welfare level is preferable to the present situation. Suppose B accepts at I_1 in the first period of time instead of C level which implies that B has to pay the principal loan plus certain amount of his future endowments that is the distance between C and I_1 without any feasible counter value. If individual B could not pay this in the first period

again he has to pay more and B will claim at I_2 and so on. This process may continue till I_4 and each time the principal loan will be increased even if that will exhaust the whole future endowment of individual B as the point I_4 shows.

In this connection, it is clear that riba is the increase of either consideration in exchange of homogeneous items. Thus, since the excess that goes to either party can be achieved only at the cost of the other party's endowment increase and decrease of either consideration amounts to riba. For a loan is actually a single commodity we assume that it is the same in both periods in quality as well as quantity, in other words its value in period one is perfectly equivalent to its value in period two. Secondly it is an exchange of equal amounts or equal levels of consumption in two different periods, where the surplus stock of A above its present consumption means the decrease of its future consumption and the future stock of B is partially its present consumption or utilization. Hence, each individual wants to allocate his stock at its appropriate time only. The exchange will take place if their two demands coincide. Therefore, it is not charity even though it has certain features of charity, in its initial form it is an exchange of fixed rights which as a matter of principle according to Islamic teachings must be accurately documented, mutually agreed upon in front of at least two sound minded witnesses at its conclusion. It demands perfectly equal amounts of its same quality and quantity or similar value should be returned. Thus, with these very strict and clear conditions of the loan contract there is no any reason to believe that the right of either party to be decreased. The increase of the principal of either party is the decrease of the right of the other. This must not be confused with the saying of the Prophet (swa) in the context of Jewish of Bani Nadir "reduce the debts and claim them before their due time". It implies to reduce their unlawful claims which were accumulated rate of interest over their original principal. For as we have explained above and history tells us the Jewish of Bani Nadir were used to lend the people on interest.

These are the essential features of what Islam knows as riba in its simplest form throughout the history and this as we see conforms with the modern notion of interest rates in conventional economics. In this sense riba clearly coincides with the modern conventional interpretation of interest in the context of inter-temporal exchange and renting transactions of similar capital funds. For instance Samuelson ((1967) expressed that interest is the price or rental of the use of money considering its services exactly as the service of a medical doctor or of a tractor." He argued that "when money is sold someone should pay a price and if it is borrowed

one should pay a rent." A similar view is envisaged by Maddalla and Miller in their recent text book Economics they expressed the concept of interest equivalent to the concept of rental price of capital and according to them. It is nothing but the rental price of money. i.e., if you have \$.10,000/- and you lend it to another at a 10 percent rate of interest for one year. you are in essence, renting your money for \$1000 and you get back the rent and the principal at the end of the year⁷⁵.

A number of important logical questions may arise from this analysis such as: Has money its own usefulness and intrinsic value? Has it a utility of its own self which the consumer can derive from it while he is consuming? Or can it offer any separate services? . Bohm Bawerk expressed the following profound observation expressing that;

"The debtor will ordinarily purchase the present dollars he receives with a greater number of the future dollars he parts with. The transaction goes under the name of a "loan" and interest under the Latin name of "Usura" which is money for the use of money. People never say I will sell you! or exchange with you! but they say I will lend them to you!"⁷⁶

In pragmatic sense the warrant or money is merely a receipt for yet not chosen goods and services which implicitly have the utility of an unspecified basket of commodities. It is indeed a promise of acquiring beneficial commodities not yet possessed or decided to use them. Even the Cambridge critics, as Hausman observed, demonstrated clearly the above absurd consequences of interest "the only feasible way is taking a loan temporarily on interest for it may be seen to have less cost than others, but later on the debtors will realize that interest charges render the payment of debt almost impossible for them and they have to borrow one loan after the other to get out of this mess. Even after paying interest equal to money times the original principal the principal still remains as it was before."⁷⁷ The practical reality and common sense dictates that the use of money by purchasing with it a piece of a good take once and finishes at all. Then some common sense questions might be asked; Is there a way to use the money and has it? How can the warrant or the promise be materialized and utilized, while keeping it in its

⁷⁵ G. S. Maddalla and E. Miiller, Economics, 1993, p. 482.

⁷⁶ Bohm-Bawerk, Ibid.

⁷⁷ Hausman, Ibid.

original nature? If this is possible then only the use and principal can be separated which requires to discover a scientific basis for this conception as far as the money is concerned! Moreover, to justify the concept of interest in the domain of time it is to secure a number of particular inventions and peculiar situations, i.e., it is to invent a way in which to convey more than all there is of a thing! It is necessary to discover in the name of the loaned thing the right to any and every possible use to derive from it - including the use that destroy it completely and then in addition to that the original principal is still safe and secure which necessarily must be paid to the lender!. Naturally, perishable goods vanish the moment they are utilized but according to this perception when they are given as a loan to some one, it is assumed to acquire permanent surrogate existence in their original form, at the same time furnish a continuing use which emanates from them without intermitting even after they actually have long ceased to exist. Perhaps, this absurd phenomena and illogical implications of interest rate is clearly observed by Bohm-Bawerk as he noted the following example;

"For instance you could burn a 100kg of coal to ashes on the first of January 1956 and then you could continue to use it throughout the year or even possibly for so many years after, and the best part of it was that you could sell this continuing use at a special price even though you had previously sold the coal itself to some one else and the right to complete use of it for another with entirely different considerations. Earlier legal professionals were completely aware of its fictive nature but through strange imprisonment. It subsequently came to be looked upon as a completely and scientifically an established truth"⁷⁸.

Further more, the very existence of the concept of interest is questionable on the basis of its speculative nature which has no real ground. Robertson (1940) observed that:

"The rate of interest is what it is, because it is, if it is not expected to become other than it is, there is nothing left to tell us why it is what it is. The organ which secretes it has been amputated and yet it some how still exists - a grin without cat"⁷⁹.

⁷⁸ Bohm-Bawerk, Positive Capital, 1888, p. 56

⁷⁹ Robertson, Ibid, p.40

We have depicted this absurd situation of interest based system in the above diagram and it is clear this repetitive exchange contract or continuous use of nonexisting property, starting from E point of the first equilibrium point of the initial contract the stock of B will continuously increase and earn more value till it reaches at I_4 , even though the principal is utilized long ago and finished. This continuously exploitative acquisition of resources of the people might result that the most or whole of income/wealth of the debtor is taken away by the lender and the poor debtor finds himself unable make the both ends meet. This miserliness condition without knowing way out, kills the mental, moral and personality or social stand of the individual which spoils his health and physical strength and puts him into vicious circle in his life. This theoretical analysis is actually the practical fact of contemporary economic dealings.

6.5.4 The Proposed Time-Multiple Counter Loans

Late Sheikh Mahmud Ahmad propounded the concept of time-multiple counter loans (TMCL). In fact it has been seen worthy of much consideration. This idea is considered to have a great potential for application in interest-free finance, specially in areas where it is not possible to determine profit or loss (like very short periods or consumption loans or government loans) or where the banks feel that cost of supervision of credit will be very high⁸⁰. The gist of the concept in brief may be explained as follows: If a person needs a fund from the bank he should provide a counter loan to the bank equal to a fraction of the amount he requires. But, the product of the amount and the time of the loan needed by the individual should be equal to the product of time and amount of the loan provided by him. For example, if a person requires a loan of Rs 12000 for one month he should deposit a sum of Rs 1000 for one year with the bank. After one month, the individual will return his loan of Rs 12000 without any increase and after one year, the bank will return the individual his deposit of Rs. 1000. During this period both the parties will be free to invest and make use of the funds provided by each other.

However, some of the scholars objected this concept and expressed their dissatisfaction with its proposal and they argued that (i) It is another form of disguised interest it makes loan conditional which is unacceptable in Islamic teachings (ii) It creates a situation where a creditor

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Akram Khan, *Islamic Banking in Pakistan: The Future Path*, 1992, p.33

gets benefit from debtor which also is objectionable to Shariah⁸¹. Although the concept as it is pointed out it still requires more critical examination in different aspects in this short visit to its content we add certain observations to the above ones examining in its economic viability and legal position; (a) If the loan is for consumption the time connection may not have any meaningful implications (b) if it is for investment we should not name it loan in Islam, and since the investment is expected to generate profit, this loan transaction which evaluated on the basis of purely time element is conceptually and practically different from the nature of investment in Islam where profit is not measured by mere time lag. If large resources are drawn from the banks in this form which do not provide return to the owners of the fund it seems kind of hoarding on the name loan and keeping large scale of public funds primarily idle in the form of loans is unacceptable to capital owners and harmful to economic development. (c) the concept treats money as a rentable asset which supplies continuously kind of services. Where practically money ceases in existence the moment it is spent (d) Another important objection arise from the Fiqh interpretation of holding double bargaining in one deal or two transactions in one contract. As MTLC seems to be exchange of loans, combining two way loan in one contract. All these are sales strongly prohibited by the Prophet (swa). (e) it is also mentioned that there is a possibility that since the borrower he is in dire to get loan he may not have any fund to lend to the bank. (f) this concept creates debt based economy where Islam is not encouraging depending on loans. unless there is genuine reasons and ability to pay it back. While we see that Islam did not encourage loan transactions it considers something needed in particular situations where the borrower is temporarily facing a short of financing. So, loan transaction in Islam is a temporary phenomenon, it is not income generating instrument, hence, it cannot be used for investment purpose.

Owing to this fact profit sharing principle cannot be applied to short term consumption purposes or temporary financing credit loans. Muslim scholars generally believe that all types of loans in Islam should be in the nature of grants in aid and not be commercial transactions. Therefor taking loan or becoming in debt three principles must be kept in mind. (1) ability repay the loan on time on its maturity (2) firm intention to meet its repayment (3) it should be taken for genuine and justified reason of lawful thing⁸². A numerous *ahadth* of the Prophet (swa) shows

⁸¹ Akram Khan, Ibid 1992, p.34

⁸² Fadl Ilahi, p.222.

the above view Salawat reported that the Prophet (swa) offered funeral prayer over a bier brought to him only after its debts were paid. In this case the Prophet (swa) wanted to discourage the habit of contracting debts which one had no means to repay it.

Demand might increase in the first stage of this arrangement but, its consequences may be very different and contrary to its beginning where ownership for the assets will be transferred to the hand of rich who hold most of the capital in the economy. Islam sets a number of regulatory principles at personal and institutional level on the modes of financing as well as the individual's moral norms.

6.6 CONCLUSION

In the forgoing discussions we have clearly elaborated that time in its abstract sense does not hold no any economic value by itself. Its nature is equated with pure conceptual ideas and unit of measurement i.e. geographical space and arithmetic numbers. Both conventional treatments and above Islamic interpretations of the subject have indicated this comprehension. Similarly the hypothesis of consumer time preference has failed to justify the existence of interest. Perhaps there is apparently causality problem, the reverse of the direction of the effect is probably appropriate. Once the existence of interest is admitted in the society, it is easy to develop the theory of time preference and hence arrive at certain rate of discount not the other way round. The current situation of the concept of pure time preference in consumption where any present asset is preferable for future involves a severe irrational implications for this behavior indicates the consumers rapacity and wasting of resources which is not desirable in any system. The existence of saving as natural human behavior, the investment and production process for future goods manifests the social desire and preference of future goods to the present ones.

The increase of deferred price above the spot price level of the same good has nothing to do with time value or riba as long as it is settled at the exchange contract analogous to the relation of retail and whole sale price. However, once the deal is concluded any decrease or increase of the credit amount on the basis of time extended would amount to riba. Loan as an inter-temporal exchange of funds may provide external economies to the concerned parties in particular and whole economy at larg. But this external advantage is not marketable in the common sense of exchange transaction, otherwise it is the real riba prohibited by Islam.

Rejecting the avidity attitude imposed by the hypothesis of consumer time preference Islam recommends for the midway and consumption balancing approach which necessitates that the principles of (i) the principle of moderation and (ii) living according to one's means. Islam sets a number of regulatory principles at personal and institutional level on the modes of financing as well as the individual's moral norms. Given certain level of endowments or resources using this principle of balancing consumption through enter-temporal adjustment the consumer may reach at the optimum level of benefits or welfare according to the Pareto efficiency condition, where any further readjustment will never bring to him more welfare without reducing the welfare of another individual according to his means not beyond his resources. So that any loan be borrowed must be paid. The credit given to the consumer can either be greater than the consumers means of payment or less or equal. If the speed of credit mechanism goes out checking, it accelerated and unwisely used. Because, by and large the modes of financing constitute the main determinant in shaping the form of the demand function of the consumers. The consumer credit for this type of needy consumers is viewed to be in the provision of *qard hassan* from government sources of revenues including Zakah. But for they have no any source of income to repay the loan their financial assistance should be considered which may not be in the form of *qard hassan*, it should be in the form of charity.

CHAPTER 7

RECONSIDERATION OF PROFIT VERSUS RIBA IN THE CONTEXT OF UNCERTAINTY AND RISK-BEARING

One of the most dominant explanations of the profit theory put forth by the contemporary Muslim economists fall entirely in the context of uncertainty and risk bearing assumption. The overwhelming majority of the modern Islamic economic writers believe that there is an intimate association of the legitimacy of the rate of return with the existence of risk, Siddiqi (1985, 1983), Zarqa (1983), Khurshid (1980) and Chapra (1985). They founded their argument on the probabilistic nature of the future outcomes from economic activities. For instance, the uncertain situation related to the yield or income from *Mudaraba* and *Musharaka* operations which may frequently turn out into profit and loss, Choudhary (1983). On the basis of this perception the uncertainty and risk bearing are considered the most important justifying factor of profit, either the existence of profit or the determination of its legal state Fahim Khan (1995), al Misri (1989), H. Hamid (1992), A. El-Ghazali (1995) and others. In fact, as far as the existence or origin of profit is concerned the conventional economists also categorically believe, that profit to be the reward of entrepreneurial activity and a disequilibrium phenomenon brought by the elements of uncertainty and market imperfection, where in a situation of perfect certainty the very existence of profit is questionable. In this reality of extremely bewildering condition of profit and *riba*, we would like to probe into the theoretical foundations of this ruling view in the contemporary literature of Islamic financial system on one hand, and positively operational reality. We want to examine the above inference and whether fixity or variability matters as far as the legitimacy and origin of the rate of return is concerned. The main arguments of this chapter may be formatted as follows: In section 7.1 the first we would critically investigate the nature of risk and uncertainty in Islam. The section 7.2 would address the role of risk bearing on the origin and legitimacy of the rate of return, the relationship between risk and return, the conventional notion of interest and risk, and acknowledging that uncertainty as a part of human ignorance it comes to the conclusion that the monopolistic nature of risk determines the magnitude of the return. Section 7.3 investigates the risk and the legitimacy of the return on the basis of the dominant view which asserts that without risk there is no profit, and dissent opinion which holds that profit is earned by ownership. In this context we would critically review the interpretations of Shariah axioms of *al-Kharaj bil-al-daman* or *al-ghurm bil-ghunm*. Section 7.4 will expose the general

Islamic point of view about risk and uncertainty or *gharar*, it furnishes the scope of *gharar* in *Fiqh* injunctions, the nature of effective *gharar* and its implications and concludes with the fact that *gharar* in Shariah relates to profit not to *riba*. Lastly, the section 7.5 focuses on risk management and implications of the predetermination on the following dimensions such as risk shifting or risk transferring, risk averting on the basis of contract, risk distribution or risk sharing mechanism, risk reduction or risk minimizing, dealing with risk in Islamic perspectives, and finally we briefly mention the major problems of risk dealings facing by Islamic banks.

7.1 NATURE OF RISK AND UNCERTAINTY

Risk is considered a very difficult concept to grasp it, and it is surrounded by a great deal of controversy in attempts to define and measure it. Risk in its literal meaning includes the phrases such as, the possibility of suffering harm or loss, hazard, a peril or exposure to loss or injury¹. In Webster Dictionary, risk refers to the chance that some unfavorable event will occur². However, the concept of risk in general means the result of uncertainty about the future, in other words the inability to predict the occurrence or size of a loss³. Risk is precisely, an uncertainty concerning loss⁴. Thus, uncertainty is a pervasive phenomenon, which may be present, to some extent in various degrees and virtually all economic or choice decisions. Risk is also defined as the variation in the outcomes that could occur over a specified period in a given situation, if only one outcome is possible the risk is zero. If many outcomes are possible, the risk is not zero. The greater the variation of the outcome, the greater the risk. However, the uncertainty is the doubt a person has, concerning his or her ability to predict which of the many possible outcomes will occur. So uncertainty is a person's conscious awareness of the risk in a given situation. It may depend upon one's estimated risk - what that person believes to be the state of the world - and the confidence he or she has in that expectation. A person may be extremely uncertain about the future in a situation where in reality the risk is small. On the other hand this person may have great confidence in his or her ability to predict the future when in fact the future is highly uncertain⁵. In the context of

¹ F.Brigham Eugene, et al, 'Financial Management: Theory and Practice', 5th ed. 1988.

² Webster English dictionary.

³ Frederick G. Crane, Insurance and Practices, 2nd ed. John Willey & Sons, London, 1984, p.4

⁴ Robert J. Mehri and Emerson Commack, Principles of Insurance, Irwin, 6th ed. 1976, p.20.

⁵ C. Arthur Williams, Richard M. Heins, Risk and Risk Management, 5th ed. McGraw-Hill, Insurance Series, 1985, p.10.

these possibilities, situations that involve risk may be classified as pure and speculative. A pure risk exists when there is a chance of loss, but no chance of gain. A speculative risk exists when there is a chance of gain as well as a chance of loss. In this case pure risk is always distasteful, but the speculative risks possess some manageable features. The uncertainty makes the people worse off, for they are not sure about the future outcome of their present decisions. This is why analysts always try to assess the importance of changes in the level of risk and cost of uncertainty associated with any proposed policies. The sources of uncertainty are varied and many of them depend on the nature of human interaction due to lack of information about the actual situation, changing environmental situations or complexity of the concept of risk or uncertainty itself. Its presence is generally considered costly. As a matter of fact, people dislike uncertainty and the risk that associate with it. So, they are willing to pay and bear expenses in order to avoid or reduce it. This attitude of the people in general toward risk is manifested in the existence of the insurance organizations, how individual response to uncertainty and what is the economic cost of uncertainty.

In connection with investment or financial context, risk may be explained as a measure of the possibility that an actual return will turn out to be lower by a given amount than an expected return over a given period of time. Hereby, we see that risk to be negative to the productivity. The situations we concern are primarily those in which the individual cannot alter the degree of uncertainty but may be able to reduce his exposure to it. The uncertainty faced by, for instance the farmer planting now and concerned about the crop price at harvest time⁶, the farmer cannot change the price of uncertainty, but he can reduce the risk it by selling his crops in a future contract. There are many ways and methods of social mechanisms intended to reduce the cost of risk.

Keeping in mind with these facts, a question may be asked, should an individual expose himself to risk taking? Perhaps the risk taking individual may have some notion of benefit or gain. Monetary rewards associated with entrepreneurial activities in business may give some satisfaction of professional recognition and social improvement for the innovative scientists. Risk taking of this kind may be constructive, creative and healthy which may have the following features; (i) the individual takes conscious deliberation a calculated risk, he carefully weights benefits against costs and decides knowingly (ii) the individual makes

⁶ Lee S. Friedman, *Microeconomic Policy Analysis*, 1984, p.200.

adequate preparation, he is not impulsive or haphazard, instead, he does carefully plan and train himself for such activities (iii) it has positively rather than negative aims. As this kind of risk taking arises out of a desire to grow, to achieve, to test oneself to master and control the risk generating factors. It does not come from ingrained wish for self destruction instead self discipline, confidence, security and high self esteem may be necessary for healthy constructively risk-taking and (iv) personal responsibility for outcomes: In constructive risk taking the individual takes chance in which he can, to considerable extent, have the responsibility for the outcome. In this context we try to examine the essence of the arguments on the role of risk and uncertainty in economic activities in two fundamental perspectives. Firstly risk as an originating factor of profit. Secondly risk as a determining element of the legal position of profit. As far as the first perspective is concerned, it is open question for any attempt of scientific inquiry about its reality in both Islamic and conventional economic perspectives. The main focus of our discussion here is on the nature of risk and uncertainty and its relation to the origin of profit. Whereas, the second aspect is exclusively related to the position of *Fiqh* injunctions and general Shariah principles in the correlation of risk and return or profit. In this connection we will concentrate on whether there is a positive correlation between profit and risk and if it exists, the nature of their relationship. In other words whether correlation between risk-bearing and the permissibility of the rate of return goes together in Islamic injunctions.

7.2 THE ROLE OF RISK IN ORIGINATING PROFIT

In connection with the source and origin of profits, we want positively to investigate the relationship between risk and profit. Profit in concept and practice, as we have studied and have been arguing in all along through our discussions in the previous chapters we mean an additional value/return or incremental growth of the principal. How these incremental values will be determined by the risk and uncertainty elements, where we can claim if there is no risk there is no profit at all? Does zero profit necessarily mean zero profit? On the other hand the more risk someone may incur even irrationally the more gain and profit he reaps? . Let us look, once again, into the nature of the term risk. It is defined as we have noted above to mean harm, loss, or exposition to injury, in financial terminology it is the difference between the expected and the realized return. All these interpretations and existing definitions of the term risk clearly demonstrate that risk implies negative incidents and undesired factors which

may serve against the business objectives or production operations. If the target of profit-oriented firm is to increase and maximize the net profit that finally accrues to it, then, is it rational to minimize the risk or to increase it. Of course the above definitions do support the first option for risk is a kind of cost so, an increase of risk would mean increasing the cost of the firm. In order to avoid this cost or loss people generally pay certain premium. Then there is no reason to believe that the factors that increase the cost of production will increase the rate of profit as well. It is common sense that loss and gain cannot work for the same direction at a given circumstance. In this section we explore whether risk is the generating factor of the element of profit in the context of conventional postulations. We further look into the conceptual relations between interest and uncertainty as well as the risk and rate of return in general perspectives. We examine also risk and uncertainty in subjective perspective depend relatively on human ignorance.

7.2.1 Risk and the Source of Profit in Conventional Thoughts

No doubt the importance of profit in economics, It is regarded as the main sources of finance for investment in fact the amount of investment that it intends to undertake is determined by the amount of profits that a company plans to earn.⁷ In conventional literature it has been argued for centuries that profit is necessary incentive for the entrepreneurs solely to undertake production but no substantial answer has been given to the question of its origin.⁸ In fact it was Knight (1921) who created an eclectic theory of profit under which all the previous theories of profit could be subsumed. He treated profit as a residual return earned by the entrepreneur as a result of his correct decisions taken in the present to bear its fruits some time in the uncertain future. Knight criticized treating profit as a residual left over after the other costs of production has been paid saying that this treatment of profit and rent as a residual leaves us with no rigorous determination of the difference between one residual and the other. It is necessary to distinguish profit from any other income shares⁹. His main argument focus on that profit is not surplus but accrues to the entrepreneurs, and this is a matter of distribution or entitlement. Entrepreneurs' function is assumed mainly to be a stake with the future outcomes of their work. The hope of earning profit is the inducing factor to undertake

⁷ Wood, Adrian, *A Theory of Profits*, Combridge, Combridge University Press. 1975

⁸ Obrinsky, Mark. *Profit Theory & Capitalism*. 1980, p.13

⁹ Knight, Frank. *Risk, Uncertainty and Profits*, Checago press, 1971,p.71-88. 153-165.

a tiresome production operation. Even those who end up with losses were levied in their mistakes by dream of profit. But the question and the problem to be solved is how is the hope of profit would turn into an actual realization of profit.¹⁰ Perhaps, Wantroubs put the matter on its right tract in considering the factors that originally generate profits from those influences on their distributions. He argued that activities that generate profit may be separated from the sharing of profits. This perception contains deep insight for it implies that the theory of profit is to be treated separately from the distribution theory in general¹¹. In this understanding, since, the focus here is on the problem of the origin of profit rather than distribution, one can easily point out that risk and uncertainty are distributive factors rather than originating ones. For, the profits as a residual income are not attributable to any well defined a transferable productive factor.

These conventional thoughts of the subject showed conflicting views and theoretical considerations. It is argued that the profit residual arises from unknown but in knowable quality something that brings forth a common sense perception, if its source is unknown little can be said about it. And as we have seen in the review of its literature many theorists and Western authors see that profit may not have any place in the economic activities. According to them there is no additional value to the price of capital and of course there is no below what they considered just price. Alkane & Demsetz argued that those who confused it with interest viewed the profit as addition to the price of commodities for this (price) is the reflection of its real value and whatever higher is the manufacturers' profit which is the loss of someone else. Relative profit is what implies a loss to someone else, if ones' profit increases another gets less.¹² Profit can be seen in this respect something near to surplus value of exploitative theory in the radical school of economic thought, however in this connection profit is regarded to arise from real process rather than imagination ones. Obrinsky also argued that the suggestion profit to be considered as the entrepreneur's reward for the function of bearing risk is unhelpful. As risk is taken in probabilistic sense, the gain to one is a loss to another. Furthermore, the wide spread usage of insurance policies transfers risk away from the firm at the cost of premium payers. However, the least uncertainty is not measurable, again not all

¹⁰ Obrinsky, Ibid.

¹¹ Weintraub, E. Roy, *An Approach to the Theory of Income Distribution*, Philadelphia, Chilton Co. 1958

¹² Obrinsky, Ibid.

those who face uncertainty are rewarded positively.¹³ This uncertainty bearing should not necessarily be viewed as the sources of profit and losses to occur.

It is argued that the degree of monopoly could not serve as a measure of profit. This proposition however is considered unacceptable on the basis of what have already been said, accordingly, it would appear that the monopolistic conditions reduce the degree of uncertainty and relatively less profit is sufficient to attract investment under this situation than dynamic competition. It is strongly argued by Wantroubs (1977) that risk is not the determinant factor of profit. It is however, one of the explanations of difference in normal rates of profit in different business activities. The profit in real life has continuous existence because generic changes are constantly occurring so that adjustment is continuous process. Profit is not due to risk, risk is there, but, it is also argued that risk incomes accrue to the capitalist rather than to the entrepreneurs who are empty handed.¹⁴

7.2.2 Uncertainty and Risk in Subjective Perspectives

Naturally, the human life can never be free from risk and uncertainty. Most of the human activities take place amid circumstances of full of hazards and uncertainty. Herishleifer pointed out that the states of the world are given as they are particular-configuration of the individual's choice environment war, peace, sickness or health. The individual has to choose not the states as these are beyond his capacity internal or external events may be, the individual's task is to adopt an appropriate action, while, he is still uncertain which state he will obtain. Thus, the state of the world is not generally humans' choice but, the individual can choose the appropriate decision in the face of the given circumstances of the nature. Nature is neither benevolent nor malevolent by itself depending on the course of individuals' objectives. Secondly nature does not reshuffle the cards in response to the individual's selection of a particular action. Hence as there are definite probabilities attached to the occurrence of each possible state. But these probabilities are given and outside the control of the individual. However, one may usually expect the higher the probability distribution of expected future returns, the smaller the total risk of a given investment. The most commonly used statistical yardstick measures to the extent to which the possible outcomes different from the outcome

¹³ Wood, Adrian. Ibid.,

¹⁴ Weintraub, E. Roy, Ibid.

that would be expected to occur on the average in the long run. The degree of risk is inversely related to the ability of an individual to predict which outcome will actually occur. In this sense risk is the variation in the possible consequent that exists in a given situation. As it is true for probability, a distinction can be made between objective risk - the variation that exists in the nature and same for all persons and subjective risk - each person's estimate of the objective risk. In order, to measure the variation that exists in nature, one would have to know the underlying probability distribution and how to assess the variations inherent in that distribution. However, although the knowledge of that is different from one individual to another according to his prediction ability and information available to him, in most situations, one does not know the objective risk inherent in the situation or given activity. Even if one knows the underlying probability distribution, one may not know how to calculate the variation in the potential outcomes, and thus forms a subjective estimate of the risk¹⁵. In the sphere of economic activity, almost all human activities take place in the present time with the expectation of getting the fruits in the future. The present motivated desire matures some time in the future which probably unknown to us. Hence it is subject to risk and uncertainty. The Qur'an spotlights this human uncertainty about future consequences of present actions. "Had I knowledge of the unseen I should have abundance of wealth and adversity would not touch me" (7:188). "No soul knoweth what it will earn tomorrow" (31:34).

Business decisions may exhibit by a range of possible outcomes, than will others, we say that these are more risky decision alternatives. The business risk depends on a number of factors namely; (1) Demand variability; the more stable the demand for a firm's products other things held constant the lower its business risk. (2) Sales price variability firms which its input costs are highly uncertain are exposed to a high degree of business risk. (3) Ability to adjust output prices for change in input costs. The greater the ability to adjust output prices to reflect cost conditions, the lower the degree of business risk other things held constant. (4) Exposure, to product liability suits, if a company's products could cause harm to users then its business risk will increase. (5) Extent to which costs are fixed operating leverage if a high percent of firm's costs are fixed and hence do not decline when demand falls off, then it is exposed to high degree of risk.

¹⁵ C. Arthur Williams, Richard M. Heins, 'Risk and Risk Management, Ibid p.10.

Nevertheless, in our decisions are guided by the long past experience by our understanding of the present and by our knowledge of the parametric changes of the natural laws. For the natural events are shaped by essentially the natural rules. Therefore, the probabilistic changes of future circumstances might be anticipated. On the basis of these anticipations and past experience, we usually calculate the results fairly and rationally with relative confidence. But some times our decisions and actions are associated with unknown factors where the decision maker will rely only on his own discretion, judgement and foresight. There may be still some kinds of risk which are not possible to be measured by any method such as; the psychological feelings of the individual like the fear of loss and hope of gain or the pessimistic attitude of the person who by and large presumably are to involve of loss without any chance of gain. In this connection we submit that not only profit is subject to this risk but, all human decisions are inherently associates with various kinds of risk of imperfection and inaccuracy. The uncertainty usually represents the limitations of human knowledge and its ignorance about the future conditions.

7.2.3 Risk and Interest Rates in Conventional Perspectives

The risk phenomenon itself is one of the main justifying reasons of the interest rate heavily relied by the capitalist theory of interest. Where in the traditional practices interest may be fixed or variable. The interest once agreed may not change throughout the loan period. Variable interest rate changes at particular intervals agreed upon between the bank and client in order to adjust the interest rate to the market interest rates prevailing at the time of the review¹⁶. Hence, the interest itself is mostly based on the notion of risk bearing, which may associate with whole or part of the original principal if the borrower could not pay back the borrowed amount of money. It is almost an established fact that the predetermined interest rate in conventional economy is subject to certain risk elements. In general the nominal interest rates on a debt security consist of a pure rate of interest, plus several other premiums such as; an inflation premium, default risk, liquidity or marketability risk premiums and maturity risk premiums. Thus, usually the interest rate varies with the change of these factors. One of the most determinants factors of the rate of interest that is charged on borrowers are the riskiness of the loan. For instance, if the borrower's financial position is not strong enough

¹⁶ Ghassan, Qal'awi, *Taqwiim ada', al-Nashad al-Masrafi al-Islami*, 1991 p.55

to ensure the repayment of the loan, he will be charged a higher interest rate than otherwise. Thus, small financial risky firms have to pay relatively higher interest rates than large blue-chips which themselves would pay higher rates compared to the rates charged on the loans of the government. The minimum rate of interest which is charged on the government securities is known as pure or natural interest¹⁷. Hence, theoretically the interest rate would consist of three parts: basic interest, risk premium, and administrative expenses. Basic interest which is known as also pure or natural interest would be risk-free interest, or interest on lending in which no risk is involved. The pure rate of interest is defined as the interest rate of risk-free security if no inflation is expected. This kind of interest which is generally considered to be constant is referred to the interest on treasury bills and such other government security papers in which there is no much price variations or in an inflation-free world. This interest is called a risk-free rate of return because of its short maturity and guaranteed soundness of the borrowing agency or institution. However, as there is no generally an inflation free world, even the real interest rate is subject to general price fluctuations and perhaps political risks. Therefore the pure rate has no fixed status as we might think it. It changes over time depending on the economic conditions particularly monetary policy. For instance, federal reserve controls and business cycles also affect the interest rates where an interest rates increase during the economic boom and decreases in recession periods. From these evidences we realize that both the pure rate and other various premiums change overtime and normally shake the certainty of the interest rate in general.¹⁸

7.2.4 The Relations of Risk and Return

As we have said in the above discussions as any human activity is subject to certain elements of uncertainty and human ignorance, it is normal to say that risk and return may go together in investments and business finance. In this subsection we want to highlight the risk and return relationship. It is argued that the objective return cannot be defined without determining whether or not the level of risk associated with this return is acceptable, it is assumed that the risk-taking depend mainly on the psychological set up of the investor and his ability to take risks. Furthermore, Islam does not force individuals into taking risks. There may be perfect valid reasons to look for a 'safe' asset to store one's savings for a rainy day or some planned

¹⁷ Mansfield, Edwin, 'Economics', 6th ed., 1989, p.645.

¹⁸ Uzair, Some Implications of Non-interest Based System, Journal of Islamic Banking and Finance, Vol.15 No.2, 1998.

future expenditure. A lot of empirical evidences are available showing the trade off between risk and return and that the higher risk projects are generally more profitable than others.

Owing to uncertainty, the heart of security analysis is the valuation of financial assets. the value in turn is the function of return and risk, it is also called the return-risk trade off. as the final investment decision making, return is the motivating force in the investment process. Two of the most important factors to be considered, when undertaking business or investment activities are the risk level and the return that are expected over the period of that enterprise. Naturally return is not guaranteed, it is expected which may not be realized, hence there is usually realized and expected return, where the realized return is ex post return and the expected return is that return which investors anticipate. It is the predicted return subject to uncertainty, hence it may or may not occur according to the expectations. Thus, the realized rerun may not mostly coincide with the expected return. Generally investors are risk-averse. they try to minimize risk in their investments, however because of the existence of a fundamental tradeoff between risk and return, most of the investors do not seek zero-risk investments, the risk associated with an investment on the average, runs parallel to the expected return. The investor is to decide the level of risk he can tolerate in order to achieve an acceptable return from his investment. On the other hand uncertainty is the state in which the investor has no knowledge about the future outcomes or their probabilities of occurrence. while risk is uncertainty with known probability. Therefore, the able entrepreneur faces the risk with given probability of return, at least a satisfactory level of profit must be foreseen, otherwise he may not undertake any risk. But, it can be rightly argued that risk and uncertainty are not essential for the existence of return or there is nothing to believe that return is always subject to risk, in other words any risky activity does not correspond with higher return, for two reasons;

i. It is very simple to observe that any risk activity is not holding a return, as there are highly risky and adventurous tasks which may not yield return, simply as any activity or decision is not promising for good reward but every activity may be subject to risk, we can conclude that any risk may not be associated with return as there is a possibility that the activity may be serving contrary to the desired objectives.

ii. Not only profit is subject to risk but even unilateral transference of assets also may involve a dangerous situation, for instance, the charity may be considered risk-less in nature. but nowadays the beggars in the middle of cross roads may face a very dangerous situation. It is important to note that the existence of relatively higher return in high risk operations than lower risk activity does not show that the risk determines the rate of return.

As we have said earlier, risk is undesirable thing, cost and loss that should be avoided. Risk is undesired an exogenous factor to the profit generating activities, which reduces the rate of return or even prevents certain economic activities. Hence, without any risk profit may be acquired. Secondly, the economic costs of risk and uncertainty have been widely recognized even in conventional economic literature. A.H. Willet, in the discussions of insurance, refers to the costs of uncertainty arising out of (i) the unexpected losses that do occur and (ii) the uncertainty itself even if there are no losses. In fact, risk entails general economic costs, apart from the cost of replacing destroyed or damaged property. Risk discourages investors and affects the allocations of resources. Many resources are used in industries where risk is slight, whereas, fewer quantities are used in the industries exposed to a high degree of risk. The effect of risk on the economy is the same as that of socially undesirable monopolies. Both, equally affect the production and prices by discouraging production, restricting supply and thus, leading to high prices.¹⁹ Thus, if the return is the target, the element of risk may serve contrary to desired results as it may lead the enterprise to costly operation or into loses. On the light of this evidence there is a strong reason to believe that risk and uncertainty provide an essential monopolistic power over other economic agents.

7.2.5 Monopolistic Nature of Risk-Bearing

The contemporary Islamic economists have argued that profit associates with the level of risk through invention and innovation, they perceived that the task of entrepreneurial activity is to be innovation or the profit is the result of only risky activities such as producing new products. R. Al-Misri has forcefully argued that 'if the rental is the return of land and wages or *ujra* is the return of work, then, profit is the return from risk bearing, innovation and monopoly. If we consider the profit that may arise from monopoly is not permissible in Islam

¹⁹ Robert I. Mehri, and Emerson Cornmack, *Ibid*, p.26.

and it will evaporate with regulated prices. Then profits remain to be generated only from risk and innovation. He further elaborated that innovation means invention of new ways and methods of production or disclosing of a new market or discovering of new industrial technology. Hence, it is observable that these kinds of profits are only temporary phenomena. However, the innovation itself is a kind of risk bearing. Therefore, the profit might be precisely defined as the return of risk bearing and uncertainty whatever the reason of this risk might be. Nevertheless, whether, the risk bearing has a role on earning & distribution, although Al-Misri accepted that risk may not be an independent element from the factors of production, he considered it as a related element sometimes to the capital and in other cases to work. And it has a role of increasing the right of the capital or service in profit in terms of earnings²⁰.

But, scrutinizing this view we may come to the opinion that there is nothing to believe rather it is absurd to assume that high risk activities always yield high return. Every decision that carried out by human being or any choice to be made by man is subject to risk of missing the objective for which it was designed to achieve. This itself is different from one person to another. Unplanned decision and haphazard action which might hastily be carried out by untrained individual is subject to higher risk and more frequent mistakes than decisions made by well skilled person who may carefully plan for it and intelligently execute it. A business activity carried out by illiterate layman would involve higher risks than those run by experienced entrepreneurs. In every field of human life the risk increases with the increase of ignorance and lack of skill or experience, on the other hand risk decreases with the increase of the knowledge and experience, where the more the individual has know how skill and proficiency the more he can reduce the possible risk, and obtains considerable profits from what seems in the eyes of others an adventurous exertion.

In general, those who are expert and have ability to work safely in precarious fields or can conduct successfully with advantage dangerous economic activities are not much in number. One may predict a negative correlation between the risky projects and able professionals, the more risky the task associates with, the less will be the number of the proficient expertises in that given task. Thus, by reducing the cost of the risk the competent

²⁰ Rafiq Al Misri *Usul al Iqtisad al Islami al Tanmiya* Devil Alqalam Dinisbiq Syria 1989 p.215-22

entrepreneurs can reap a higher margin of profits. Similarly, innovations or discoveries are rare property of very small extraordinary people with superior qualities or fortune, which in its initial period enjoy a large demand for relatively small magnitude of products, or since this kind of firm is the sole producer in the market it may have an absolute power to put the price according to its choice in which it can maximize the profit. This is, actually a practical fact that the lower risk activities are highly competitive and hence yield less return, while, the highly risky economic activities are less competitive. Thus, in this sense the entrepreneurs enjoy certain kind of monopolistic power.

Perhaps, this is the situation that Ibn Khaldun has observed while explaining the factors that raise the level or profit from commercial trading activities "it is more advantageous and more profitable for the merchants' enterprise and a better guarantee market fluctuation if he brings good from a country that is far away and where there is a danger on the road, in such a case the goods transported will be very few and rare, because the place where they come from is far away or because the road over which they come is beset with perils so that there are few who could bring goods and they are very rare. When goods are few and rare their prices go up. On the other hand when the country is near and the road is safe for traveling, and there will be many to transport the goods. Thus they would be found in large quantities and the prices will go down . . . Thus Merchandise becomes more valuable when merchants transport it from one country to another. (Merchants who do so) quickly get rich and wealthy. 'On the other hand those who travel back and forth between the cities and towns of a particular region earn little and make small profit, because their goods are available in large quantities and there are a great number of merchants who travel with them²¹."

Thus, naturally, the relationship between risk and return seems to be positive only through the monopolistic power that the successful entrepreneurs would enjoy in marketing the product of their achievement, or delivering scarce and highly demanded goods and services. Moreover, as we have seen in the previous chapters, profit arises from transference or transformation activity of goods, including any property or asset from one state to another that is production process, such as, manufacturing, growing, or simply intermediation of

²¹ Ibn Khaldun: *The Muqaddimah & Introduction to History*. Tramze Rosenthal: Translation Ballingen Foundation 1958, p.336-38

commercial activities. This transformation is the essential factor that generates the increase or the additional value. Hence, the profit is essentially dependent on this transformation process which necessarily requires effort and careful work, *riba* is simply an increase of the original amount without this transformation, i.e., sale and purchase, transferring goods over geographical or time space by transporting them or preserving it and then selling it at higher profit. Through these processes additional value and considerable economic advantage may be created.

7.3 THE LEGAL POSITION PROFIT IN CONTEXT OF RISK & UNCERTAINTY

In the context of Islamic financial system, it is argued that risk taking may not be questionable in the case of an entrepreneur, but a small saver may not be willing to jeopardize his hard earned savings in a risk taking exercise. Islamic banking would argue according to the maxim of Islamic *Fiqh 'al-ghunn bil al-ghurm'* which is interpreted as - gain is the result of risk taking that saver is not entitled to a return on his savings unless he puts them at risk. Islam relates the existence and legitimacy of the profit to the element of risk is the point of contention in the contemporary Islamic economic studies. Both pros and cons of this matter have a vast range of economic ramifications and financial implications. According to the findings of this research, the legal correlation of risk and return seems to be untenable proposition and logically refutable inference not consistent with the authentic Shariah objectives. Several important objections are raised against this risk argument for the justification of return. To examine the pros and cons of the subject we review first the arguments of the dominant view that see the necessary linkage between the legitimacy of the return and the existence of risk or uncertainty. Then present the views of against this postulation. And lastly we look into the basic message of Islamic maxims related to the issue.

7.3.1 Risk-Bearing Determines Lawful Return

Islamic scholars have general believe that financial capital is entitled to claim a return only through commercially productive activity which involves the possibility of loss, and in no other case is financial capital allowed to claim return. However, there is complete flexibility to adopt any mode of financing as long as the basic principle no risk no return is not violated. Fahim Khan (1995) has strongly contested this point and asserted that profit by definition to

be the reward for risk -bearing which cannot be predetermined and any reward that is predetermined cannot be profit by definition. According to him any reward that is predetermined can be rent (including wages) or interest, the determinant principle of profit is by risk bearing only. For the assumption of risk negates the predetermination, he further emphasized that banks are free to design or device instruments to earn profit in any of these ways but any instrument that ensures profit without carrying risk of loss will not be an Islamic instrument irrespective of whether it is a trading leasing instrument or profit loss sharing one²². The learned scholar added that 'modes of financing that are reducing risk elements is desirable, but one that eliminates it, is not. It seems very difficult for one to comprehend what is the magnitude of the loss that is sufficient to determine the legitimacy of the rate of profit. On the basis of this postulation most of the contemporary Islamic economics could feel uncomfortable to accept the fixed return modes of financing, such as leasing, mark up in trading activities etc. Majority of modern *Fiqh* scholars are of the view that no risk no return of Shariah principle is to be strictly observed. H. H. Hassan (1992) asserted that there is no gain without risk. In this context, if we want to build new theory we have to keep in mind the two terms such as *riba* and *gharar*. Once we are aware of these two concepts then, we are safeguarded²³. The mainstream views of contemporary Islamic economic writers hold that the one who bears the risk is the one who is to get the return, in other words the one who faces the risk is the one who is entitled to the profits. M.A.Choudhry (1983) has come up with this very strange view "Islamic entrepreneurs are risk-averse only up to certain limited point, to the level the total returns from an investment are expected to be below the degree of risk involved or at least in proportion to the degree of risk involved. And hence, a risk-aversion based on pure economic return is unacceptable in Islam." Which implies that the entrepreneur should always observe the balance between the profit and return which is the subject matter of the business activity and risk level which determines the legitimacy of the return. Therefore, the Islamic entrepreneur to maintain this probably desired balance, he seeks risk as long as his total return is above the degree of the existing risk, and vice versa in the opposite situation. Risk can only be averted on (reasons) other than economic grounds²⁴(probably once, this equilibrium of risk and return is reached).

²² Fahim Khan, *Essays in Islamic Economics*, 1995, p.120.

²³ Hussein Hamid Hassan, *The Jurisprudence of Financial Transactions(Fiqh al-Mua Malat)* Ibid, p.105.

²⁴ M. Alam Choudhry, *Capital Valuation in Islam*, in *Fiscal Policy and Resources Allocation in Islam* 1992

Following this general opinion of Islamic scholars about the concept of risk and uncertainty S.A Siddiqui (1996) also asserted that certain risk-free return may be considered as *riba*²⁵. These arguments constitute the generally believed view that risk-bearing serves as a condition for the legitimacy of the rate of return. This perception of assuming the existence of the risk element stands for the sole difference between profit and *riba* has led some of the Muslim economists to an apparently very paradoxical situation. Interestingly they hold the apprehension that profit to be equivalent to a pure interest rate plus a risk premium or they adopted that risk-free rate of return as the bench mark of the acceptable rate of return. Naqvi (1987) has based his analysis on the assumption that profit rate to be simply the pure interest rate plus a risk premium when uncertainty prevails, presuming that the sole difference between profit and interest to be the risk element Then, on the basis of this equation he deals with the uncertain situation as if it was certain. According to him, the profit rate could be decomposed into the interest rate in such a condition. He expressed his concern about a mere substitution of profit for interest, this is at best a trivial solution of the problem for whatever it is said against interest rates will apply against profit rates as well. This approach led Naqvi to conclude that the proposed substitution of profit for interest being simply a pure rate of return. It is neither a necessary nor a sufficient condition for the establishment of an Islamic economy. According to this formula, zero interest would mean zero rates of return resulting from the relationship between interest rate and savings²⁶.

Anas Zarqa who contested against implications of the above arguments asserted that the assumption of certainty is not only unrealistic but, it is un-Islamic as well, for at least two reasons; Firstly, the Holy Qur'an emphasizes human uncertainty about future consequences of present actions (7:188) and (31:34). Secondly, many rules in the Shariah make sense only when uncertainty is admitted as a basic fact of life to give one example *Mudaraba* agreement is legitimate *halal* when the financing partner *Sahibul Mal* stipulates his share as a given percentage of prospective profits. But it is illegitimate to stipulate it as a given percentage of the money advanced to the working partner. Zarqa has strongly argued that in this sense of an uncertain world where profits are unknown in advance Islam considers *zulm* (

²⁵ Shamim A. Siddiqi, *Mudaraba Finance in the Contemporary World :An overview of Mudarabas of Pakistan*, A paper presented in a Seminar on Business and economic Challenges and Islamic Institutions, organized by IPS, Islamabad 1996, p.3

²⁶ Syed Nawab H. Naqvi, *Interest and Resource Allocative Efficiency in Islamic Economy*, in *Monetary and Fiscal Economic Policy in Islam*, ed. M. Ariff, ICRIE, KAU, Jiddah, 1982, p.75-95.

transgression) to assure the financing partner of a fixed sum, while, the profits out of which it should come are uncertain. He argued also in a world of perfect foresight the Shariah rule would be superfluous²⁷. However, Zarqas' arguments in the purpose of amending the view of Naqvi seem they have missed the target and probably they imply to support in a way or another, than to be critical to Naqwi's view. Furthermore, it is not clear whether, Zarqas' view of rejecting the assumption of certainty in total on the basis of Islamic principles would mean that its opposite (uncertainty) is considered acceptable, so that business enterprises should seek it, rather than avoid it minimize it. For, there may not be a known concept between the two.

7.3.2 Profit is Earned with Ownership

Any economic reader who sees the above arguments would confront unrealistic justifications and may keep himself to ask how desirable risk taking should be in Islamic points of view?. Does Islam glorify risk to such an extent that any legitimate gain is determined by it? If the institutional arrangement is such that the depositors can earn return without taking a risk, should he necessarily seek for risk? . The risk is not a good or service offering by the risk bearer to another, so that someone may ask for its price, as a reward of its value. But, it is simply considered as the individual's psychological feeling which may have certain influences in his economic behavior and characteristics, it may not have any economic impact.²⁸ Thus, the profit ratio that goes to the capital owner has its own rationale in the combination of capital and labor and accordingly distributing the outcome which emerges from the real economic activities of transforming the goods from one state to another in order to add incremental growth of value to the existing stock or in commercial transference from one place to another in order to provide a gain for the participating parties. We are inclined to the view, the notion of risk to determine the legitimacy of profit is very far from the spirit and the central purpose of Islamic Shariah. More over the *hadith* of the Prophet (saw) *al kharaju bi daman* does not necessarily mean the counter implication or opposite meaning, so that the return on the capital is not guaranteed²⁹. Moreover, there are number of established principles in Islamic injunctions which clearly show Islam stands against risk and it does not recognize

²⁷ Anas Zarqa. Comments, on Naqvi's Arguments, Ariff, Ibid.

²⁸ Ghassan Burhanudin. Ibid., 56

²⁹ Ghassan Burhanudin qal'awi, Ibid.

any positive role for rationalizing the return or profit, such as *al-gharar*, gambling, and "*shirkat al-abdan*."

Risk bearing on its own merit is not a factor of production because risk does not add or increase a value Kahf (1991) pointed out that profit is earned by virtue of ownership and not of risk bearing. Muslim scholars have repeatedly made a statement in *Fiqh* books profit is earned by ownership and work. But earning of profit cannot be justified by risk bearing as risk bearing is not the factor of production while capital is³⁰. Perhaps those who are of these above views forget in their analysis one important factor, they forget the role of ownership and hence, they mix the desirability with the existence, that is the existence of risk which as a physical science teaches us is a natural phenomenon. The certainty assumption is confused with the desirability of the risk. Except in few cases the ordinary nature of human behavior has never shown that risk is desirable for itself, but on the other hand in any human activity some elements of risk would inevitably associate with. With any return more or less there are some kind of risk associate with it, the people try to minimize or even eliminate the element of risk and uncertainty but, in practice we can only reduce the risk, for it will not be feasible or possible to eliminate it. Therefore, the existence of the risk element does not imply that risk is desirable economically, or it determines the existence of the rate of return. It is also argued that. If the entrepreneurs were to decide this choice on pure lucky the risk would be 50% which is pure gamble (in probabilistic terms) clearly such enterprise is forbidden in Islam. So, acceptable risk must be less than this level however, the chance of risk occurrence cannot be eliminated completely at least in theory. On the other hand it is obvious that risk minimizing is what is required in Islam no way is argued that risk investment was encouraged in Islam or comparatively save trade or investment operation is discouraged³¹.

7.3.3 Textual Analysis of *Fiqh* Maxims

As we have seen in the above discussions, the Islamic scholars justify the correlations between profit and risk on the basis of the well-known *Fiqh* principle and the *hadith* of the Prophet (saw) "*al-kharaju bi daman*" the benefit associates with the liability for loss. The widely

³⁰ Monzer Kahf, Time and Discounting Value, Review in Islamic Economics, 1991, p. 54

³¹ Asghar, Comments on Choudhary's Paper, Ibid.

known Islamic maxim "*al ghum bi al ghum*" appears to be coined from the above *hadith*. This *Fiqh* maxim in general is noted to mean 'entitlement to the gain is linked to the responsibility for loss'. The *hadith* in its literal meaning points out who is entitled to the return is the one that bears the risk of the thing, and that its entitlement goes with the responsibility for possible risk or loss. In other words, who is responsible for its loss has a right of its yield. In Islam the ownership may be transferred from one individual to another, it may be original or temporary through exchange and lending respectively, depending on the nature of the contract or transaction. While there is no doubt in case of permanent or original ownership that the liability and entitlement go together. But, in case of temporary ownership certain questions may be raised to whom the yield of the property accrues? . To the answer of these questions as this *Fiqh* maxim is applied, in general it is interpreted that the entitlement to return or benefit goes with the responsibility for the risk. And the right on the yield associates with the responsibility. So, to the extent of having command or authority over something is inherently linked to the extent of risk taking. However, both cases of selling and lending transfers the ownership from one hand to another in the sense that even in case of lending the borrower have full authority to utilize that good and he is not bound to return the same good itself, but what is important is the return of its similarity. Secondly if that good lost or get destroyed he is responsible still to repay it. Therefore, the responsibility for the risk is the manifestation of the ownership which determines the entitlement to profit. And entitlement to profit does not mean the existence and legitimacy of the profit. These are three different concepts in linguistic as well as legal implications.

Nevertheless, the mainstream contemporary Islamic scholars have mixed these meanings in the context of risk and return relationship, as we have seen in the above discussions they interpreted the above *Fiqh* maxim to mean either in origin, legitimacy, or in both. In some respect they linked the existence of the profit to the exposition to risk and uncertainty and some times the entitlement or to its legal, according to this view there is no profit without risk. Hami Hassan a prominent *Fiqh* scholar argued that "you never get any reward, return or profit unless you carry risk, the one who faces the risk is the one who is entitled to the profits" Hami concluded his discussion on this point that: "If there is no risk then there is no return, no profit, no share at all from the investment. The one who bears the

risk (the *daman*) is the one who is entitled to the return³²." He added that there is no separation between *Kharaj* and *daman*, these are together. From this point of view he inferred and asserted that "no *riba* means there is no separation between *Kharaj* (gain) and *daman* (risk)". This could imply that if there is no risk there is *riba*, in other words under complete certainty there is no lawful return or risk-free return means *riba*. Referring the principle to its original context, it is reported from Aisha that the Prophet (saw) judged on "*al-Kharaju bi daman*". It is interpreted that if a person purchases, i.e. slave and employs it in services then finds defect he can return it to its original owner and the purchaser retains its earnings during this period. Because if the slave would die this period he was to die from the purchaser. The text of the *hadith* shows that "a man purchased a boy and after certain period the purchaser saw defect in the boy. The man complained to the seller but the seller rejected his complain then the man told to the Prophet(saw) that the purchaser made use of my boy. Therefore, the Prophet (saw) said *al-kharaju bidaman*". (Abi Daud, 3046).

It is very clear that this principle confines the benefit/profit to the existence of legal ownership, where as long as the ownership of the property attributes to the individual he is entitled to gain its benefits and has a right to claim the return of given property. In this case the *daman* associates with the ownership. On the basis of this view the Hanafi jurists hold the *qhassib*(usurp) to have no right to retain any kind of outcomes or fruits of the property, similarly the seller of a thing before possessing it.³³

The same course of interpretation can be applied to the *Fiqh* maxim "*al-ghurm bil ghurm*." Literally *Al-ghurm* means a liability, debt or an obligation upon an individual and *al-ghurm* benefit, gains or what someone to receive in return, this implies that whoever bears its cost gets its benefit. So, the purpose of this message is that the recipient of the benefits bears the costs of the property, complying with the socio-justice principle of balancing between benefits and burdens. In this case it may not be necessary that *daman* to be linked to the ownership of the property, for instance the object may be public good, or common utility where the government collects a certain amount of tax from the public and accordingly the people get benefits from them, like common water, residence, common parks or play grounds etc. On the basis of this principle *Fiqh* scholars have stated that (i) upon the purchaser

³² H. H. Hassan, Ibid, p. 105.

³³ Wahab Suhaili, '*Nathariyat al-Thamman*', p.215

costs of writing the sale documents for transferring its ownership (ii) upon the partners of the same property the expenses of renovations or cost of repairing their property in proportion to their shares. As the implications of this maxim the public treasury is to bear the compensation of a killed person if the murderer is unknown or the required expenses of orphans and street children for their education in exchange that the government would acquire their assets as inheritance if they die without offspring. Similarly upon the wife is to obey her husband in correspondence to his responsibility to bear her financial spending. On the basis of this axiom it is the duty or responsibility of the users to bear the costs of maintaining. So, this axiom has a very significant implication on all common interest and public utilities. Since, no one cares privately about the public utilities it is for the government to put a rule that those who pay the price of given public utilities will benefit from it. So *al ghum*-the booty/benefit *bi al-ghurm* - is for the due payment. From these discussions we can understand that the above maxim or the Prophet's (saw) *hadith* may not concern with two important things of our investigations namely: the legitimacy and the origin of profit.

Precisely it means that whoever gains the benefits of something have to pay its due costs, in other words who receive the utility of a thing should be prepared to bear its due expenses or risk if any. It is similar to say no gain without pain. But this does not mean the pain is necessary condition for the gain, or any pain must produce a gain. Similarly, the above maxim does not show as sometimes might be understood in the contemporary writings, if there is no risk or cost there is no gain/profit. Which implies that the risk determines the benefit. Or in other words the existence of risk or cost is prerequisite for the existence of the benefit. If this means when there are costs there is a gain, or to get benefit you have to pay its price. This is simply the basic principle of exchange. If someone is to get certain goods or services, one must pay its price according to the demand of the seller. Thus, risk or cost is equivalent to the price or the value that is to be sacrificed, and hence, we may say if there is no price there is no profit. Perhaps, this indicates the appropriate explanation of profit, whereas, this transaction manifests the profit, that is to compare the price or the cost with what is obtained. However, this does not mean that if there is no price there is no benefit, for someone can obtain benefit without any price, such as charities, *Zakat*, assistance, booties, social securities public health care, education etc. Although, according to this interpretation the above view of Islamic scholars is very right and addresses the fundamental principle of price theory, but, in exchange context both reciprocal items should be precisely defined. The nature of goods

or services should be assured in both quantity and quality as a prerequisite for normal exchange. Each party should certainly know what it is receiving and what it is parting out, because if the price is uncertain no profit or loss is possible to be identified. Hence, mere risk cannot stand as one side of the equation, for it is not something to be purchased but something to be paid for its evasion

We may further argue that if the risk actually takes place definitely it is certain kind of loss and some costs will be borne for repairing the damage that might arise. So, actual risk amounts to loss or cost. If this is the case, it is very difficult one to believe that the existence of costs or even loss show the existence of profit. It is against common sense to say that loss indicates profit. Loss and profit are inversely related phenomena. Since, costs and loss go to the same direction, the increase of actual risk increases the costs and hence it increases the magnitude of the loss to be incurred. Thus, there is no way of justifying the existence of profit on the basis of actually realized risk. But, in case the situation is matter of expectation which may happen or might not, the situation is more meaningless, there is no reason to link the origin of the profit to the expected risk, as it seems an economically irrational and logically absurd to say that there will be no profit if no risk is expected. For instance, it seems meaningless to say that farmer will not get a yield from his crop production efforts if there is no expectation of risk, i.e., drought, pests, and so on. Perhaps the most definite expected risk upon the living thing is its death, and it is a universal law that "every man is mortal," or in Qur'anic words "Every soul shall have a taste of death. Only on the Day of judgement shall you be paid your full recompense" (3:185). But, a question may be asked what is the effect of this natural risk on the existence of profit and loss. It is very clear that practically business transactions are conducted outside the sphere of these expectations. The ruling injunctions are pragmatic in the sense that they incorporate only what is taking place on the ground rather than conceived situations. In the context of these two states of risk the legal position of profit is very difficult to be explained in useful way.

7.4 FIQH STUDY OF GHARAR (RISK AND UNCERTAINTY)

We have studied in the above deliberations the nature of the risk that addressed in the context of *Fiqh* maxims and the Prophet's (saw) sayings about the risk and return relationship. We have come to the conclusion that the existence of risk has nothing to do with the origin of

profit, except that it may increase the cost and hence, it will serve against profit. Now in this section we would turn to the position of *Fiqh* injunctions about the concept of risk and uncertainty, in order to know whether risk and uncertainty are desirable or permissible according to Islamic injunctions. The Islamic terminology of risk and uncertainty is *gharar* the Arabic word *gharar* means risk, hazard, danger or deception etc³⁴. In the language of law it means to undertake anything blindly without sufficient knowledge or to risk oneself into a venture not knowing exactly what the outcome will be. But, technical interpretations of the Islamic jurists may be summarized in brief; *gharar* is uncertainty related to something or activity whether it may happen or not, or it is doubt in the existence of a sale object³⁵. It is also said that "*gharar* in sale is what the buyer does not know what he bought or the seller what he sold." *Gharar* in trade context comprises both what is unknown in its existence and what is uncertain in obtaining it, or *gharar* is what its end is uncertain³⁶. It is reported from large number of Prophet's companions (ra), that "the Prophet (saw) has prohibited "*gharar* in sale." This *hadith* as al-Imam al-Nawawi described it, it is one of the great basic principles in the field of Islamic commerce. It contains an unlimited number of issues, and it is the major principle for the injunctions of the transaction contracts. Examples of transactions that may involve *gharar* are considered as: sale of fish in water, bird in the air, a foetus in the womb, catch by a game-catcher, and fruits of trees at the beginning of the season when their quality is yet to be established. All such transactions are forbidden in Islam since they involve the risk to the buyer.

7.4.1 The Scope of *Gharar* in *Fiqh* Injunctions

However, what we mainly concern with, is when the element of *gharar* or uncertainty associates with profit and profit sharing which may take in different features such as, in existence, acquisition, quantum, and characteristics. All these basic attributes of the return may not be known in advance, hence when the actual outcome is realized the distribution will take place. The uncertainty of profit is mostly equated with the uncertainty of agricultural products. And on the basis of certain teachings that seemingly show the un acceptance of a fixed amount of the products is analogously used to prohibit the fixed rate of return from

³⁴ Abdul Qadir Al-Razi, "Mukhtar al-Sihah", Mu'assasah Ulum ul-Qur'an, Beirut, p.471.

³⁵ Ibn Abidin, Ibid, vol.4, p.147

³⁶ Sarakhsi, "*Al-Mabsut*", Darul Marifah, Beirut, 1398 H, vol.13, pp 194

investment. This is old confusion where during the successors (later followers of the Prophet) some people thought that it is wrong to let ones' land on a lease, whether in cash or kind in fixed or proportion of the products. In this context the leading theologian of the *Umma* like, Abdillahi Ibn Abbas explained the case that the Prophet (saw) had not declared it unlawful but simply expressed the view that normally it is preferable to let out land to a brother for cultivation without rent, with an eye in recompense of the Hereafter than to charge something from him in whatever form it might be. Ibn Abbas told to some successors who asked him for clarification of the subject "the Prophet(saw) had not forbidden the letting out of land on rent or division of the crop. The Prophet (saw), nevertheless, had said that "it was better to give land for cultivation to a brother (in Islam) free of rent than to charge any thing for its use³⁷." The Prophet (saw) recommended also that crops of groves should not be given a contract for a number of years due to its uncertainty. It is related by Jabir that "the Apostle(saw) of Allah (swt) forbade the sale of the crop of a grove for some years and he told that some allowance should be made for loss suffered through a sudden calamity³⁸."

As we all know the concept of *gharar* (risk and uncertainty) is a relative term it may range from zero to infinity and between these two extremes *gharar* may have various degrees according to its intensity and effect on the contract. The *Fiqh* scholars have been aware of this relative nature of *gharar* and its flexible situations. Accordingly they divided it into large or dominant, medium and small *gharar*. Moreover, the *Fiqh* scholars tried to put limits in differentiating between small and large *gharar*. But still the definitions they proposed seemed to be difficult to control. Ibn Rushd examines the matter from its separability perspective, hence, the uncertainty or the risk that cannot be removed from the contract is considered to be small one and hence ineffective. In this connection he stated that: "al-*gharar* which cannot be separated from the contract is small *gharar*³⁹." Shafi'i scholars also tolerate *gharar* "when *gharar* cannot be removed except with great difficulty⁴⁰. Al-Dasuqi observed the matter on subjective perspective, depending on how the people evaluate it, and he defined the small *gharar* as, "What the people normally tolerates to one another⁴¹." According to Yasin in case

³⁷ Bukhari and Muslim. *al-Ma'arif al-Hadith*, (546), Vol.IV, p.375.

³⁸ (Muslim; *Ma'arif al-hadith* 521) English Translation, p.357

³⁹ Ibn Rushd (Grant father), *Muqaddimat al-Munahidat*, vol.2, p.222.

⁴⁰ Nawawi *al Majnu' Sharhi al Muhadhab*, vol.9, p.258.

⁴¹ Dusuqi, *al-Sharhi al Kabir*, vol.3, p. 60

of the limits of *gharar* no one of the *Fiqh* scholars has successfully come up with well-defined criteria. Although Dasuqi's one is showing deep insights but the human nature of preference and tastes are different from individual to another, which would make the criteria uncontrollable. Yasin sees that the control of small *gharar* to be left to decide by the time, environment, social circumstances, and the development of the human civilizations. Then there is no principle to differentiate between large *gharar* and small one. Moreover, it is highly improbable to identify a medium *gharar*. Therefore, it is pertinent that the measuring criteria to be subject on the convenience and customs of each time and place. In this way the *gharar* is considered, one of the main flexible features in the principles of Islamic Shariah⁴². And in this context we see that *gharar* stands for the human ignorance of either party of the transaction contract about the terms of the contract or the basic characteristics of the object as well as the future condition of the concerned deal. This uncertainty and ignorance that may associate with business transactions are relative terms which would range from zero to infinite, it would be different from state to another or from individual to another, it would be different in its re movability and resistance. On the basis of these various characteristics *gharar* would affect the transactions in various ways.

7.4.2 Effective *Gharar* and its Implications

We have seen in the above discussions of *Fiqh* scholars about the concept of risk and uncertainty or *gharar* in *Fiqh* terminology that they divide it mainly into large and slight or small *gharar*. The first may be called effective *gharar* which causes the invalidity of the contract while the second type is negligible and tolerable for it does not affect the validity of the contract. According to Saddiq M. Al-Amin Al-Dhareer can be defined as "The effective *gharar* is the dominant and excessive *gharar* that associates with the exchange contracts, provided that the object of the contract is the principal item, without pressing need for the contract itself⁴³."

It is clear from this rule that effective *gharar* should fulfil the following four conditions:

- i. The *gharar* should be excessive and dominant

⁴² Yasin A. Ibrahim, Ibid, p.100.

⁴³ Saddiq M. al-Ameen, Ibid., p.44.

- ii. It should be related to contracts of financial exchange.
- iii. The *gharar* should be the objective matter of the contract.
- iv. There should not be a need for this particular contract.

The *Fiqh* scholars are in a consensus that the effective *gharar* is formidably excessive *gharar* and that slight or small *gharar* is not effective at all. And the dispute between the *Fiqh* scholars on this point is not related to the nature of this principle, but to their practical applications. The dispute is on the medium case whereas, *gharar* oscillates between being excessive and slight, and where sometimes the *Fiqh* scholars relate it to the large and prohibits it, for it makes the contract invalid, while others may relate it, to the small *gharar* and accordingly permit it, and hence the contract remains valid. Some of the examples which jurists mention in small *gharar* are; (i) use of a public bath or drinking water for consideration even though the peoples' consumption of water or staying in the bath room is different from one person to another (ii) *ijar* or renting of residence house for one month even though the month can be thirty or twenty nine days.

Some of the economic activities in which *gharar* is dominant for the dispute of people on them were highly frequent during the Prophet (saw). Some of these may be referred to the following example: *Al-Muzara'a*, with the condition of one of them to have the output of certain place, or the fruits of certain trees, or fixed rates of crop products, or sale of *al-Hassat*, *al-Mulabasa*, *al-Munabada*, the unborn animal without its mother, selling fruits before its emergence, selling an uncertain thing in existence etc. Some of the *Fiqh* scholars include this list all the thing the Prophet (saw) has prohibited for they contain *gharar*.⁴⁴ Similarly there are number of sale contracts the *Fiqh* scholars consider to be medium *gharar*, such as the followings: Sale of what is under the soil, sale at market price, *al-Muzara'a* etc. It is very clear that establishing a criterion for definite separation between large and slight is not an easy thing. Al-Dhareer is of the view that this separation is extremely difficult to devise a rule for determining the classification among *gharar* categories in all the cases. If we try so, we always find that we have determined the two extremes and left the middle area open, a matter that inevitably gives rise dispute. Thus, he opined that we should formulate a general rule for large *gharar* alone by saying that this is the effective *gharar* and any thing else is

⁴⁴ Yasin Ahmad Ibrahim. Ibid. p.98,

small *gharar* and hence, ineffective. Perhaps the best rule is that mentioned by al-Baji, for this rule greatly reduces the disputes on the large effective *gharar* and the slight ineffective *gharar*. It is also a flexible criterion because the characterization of a contract as a *gharar* contract is inevitably influenced by the differences in business customs, social norms and time or the nature of the transactions and environmental conditions. It is the society that confers such characteristics on the contract. According to al-Baji, "the *gharar* sale that Islam has forbidden is one that gives the impression that *gharar* dominates to such an extent it becomes its hallmark ⁴⁵." The second condition states that *gharar* effects only on a sale contract. It is so, because, the subject matter and substance of the *gharar* that has been forbidden in sales, may not be obtained in other contracts as it is not applicable to the meaning of sale contracts. Therefore, it should have no effect on non exchange contracts, because, there is no evidence, such as a text (tradition), to forbid *gharar* in these other contracts.

The third condition is that *gharar* must affect the principal object of the contract. There is no disagreement among jurists on the rule that *gharar* that affects the validity of a contract is that which captures things originally or the primary thing in the contract, where the contract is made for the sake of its association with the *gharar*. But if the *gharar* simply entails the object of the contract, it does not affect the contract. In accordance with a legal maxim of Islamic law "things may be lacking in derivatives that are not lacking in others⁴⁶," the *gharar* does not affect the subsidiary or derivative to the thing intended in the contract. The example of this point is mentioned as follows, sale of unripe fruits with its trees, the unborn animal with its mother - the pregnant animal, etc.

The fourth condition: There should not be any need which must be fulfilled through the contract. It is the condition of effective *gharar* in a contract that people should not be in need of the outcome of that contract, for if there is any need for it, *gharar* will not affect it, even if it is excessive and exorbitant *gharar* and even if the subject is a contract of trade and financial exchange. Some of the *Fuqaha* qualified this result; Maliki scholars permitted *gharar* in case of necessity⁴⁷ while Shafi'i scholars tolerate *gharar* in case of "*hajja*" (need)⁴⁸.

⁴⁵ Sadiq M. al-Ameen al-Dhareer, Ibid, p.46.

⁴⁶ *Al-Majallat al-Adliya Maddat* (56)

⁴⁷ Ibn Rushd, *Bidayat al-Mujtahid* Vol.2, p.156

⁴⁸ Al Nawawi, *al Majmu' Sharhi al Muhadhab* Vol.9 P.258.

Perhaps, Ibn Taymiya is the one who profoundly elaborated the matter, comparing the concept of *gharar* to *riba*, he expressed that the evil of *gharar* is relatively less than that of *riba*. Accordingly he permitted some certain things if the need compels that, for its prohibition in this case draws more difficulties than its evil of being *gharar*. For instance, selling housing property in complete even if the buyer does not know what is inside of the buildings and furniture, or selling pregnant animals even without knowing how long it was pregnant. According to Ibn Taymiya there is a permission in simple and small *gharar*, if it is associated with need for that thing. He is of the view that although the evil and corruption of *gharar* in sale, would itself may generate enmity, angry, and eating people's property unjustly, it is well known that if this problem confronts significant interest or benefit the last has a priority to the first. So the intensity of the need will overtake the smaller *gharar*, for the whole Shariah principles are based on this, where, if the problem that calls for prohibition confronts genuine need and requirement of the people, the former is permitted for the sake of the later. Then, he concluded that if this is so, then, how if there is no any problem of *gharar* at all? . No, doubt that all contracts in this nature have been ordained, because people need them and one of the unanimously agreed upon principle of the Shariah is the principle of "removal of hardship" on the strength of Qur'anic verse "He made no hardship for you in religion"⁴⁹. For blocking these kinds of contracts on the basis of their association with *gharar* puts the people in into hardship, hence it is the Lawgiver's justice and mercy to permit contracts that people need even if they contain *gharar*. And according to Islamic law the need is different from the necessity where need is that want which if you do not satisfy it you face certain difficulties and hard ship. Hence, need for a certain contract implies that otherwise the person suffers hardship and inconvenience because he loses a benefit recognized by the *Sharia*.⁵⁰ However, the necessity concern with the matter of survival, as if you do not meet it, it may cause the life of the person endanger or terminate.

7.4.3 Relationship Between *Gharar* and Profit

From the above discussions we may conclude that risk and uncertainty that associate with business transactions or in *Fiqh* terminology *gharar* is prohibited in Islam. Therefore, no

⁴⁹ *Al- Hajj* verse78, al Bada'i, vol.5, p.157.

⁵⁰ *Al-Muntaqa on Al-Muwatta'*, vol.5, p.113.

way of these concepts is considered Islamic concepts or used as a justification of profit permissibility their presence in the contracts. Islam considers the presence of these elements in transaction contracts something undesired and obligates their removal and elimination from business dealings to the possible extent. The higher the uncertainty and risk the greater would be undesirability for that contract. Therefore, as far as the legitimacy of the rate of return is concerned, there is a negative correlation between *gharar* and the lawfulness of the rate of return depend on the above conditions. The more toward uncertainty the more the profit would subject to suspicion. On the other hand the business contracts that take place on certain and *gharar* a free situation is pure and produces legitimate profit. However, the existence of natural risk and uncertainty does not turn the lawful thing by nature into unlawful and vice versa. The *halal* things remain *halal*, under any circumstances of risk and uncertainty and the prohibited things remain so, in any degree of uncertainty or certainty. For instance, *riba* is unlawful naturally it is an illegitimate increase irrespective to whom it may accrue or under what state of certainty be generated as long as it retains its natural features. On the other hand, although, theft and robbery may involve the highest degree of risk and uncertainty, they remain illegal and prohibited even if they are conducted under a complete certainty. Thus, assumption of certainty and uncertainty are given natural states which have nothing to do with the legal position of the excess values (*riba*, profit). It is the human attitude in the face of these realities which is the context of permissibility and the prohibition. The principles address man's actions and deeds who would bear their responsibilities. However, since risk and uncertainty are relative terms Islamic injunctions show a great flexibility in dealing with these problems. It is permitted for the sake of need, in convenience, impossibility of its separation from the object.

Furthermore, we have clearly elaborated that *riba* and profits are fundamentally different from each other in the context of exchange economy. We have asserted that *riba* is based on the transaction of two identically homogeneous goods, which may be expressed as an exchange of a good for itself with excess. But, profits depend on the exchange of different goods or in Islamic terminology trade activity either through commercial activity or through transformation through value added processes, where goods go from one state to another and by this way generate more value. So this transformation to take place, it is required planned effort and rational exercise incorporating with the existing conditions in order, that effort to generate a lawful profit. In these kinds of activities the risk element and uncertainty are neither

necessary nor sufficient condition to determine the permissibility of profit and prohibition of *riba*. According to these criteria *riba* will remain unlawful and profit rates genuinely lawful return under any risk degree and certainty. Nothing will change with the change of these factors, except that some level of *gharar* may associate with the profit in certain specified conditions. Thus, the uncertainty of incurring risk can be significantly minimized or completely avoided. This is the role of the entrepreneurship and managerial work to guarantee the maximum possible level of safety for the enterprise through minimizing shifting or distributing the degree of risk that may result from a calculated uncertainty.

7.5 RISK MANAGEMENT

In fact, risk is universal, present in all things all lives, inherent in being. The concept of a person free from all risk is as theoretical as the concept of perfection. On the basis of this fundamental natural reality, any investment or business activity has to undergo a certain kind of risk and uncertainty. Dealing with risk concept, the financial and business behavior toward risk may be classified into the followings; (i) risk shifting/transferring schemes. (ii) risk sharing/distributing schemes. (iii) risk minimizing or reducing schemes.

7.5.1 Risk Shifting or Risk Transferring Schemes

Another technique of dealing with risk, is the method of shifting risk to someone else. The usual way of doing this is to transfer the risk to an insurance company⁵¹. This method is also considered as a way of risk distribution or spreading its cost over large number of people, for when the insurance companies identify the concerning risk it spreads its resulting expenses over its client. From the resulting implications of the former scheme financiers are attributed to risk transferring agents while the enterprises are risk absorbing class. This is a natural phenomenon of fixed and a predetermined rate of return attached to the principal of capital irrespective of whether the return stems from profit generating approach or not. Predetermined rates of return are considered kind of risk shifting schemes which transfer risk and uncertainty to other parties, so that nothing unfortunate might happen to the capital owner, in other words it is risk covering method by shifting the uncertainty about the future yield of capital from the

⁵¹ Frederick G. Crane, Insurance and Practices, Ibid, p.8.

lender to the borrower. This creates an imbalance stand for the parties that face of future uncertainty while, all human activities, particularly the decisions related to business operations are inevitably subject to risk and uncertainty. Fortunes and misfortunes are the facts and natural reality of the life, in which all human individuals are exposed to it. The theories of choice under uncertainty suggest that risk-aversion is a universal behavioral model. A risk averse individual always prefers a non risky alternatives to paying actuarial fair. Risk shifting naturally implies the shifting of risk to market, to other agents or often to groups in society or society taken as whole. When the individual bears his risk privately, society often indirectly shares in his risks. Society has long recognized that an individual's capacity for running a business well need not be accompanied by his desire or ability to bear the concomitant risks. In the absence of institutions such as the stock market and insurance, socially profitable undertakings such as the development of innovative technology and natural resources explorations may not have taken place.

7.5.2 Risk Aversion on the Basis of Contract

Every transaction involves a contract. Given the state of personal wealth distribution and the portfolio assets held as private property by resource owners some owners will seek contractual arrangements with others in a combining resource for production. There are variety of arrangement open for them. The Islamic banks, however, use different techniques to avoid or reduce these kinds of risk, such as, insurance and contract terms. In this connection there are variety of arrangement open for them. At least two reasons may be given for the existence of different types of contractual arrangements. First is the existence of natural risk. Defined here as the contribution by the state of the world to the variance of the production value. Given a non-zero yield, various contractual arrangements allow different distribution of income variances among the contributing parties. Under the postulate of risk aversion, an individual will seek to avoid risk if the cost of doing so is less than the gain from the risk averted. He may avert risk either by searching information about the future by choosing fewer risky options when investing, or by choosing among arrangements with which his burden of risk can be dispersed to other individuals such as insurance and various contractual arrangements. Another reason for the existence of different contractual arrangements lies in the different transaction cost that are associated.

Under a fixed-rent contract, the tenant bears most, if not all, of the risk; under a wage contract, the landowner bears the most, if not all of the risk and in loan transaction the borrowers bear all risk. Profit sharing is analogous to share tenancy may then be regarded as a device for risk sharing (or dispersion) that is the variance of the output yield is distributed among contracting parties. Maintaining this analogous we will compare the different contract arrangements open for the tenancy under risk assumptions. Given the postulate of risk aversion a share contract would be mutually preferred by the land owner and the tenant. However, in varying degrees, risk exists in any tenancy. Some studies on this subject suggest that the choice of a contract should be considered into account both the difference in transaction costs and the postulate of risk aversion.

Given the state of risk associated with a particular output a higher transaction cost will lead to lower returns to the productive assets. On the other hand, given the transaction cost, the risk aversion implies that asset values and the variances of income are negatively related. While in itself the dispersion of risk under a share contract will lead to higher values for the contracted resources, the higher associated transaction cost will lead to lower asset values.

Observed stipulations of share contracts this has been done so in order to verify the hypothesis that contractual arrangements are chosen to disperse risk bearing and minimize transaction cost, but also to illustrate that the contractual stipulation in sharecropping are consistent with the efficient use of resources. The characteristics of a fixed-rent contract have very special interest in one particular respect that their frequent inclusion of the provision for rental reduction according to local customs in a famine year, a provision which is absent under 'iron-sheet' rent which may be called *escape-clause* for the tenant, the inclusion of which in a fixed rent contract imposes a risk burden on the land owner. The local customs may be interpreted as a set of market prices for unfavorable environmental situations, i.e., "famine" adjustments even though the exact magnitude of the possible reduction may not be stated beforehand when the contract is signed. The escape-clause comes into play only in the year so "bad" that market considers it to be a famine. Given a sufficiently large number of fixed-rent contracts which include the escape clause, competition among land owners to keep their tenants will yield certain market rates of rental reduction which each land owner will follow. Other things being equal, the increased risk burden on the land owners associated with the inclusion of the escape clause implies that a premium will be added to the 'fixed' rent over the

'iron-sheet'. Although shifting the risk burden by including the escape clause in a fixed-rent contract is not quite the same as the risk dispersion in a share contract, we may still imagine the formation of share contracts via the escape clause. Suppose the famine is defined as occurring when the actual harvest is reduced to a certain percent of the expected mean or past yields when the contract was concluded due to natural causes.

In further argument, there could exist in the market not just one escape-clause as observed. But wide range of similar clauses each associated with it a different level risk and unfavorable situations as such, risk burdens could be dispersed between the contracting parties in an infinite number of ways each with slightly different arrangements this hypothetical world perhaps would exist if the cost of negotiating and marketing all of different escape clauses - in particular the cost of defining different levels of famine in the market and cost of negotiating the rental reduction for each - the incremental gains of having them may be so small that no further custom is developed by the market. In fact the escape clause fixed rents and minimum guarantees associated with share rents are considered market practices that serve as intermediate arrangements between pure fixed rents and pure share rents. Each one of them has different risk distributions and transaction costs, thus, widening the range of contractual choice. In this context we may remember one of the basic principles of Shariah that 'naturally things are lawful'. 'As a matter of principle a contract is determined by the mutual consent of the two parties and accordingly they bear its obligations

7.5.3 Risk Distribution or Risk Sharing Scheme

Profit sharing is considered the other side of risk sharing and Islamic economic studies how justly the uncertainty or risks are distributed among the involving parties. While risk shifting schemes probably only one party bears the most burdens of the uncertainty in terms of insurance while he is still obligatory to pay the capital rent or predetermined rate of return. The profit sharing in contrary to the above, guarantees a fair model of an economic venture, where both financiers and entrepreneurs are facing the uncertainties of life with conscious, and equitably sharing its consequential outcomes.

Nevertheless, the predetermined rate of return which is guaranteed yields in economic or business activities would cause undesired income distributions. However, on the basis

of our previous conclusions (in chap.4) with the acknowledgment of the injustice and mal distribution affect which may arise from the fixity of the rate of return and this practice. there are many reasons to believe that the predetermination is undesirable due to the grounds other than being *riba* context. It is also pointed out that the average rate of return adjusted with the risk involved can be used as the discount rate in An Islamic capital market. The price of risk will depend on (i) the minimum acceptable rate of return, (ii) the actual rate of return and (iii) the expected rate of return from co-variance between the share's rate of return and market average. It is further, highlighted that the partners in *Mudaraba* case would like to achieve a risk return sharing formula that will allocate the risk among them in mutually desired way. Zarqa proposed a model of determining optimal risk allocation or its pricing among the *Mudaraba* partners⁵².

In fact, after all, an alternative to interest-based financial system was sought only because of the prohibition of *riba* in Islam. The Islamic economists have taken an extreme position on this point where as the alternative is exclusively based on sharing and the economic rationale for this alternative is built around that concept itself. In supporting this view Siddiqi strongly argued, it is an uncertain world in which the value of product of enterprise cannot be predetermined so to claim a predetermined positive return on money capital when capital and enterprise jointly engage in production runs counter to this reality. It amounts to *zulm* specially exploitation of the entrepreneur by the capitalist. As the entrepreneur is left alone to bear the uncertainty which in reality applies to both. It is an unjust arrangement. And Islam abhors injustice and exploitation and seeks to forge human relationships on the basis of justice and cooperation. A replacement of the unjust and exploitative institution of interest by the just and cooperative arrangement of profit sharing is therefore, socioeconomic as well as a moral and spiritual imperative. Ariff also has pointed out that what makes profit sharing permissible in Islam while interest is not the profit-sharing ratio and not the rate of return which is predetermined and predetermination is the problem. According to Zubair "one is definitely better off by sharing profit rather than getting a fixed and predetermined amount of money." The arguments can be summarized as follows (1) a fixed charge on capital is unjust since the productive enterprise in which capital is invested is

⁵² Anas Zarqa. Comments. on Naqvi's arguments, Ariff, Ibid.

uncertain. It would be just if capital shares the actual profits of the enterprise. (2) interest results in a less efficient allocation of resources than profit sharing. Profit-sharing makes the investable funds go to the projects with the highest profitability, whereas, in the interest-based system, the fund goes to the most credit worthy borrowers whose projects may not necessarily be the most profitable (3) as a system based on profit sharing will be more stable than a system on a fixed charge for capital as the cost of capital in a sharing system automatically adjusts itself to variations in productivity under changing business conditions. (4) switch-over from interest to profit-sharing is more conducive to economic growth, as this would increase the supply of risk capital for investment and as the cost of capital in a sharing system is always below the productivity of capital - which the interest-based system fails to insure.

A conceptual question would arise from the relationship between the variability of the return to be shared and its permissibility. If the rate of return is *riba* originally, it will remain unlawful at any rate. On the other hand irrespective of the fixity and variability of the resulting profit, the distribution of the profit can take place among participants of the investments. Therefore, there would be a possibility that we may conduct in a business which is free of interest but not based on sharing, or not with a variable rate of return, for instance a proprietor who is running his own business on the basis of leasing may earn naturally lawfully and a constant rate of return. This same proprietor's business may commit *riba* with certain conditions. However, Siddiqi is of the view that the above logic and rationale would no longer apply. If sharing of the outcome of the investment is neither necessary nor sufficient condition for interest-free system, then, we cannot claim for interest-free to be based on sharing. Siddiqi argues that;

"What is worse, if the alternative, in practice is built around predetermined rates of return to investable funds, it would be exposed to the same criticism which was directed at interest as a fixed charge on capital. It is so, happens that the returns to the finance provided in the modes of finance based on *Murabaha*, bay' Salam, leasing, and lending with service charge are all predetermined as in the case of interest. Some of these modes are said to contain some element of risk (which could probably justify them). But all these risks are insurable and are actually insured against. The uncertainty or risk to which the business being so financed is exposed is fully passed over to the other party. The financial system built solely around these modes of financing could hardly

claim superiority over an interest-based system on grounds of equity, efficiency, stability, and growth"⁵³

Murabaha operation as the most important financing techniques of Islamic banking in practice is justified under the Careens allowance of trade that is buying and selling at profit. And *Murabaha* is buying and selling at profit. The banks are free to charge any rate of profit as they wish or practically feasible. In this context *riba* is interpreted to relate only to financial operations, that is, a contractual obligation to pay as increase by the borrower in a loan. It has been argued that the mark up profit margin techniques in trade and rent are nothing other than interest by a different name⁵⁴. If the presence of these conflicting criteria and interpretations, a number of authors see the difference between Islamic banks and conventional ones to be exclusively in legal and ideological senses, According to them this does not necessarily constitute in itself an economic difference⁵⁵. For instance, they argue that financing of the purchase of a machine or of raw material through an interest loan is economically identical with the financing through leasing or mark up while legally they are different. Ideological difference can arise: if Islamic banking is understood as the program of economic and social reform.

Unfortunately, the reality does not coincide with these ideal assertions in two respects. The share of PLS financing of most existing Islamic banks is very negligible. Secondly the bulk of financing business of Islamic banks is of the mark up and leasing type which gives the bank a predetermined income. Perhaps, the low percentage of PLS financing can be due to weak demand of entrepreneurs. Entrepreneurs with good profit expectations may prefer a financing of their projects on the basis of fixed cost of funds (*Murabaha*, leasing rates etc.), so that they should not have to share the expected profit with someone else. Entrepreneurs with weaker projects may shy away from PLS financing because they have to concede the bank, some rights of interference into the management if their business does not perform well enough. PLS techniques have higher transaction costs comparing with predetermined returns for the bank, specially in medium or long term project financing. For the bank has to study

⁵³ M.N.Siddiqi, Islamic banking, Ibid.

⁵⁴ Abdallah Said, Islamic Banking and Interest, Ibid, p.93. see also M.N. Siddiqi's Issues in Islamic Banking, and IIC report.

⁵⁵ V. Nienhaus, Ibid. p.234

and evaluate entrepreneurial appraisals or proposals. This requires highly qualified expertise and costly personnel. Further more the bank must find adequate protective measures against manipulations of the partner's profit. Very interestingly what makes PLS partnership so attractive for Islamic economists - namely the sharing of risks - makes PLS partnership so unattractive for the Islamic banks. When Islamic banks' operations became widely known, among Islamic economists the banks were criticized even by the proponents of Islamic banking. The Problem lies with the basic theoretical assumption of the subject, which is the rationale of prohibition of *riba* on the basis of the predetermination hypothesis which under this assumption may assure a fixed rate of return to the financier while the borrower is left to bear the entire business risk⁵⁶.

7.5.4 Risk Shifting Mechanism

Financial risk is an additional risk placed on the common stock holders as the result of the decision to use debt or preferred stock financing. Conceptually the firm has certain amount of risk inherent in its operation of future EBIT. To illustrate the business risk, we consider a new firm which expects an EBIT., i.e., \$4 millions require assets of \$20 millions and have a zero tax rate. To begin the analysis of this, divide the \$4million expected IBIT by the \$20 million of assets to obtain the expected return on assets which in this case is $ROA = \$4/\$20 = 20\%$. If the company used no debt then the following conditions will exist: Its asset would be equal to its equity. Its return on equity (ROE) would be equal to return on assets (ROA). Its equity would be exactly as risky as its assets. Now suppose the firm decides to change its capital structure by issuing \$10 million of debt at $K_d = 15\%$. Substituting these funds for \$10 million of equity, its expected return on equity would rise from 20 to 25 percent. Expected EBIT \$4,000,000, interest (15% on \$10 debt) \$1,500,000. Income available to common = \$2,500,000. Expected ROE = $\$2,500,000 = 25\%$. Financial leverages increases the risk as well as the expected return to the equity investment, depending on the relative level of interest and expected EBIT. Suppose the EBIT actually turned out to be \$2 million rather than the expected \$4 million. The ROA turned out to be 10% rather than 20%. If the firm uses no debt then ROE would decline from 20% to 10% however with debt financing ROE would fall from 25% to 5%. The above analysis can be concluded that as the use of debt generally

⁵⁶ Ramadan Akhtar, Mudaraba in Micro-Enterprise, Research Paper, 1996.p.7

increases the expected ROE this situation occurs whenever the expected return on assets exceeds the cost of debt⁵⁷

7.5.5 Risk Reduction or Risk Minimizing

Risk management mainly aims at risk control. Risk control means to reduce the total amount of loss caused by risk. The total amount of loss is a function of risk frequency and risk severity the amount depends on how many times the risk occurs and how big they are? There are number of risk control techniques, for instance risk prevention and risk reduction. The risk prevention activities or the loss that it may generate is aimed at reducing the chance of risk or its frequency. Risk reduction measures are designed to limit the severity of the losses that results from the risk, for instance lightning rods, traffic signals, are risk prevention devices. Similarly fire alarms and sprinkler systems are risk reduction devices, they do nothing to do about prevention instead they limit the severity of the fires after they begin.

i. Moral measures of risk precautions

No doubt, one of the main purposes of Islamic Shariah is to relieve any unnecessary burden or difficult and any possible uncertainty and anxiety from the people. Qur'anic verses are strongly supporting in leading the person from the uncertainty to the greatest level certainties of life. No one will deny the fact that risk is a kind of cost or loss, or in other words, the risk and uncertainty cause a cost or at least create a moral pressure so that the individual tries to avoid it. If it is so, no way Islamic injunctions encourage incurring this kind of costs or risk generated burdens. Moreover, the fundamental principles of Islam clearly show this fact, they aim at eliminating any possible harm, or difficult which might happen to the person. There are numerous verses of the Qur'an which clearly indicate reducing any probable burden from the people is one of the main objectives of Shariah principles. Allah (swt) says: "Allah intends for you ease and He does not want to make things difficult for you." (2:185). And the Prophet (saw) has said: "*La dharar wala dhirara*" (no harm to someone and no reciprocal harm). More over the Islamic *Fiqh* scholars derived a general maxim, "the harm is removed." Due to this reason Islam permitted insurance and human integrity.

⁵⁷ F.Brigham Eugene., et al, 'Financial Management: Theory and Practice', 5th ed. 1988. p.68.

In the case of risk, where it is only future worry and psychological pressure of an individual or pessimistic view that undesired event may happen in the future period. Islam makes certain fundamental precautionary measures in this regard. Islam aims to help the person to lead a life relatively free from anxiety. Even the whole concept of *qadda wa qaddar* (divine will and decree) *tawakal* (reliance on God) and *sabr* (perseverance), all these conceptual measures help toward realizing the persons' peace of mind and inner tranquility. Moreover there are number Shariah principles that recommend the reduction or elimination of the risk as the basic objectives of Islamic law. "The difficulties are to be removed to the possible extent."

ii. Economic measures; Risk diversification

Risk analysis is very important and well sophisticated in conventional banking operations, and the central banks impose certain measures to ensure that the banks do not exceed a normal allowable risk level. Though both Islamic and conventional banks share similar risks that need to be managed, such as, credit and foreign exchange risks. They differ in the level of such risks. Islamic banks are expected to be active in equity and project financing and should expect to monitor investment risk carefully. At the present systematic risk analysis and measurement is not well developed and modernized in Islamic banks, which may lead to more risk portfolios or, risk avoidance which partly shows why the banks are shy of entering into long term PLS transactions and mostly concentrate on short term financing⁵⁸. Therefore, while there are participatory modes of financing in which conceptually, the capital owner is bearing risks in a full amount and during the entire period of investment such as *Mudaraba* and *Musharaka* there are other modes of mark up trade-based financing and leasing (*Murabaha*, *ijara*-based financing) which reduces risk to practically zero⁵⁹. Islamic banks also used to avoid any risky modes of financing in their traditional forms and concentrate in their financial activity on the later financial techniques. It is argued that mere allowing of bay' (sale) does not mean in it self extolling risk, for bay' can be conducted without any risk or with negligible level of risk.

⁵⁸ Fuad Omar and Abdel Haq, *Islamic Banking: Theory* Ibid, p.115.

⁵⁹ Tariqullah Khan, *Interest-free Alternatives for External Resource Mobilization*, (With special reference to Pakistan), Research paper # 44, IRTI. IDB. 1997, p.38.

Some clear practical examples of these are *Murabaha* and *ijara* which serve as the cornerstone of Islamic banking in practice and generate fixed profits, fees, rents, etc. In all these areas together with certain retail and whole sale transactions are considered with negligible risks or avoidable uncertainty. Theoretically the Islamic banks bear the risk of loss or damage to the goods from the time of purchase till the time of goods delivery to the client. And according to Islamic law, the client has a right to reject goods which are damaged, deficient in quantity or do not meet his specification. And the level of the risk may decrease or increase with the distance of transportation the time involved as well as the political environment.

Financing on the basis of risk sharing with which the theoretical model of banking is essentially identified does not seem to be practically realized. In contemporary operations the Islamic bank agrees with its *Mudaraba* client on the profit-ratio which is specified in the contract. The ratio may depend on the bargaining power of the client, the profit forecast of the *Mudaraba*, the personal aptitude of the client, marketability and the duration of the contract. If the *Mudaraba* does not yield any profit or gets loss, the *Mudarib* does not receive any remuneration for his labor. And in case of loss, the bank bears the loss provided not proved any misuse or mismanagement on the part of the *Mudarib*. But, the bank almost eliminates the uncertainty involved in a pure *Mudaraba* venture. The actuarial risk in the venture as utilized in Islamic banking is quantifiable and insurable. In this way the cost of capital is almost constant. The discussion on *Mudaraba* as practiced in Islamic banking indicates it is mostly used for short term commercial purposes where the outcome is almost certain. The bank in minutes detail prescribes how to sell the goods. The mark up is justified on the basis of a generally accepted axiom with an increase in deferred price in a sale transaction⁶⁰.

Islamic banks mostly rely on framing the contracts in such a manner that protects them against any risk. Therefore, contract terms are phrased in such a way that helps the Islamic bank avoid any risk related to goods. Confirming the risk-avoiding behavior of Islamic banks, the contract of *Murabaha* for instance (DIB) states that the client "Affirms that he has presently examined, and inspected the goods in such a manner that negates the existence of any uncertainty (*jahala*) according to Islamic law, and that he accepts in its present conditions

and he has received the obliged delivery, and he bears the responsibility of any risk after the date of its receiving."⁶¹ JIB's conditions include also that "the client does not have any right to have recourse to the seller(the bank) for any reason whatsoever."⁶² According to the contract, it is the client alone, who should be aware of the contract terms and would bear the responsibility for fines or punishments. Mostly, any risk relating to the goods, which the bank theoretically has to bear is effectively avoided.

The risk exposure level needs also to be reduced through geographical and product diversifications and pursuit of more activities off the balance sheet⁶³. However, as the recent studies on this matter demonstrated, the present infancy of Islamic banks implies that their risk analysis and risk measurement are not yet developed to the necessary extent. Perhaps that is the main reason of their excessive dependence on precautionary risk aversion on the basis of a contract. A number of restraints acquiring a satisfactory level of risk minimizing management and measuring may be attributed to the following reasons (a) liberal attitude toward risk, (b) lack of qualified professionals (c) weak diversification of products and financial operations. As far as the first case is concerned, it is suggested that the nature of Islamic transactions requires a more liberal attitude toward risk for profit-sharing principle is generally interpreted as a risk-sharing principle on the basis of no profit sharing without risk-sharing (*al-ghunm bi'l-ghurm*), that is earning profit is legitimized by engaging in an economic venture and thereby contributing to the economy⁶⁴. In lieu of a lender-borrower relationship, Islamic finance relies on equitably risk-sharing between the person who provides the capital and the entrepreneur. The present literature has taken for granted that this practice derives from the central tenet of Islamic banking based on the prohibition of *riba*. So instead of paying efforts for risk minimizing, it is advocated as we have seen in above that risk avert to be undesired practice. In case of the second constrain of lack of qualified professionals, Islamic financial systems suffer from a shortage of qualified managers in different areas of their operations. It is argued that the level of success the Islamic banks achieve will depend at the micro level on the quality of management and the level of staff trained on the modern techniques of risk analysis and hence its management and measurement and equipped with

⁶¹ Dubai Islamic Bank, *Al Aqd bay' al-Murabaha*, 1996,

⁶² JIB, *Al Aqd bay' al-Murabaha*,

⁶³ Fuad Omar and Abdel Haq, *Islamic Banking: Theory Practice and Challenges*, Zed books, Ltd. London, 1996, p.115-17.

⁶⁴ *Ibid.*, p.116.

Shariah knowledge. It is pointed out, due to this shortage of qualified and committed Islamic bankers many staff do not have the commitment required to implement Shariah guidelines for instance, differentiating *gharar* and *riba* where most of the peoples' financial contracts are subject to *gharar* but, *riba* confines into very specified circumstances.

In the third problem it is noted that many Islamic banks do not have the diversity of products essential to satisfy the growing demand of their customers for structured instruments and techniques for financing trade, leasing, and money market instruments. The importance of investment diversifications and upgrading the quality of the services or inventing new methods and financial instruments under the framework of Islamic principles cannot be overemphasized, so it is not surprising to see that most of the Islamic banks are dependent on conventional banks in this regard. One of the main conclusions made by Fuad Omar and Mohammad Abdel-Haq (1996) is that the survival and vitality of Islamic banks depend on the quality of their services and the satisfaction level of their clients, it was observed that the quality of their services improves if there is competition from Islamic banks in the country. It is also recommended Islamic banks can make use of the Knowledge and experience of the conventional wisdom, for in quality services and successful marketing is highly developed⁶⁵.

7.6 CONCLUSION

Departing from the dominant view of contemporary studies "without risk there is no profit," and we have come up with the conclusion that the fixity and variability of the rate of return, or the association of the natural phenomenon of uncertainty and risk bearing to economic activities have nothing to do with the determination and eligibility of both *riba* and profit terms. On the basis of this fundamental discourse we assert that the factors which relate to profit sharing or entitlement to business outcomes must be separated from those originate the profit or determine its permission. Thus, the underlying technique of profit sharing (*Mudaraba* and *Musharaka*) according to this study is related with distributional aspect, depending on the level and nature of the participation.

This work submits its strong reservation on the validity of the current conceptualization in the justification of the permission of profit and prohibition of *riba* on the basis of the

⁶⁵ Ibid, p.117

assumption of certainty and uncertainty. Risk and uncertainty are a natural reality and part of the human ignorance which can be reduced with acquiring scientific understanding of the things. It is not risk itself to determine the magnitude of the return but the monopolistic nature of risk bearer and competent entrepreneurship under uncertainty by minimizing the degree of risk/cost of uncertainty. He may acquire high yields. Therefore, profit is earned through efforts and ownership. In this context critically reviewing the interpretations of underlying *Fiqh* axiom, i.e., *al-Kharaj bil-daman* or *al-ghurm bil-ghunm* we find that the central messages of these axioms are not suggesting that risk is an essential factor for determination of profit. But, risk and uncertainty is known as *gharar* in the *Fiqh* context where if there is no risk and uncertainty there is no *gharar*. Risk/*gharar* is an undesirable element which must be removed. Islam prescribes risk management by elimination or minimizing its effects through risk reduction, risk distribution /spreading or risk sharing mechanisms, i.e., However, certain reservations are made over the schemes that result risk shifting or risk transferring and risk averting on the basis of a contract at the cost of the others.

In this connection *gharar* may arise when the risk and returns are not fairly shared and the appropriation of the outcome is not considered with the level of risk and uncertainty involved. Therefore, the task of management is to work out the most efficient way of sharing the risk and return. However, we have to keep in mind that this exercise falls entirely outside the domain of *riba* and the return achieved with the absence of *gharar* or risk cannot be equated to *riba*. As we have established, earlier *riba* is an absolute term which falls outside the scope of *gharar* and profit. Thus, the notion of fixity or predetermination assumption of the rate return is unable to convert what economically and legally is recognized as a justified profit into prohibited *riba*. As a result, the predetermination of the rate of profit, even though it may accompany certain degree of *gharar* (risk and uncertainty which are tolerable to some extent in Islamic jurisprudence), there is no evidence to justify its equivalence with *riba*.

PART THREE

POLICY IMPLICATIONS

CHAPTER 8

PROFIT-SHARING AND PARTICIPATORY FINANCING: CRITICAL ASSESSMENTS AND RECONSIDERATION

Profit-sharing system is generally referred to a method of participatory engagement in business activities and sharing the resulting outcomes according to pre agreed proportions. There is a general consensus in the legitimacy of sharing profits, where the capital and expertise are added together to participate in the transformation process of capital formation and production function of an enterprise, where, should both capital and expertise come from one party (e.g., sole proprietor) all profit belongs to it or should these two come from separate parties with agreed proportions (e.g., *Mudaraba*, *Musharaka*, or corporation) they share the outcome in mutual agreement. However Islamic economic theorists emphasize the investment activities of the Islamic financial institutions would be based on the two legal concepts of *Mudaraba* and *Musharaka* alternatively known as profit and loss sharing system (PLS), they contended that an Islamic bank, unlike the interest-based financing in which the borrower assumes all risks, would provide its extensive financial resources to the borrowers only on a risk sharing basis. But, in practice Islamic banks generally have come to realize that PLS as envisaged by the Islamic economists, cannot be utilized extensively in Islamic financial institutions due to the risks it imposes to the bank. Owing to this reason Islamic banks have almost abandoned from these modes of financing and transformed their financial operations almost into risk-free financing mechanisms such as *Murabaha* and *ijara*. Keeping in mind with these contemporary apparent conflicts between the theoretical concepts of profit-sharing system and its practical application by Islamic financial institutions, certain important questions may automatically arise, i.e., What is the nature and scope of the profit-sharing in Islam? Whether a particular kind of business forms or financial organizations being considered Islamic one, in other words, is there a role of organizational set up on determining the Islamicity of the business operations? Does profit-sharing system in Islam imply a particular mode of financing parallel to *Murabaha* and *ijara* or simply one of the organizational structure which encompasses all kinds of profit-oriented activities? On the basis of these equations the arguments in this chapter are organized as follows: section 8.1 briefly summarizes the kinds and forms of business organizations in contemporary Islamic financing and possibility of the conversion of *Musharak* and *Mudaraba*. Section 8.2 discusses the general Fiqh principles of joint enterprise governing the determination of profit and its distribution among partners.

liability of the worker or partners for capital loss and lastly the rights and responsibilities of partners. Section 8.3 demonstrates the scope of profit sharing. It is to determine the position of profit sharing in economic sectors and financial modes. Section 8.4 critically reviews the current contentions between theoretical presentations and practical applications. It argues that the problem results mainly from conceptual misgivings and practical misuses of modes of financing under profit sharing. Section 8.5 critically reconsiders the modern reformulation and practical requirements of profit-sharing system. It examines the nature of common joint enterprise, the role and responsibilities of common entrepreneurship, profit distribution and predetermination of returns. Finally we present the finding conclusions of the chapter.

8.1 TYPES OF BUSINESS ORGANIZATION IN AN ISLAMIC ECONOMY

Basically from purely an organizational point of view, there are three main forms of business organizations in the modern conventional economic system which may be discussed in brief such as (i) sole proprietorship (ii) partnership (iii) corporation. Comparing these three forms we find that in terms of number of firms about 80 percent of the business firms are operated as sole proprietorships, while the remainder is almost equally divided between partnerships and corporations. However, by the volume of business activities, about 80 percent of it is conducted by corporation about 13 percent by sole proprietorship and nearly 7 percent by partnerships. Since most of the business operations are conducted by corporations, the modern financial literature extensively concentrates on these important forms of organization¹.

In the Fiqh teachings we find diverse forms of business organization with large degree of flexibility in their practical operations. *Musharaka* or *Shirkat* is normally translated into partnership. However, in the contemporary usage of Islamic financial system it is called participation financing, perhaps, for emphasizing the particular features of joint participation. The most important permissible forms of *Shirkat* (partnerships) in Islamic Fiqh context may be summarized in the following table.

In Fiqh context *Musharaka* or *Shirkat* is divided into two broad categories: (a) Property Partnership (*Shirkat Mulk*) it implies to joint ownership through donation, gift, heirs.

¹ Eugene F. Brigham, Louis C. Gapenski, *Financial Management: Theory and Practice*, 5th ed. 1988. p.7.

etc. and it is not basically motivated by joint exploitation or profit seeking (b) Contractual partnership (*Shirkat Uqud*) It is a joint participation of business activity motivated by joint exploitation of sharing the outcome. It is the contractual partnership which is related to the business activities and hence it serves for our interest in this topic. The contractual partnership may be divided also into, (i) The financial partnership (*Shirkat al-am wal*) where the monetary capital is the subject matter of investment in the business operation. (ii) The labor partnership (*Shirkat al'amal*) where the basic matter of investment entirely consists of services and skills of partners (iii) credits partnership (*Shirkat wujuh*) where credit alone is used for partnership investment. The financial partnership may take one of the following forms: such as *al Mufawada* a Partnership with equal capital contributions and hence equal rights and responsibilities or *al'Inan* which is a partnership with the contributions of different proportions of capital contributions and labor participation, this may entitle some various levels of rights and responsibilities to the partners. And lastly the form of a limited investment partnership is known as *Mudaraba* which is treated separately in the Fiqh books for its peculiar features. But it may be considered part of the financial partnership for it is basically working with capital funds.

8.1.1 Contemporary Business Forms

In the contemporary Islamic economics we do not find much difference in business organizations from the conventional business organizations mentioned above for the permission to trade in Islamic principles of business implies permission to profit which arises from a productive engagement in financial enterprise, regardless of the organization of the business. Therefore studying the contemporary forms business organizations there are mainly four kinds of business forms namely (a) sole proprietorship system (b) *Mudaraba* (c) *Musharaka* and (d) corporation. The last three forms are known as in the contemporary writings of Islamic economists a profit and loss sharing system. Therefore, basically Islamic business organizations may accordingly be reduced to only two main forms; (i) Sole proprietorship and (ii) Profit and loss sharing system (*PLS*). Before, we go into the details of the answers for the above questions it is important to discuss briefly the nature and scope of the above four kinds of business forms in Fiqh literature and contemporary literature.

A. Sole Proprietorship

A proprietor is a business owned by one individual. Perhaps it is the initial stage of business development, This is the simplest form of the business organization, for going into business as a single proprietor is very easy as one merely begins and runs business operations, except that in the modern economic systems most cities even the smallest establishments to be licensed and occasionally state licenses are required as well. It is also considered the oldest way of conducting business. Other forms of organization developed later on, with the needs and complexity of the economic and social life. The Islamic economic system encourages private enterprises and considers one of the basic right of the individuals and it does not restrict or bind it in any other way except that business should be conducted within the bonds of the *Shariah*. It simply means that the nature of business should be lawful. As far as the nature of the business activities is concerned the individual is free to choose rationally his own way and dealings. He can acquire capital and invest it as he sees to be useful according to the general framework of Islamic injunctions. He is free to hire his employees and other factors of production and ultimately he alone faces the risk and responsibility of his own decisions. He is free to manage his financial dealings, i.e., taking loans or selling the goods on credit etc. Consequently his liability is unlimited and in case he cannot meet his liabilities, he may sell all of his assets to pay off the debts. This may cover any business where the capital is owned by single proprietor and run the business either himself or hired employees(s) on fixed wages.

B. *Mudaraba*

Mudaraba is a kind of business organization or a contract between two or more persons whereby one or more of them provide finance called *Rabb-ul mal*, while other party(ies) provides entrepreneurship and management called *Mudarib* to carry on any business venture with the objective of earning profit, and profit is shared by them by certain agreed proportions. Literally, the term is derived from the Arabic word "*daraba*"(strike on the ground) which means walking thereon. Because the active partner or the entrepreneur has to go out in pursue for trading and seeking profit. Or because each of the parties seeks a share

of the profit². Majority of Fiqh scholars use this name but Maliki as well as Hanafis call it *qirad* (gnawing) Its origin dates back to the pre-Islamic era. While, discussing the legitimacy of *Mudaraba*, the *Fuqaha* usually call attention to the *Mudaraba* enterprise the Prophet (saw) had with Khadijah which started 15 years before the beginning the revelation. It is reported from Abbas bin Abdul-Muttalib that "when he used to give property in *Mudaraba*, he used to stipulate on the *Mudarib* not to travel with the property by sea nor to cross a valley or purchase with it living animals and if he did so he would be held liable' Al Abbas referred to the Prophet (saw) seeking his opinion and the Prophet(saw) allowed."³

As the trade was the main economic activity of the Arab tribes, a good deal of the caravans was financed by persons who did not accompany the Caravans. However, Hamoud (1985)⁴ quotes Al-Razi (606.H) saying that in financing the battle of 'Uhud, the *Quraish* used funds accumulated by means of *riba*. Many Jewish people were working as money lenders in Madinah and they used to lend out at the rate of 12% per annum. Therefore one may conclude that the most dominant mode of financing during the pre Islamic era was *riba*-based borrowing and that *Mudaraba* may perhaps have ranked second in terms of practical importance.⁵ In practical operations for the sake of convenience, it is preferred to name the capital-bringing party as "Proprietor" and the business-running party as "Entrepreneur," the profit will be shared on agreed proportions which implies that in all cases it will be some percentage of the profit rather than fixed salary or percentage of the principal capital. And the loss if any is entirely borne by financiers in proportion to their capital contributions. It is not necessary that the *Rabb ul mal* or entrepreneur is always a single individual. It can be a group consisting of any number of persons. Yet, for the sake of simplicity, they are called the proprietor and the entrepreneur. The *Mudaraba* mode of finance has different types in Islamic Fiqh literature, where some of the Islamic jurists have completely agreed and they showed certain reservations in some points for their particular conditions. *Mudaraba* in its limited form may be divided into three kinds according to the level of the participation of the two parties, financing party and active or entrepreneurial expertise.

² Ibn Hisham. Serat, vol.1. p.187

³ Al-Baihaqi, Ibid, vol.6 p.224,

⁴ Sami H. Hamoud, Islamic Banking, 1985, p.135

⁵ M. Kahf and Tariqullah Khan, Principles of Islamic Finance, Research Paper # 16 1992

1- Simple or limited *Mudaraba*: As we mentioned before, traditional *Mudaraba* is that joint enterprise of two parties where the capital comes from one party and labor from the other. And this unilateral feature of *Mudaraba* is considered the essential feature of its original nature which approved by all Fiqh scholars. S.A Siddiqi (1996) also observed this strict conditions and intimate acquaintance of the two parties and strong personal quality requirements. The fundamental principle of *Mudaraba* financing at this stage is the mutual trust and understanding of the two parties, with complete knowledge of the capital owner about the *Mudarib's* competence, honesty, and integrity, as well as the *Mudarib's* deficiency of financial resources. The best example noted is that trade relation between the Prophet (saw) and his wife Khadija (*ra*) before his marriage, the important thing to remember in this case is that Khadija (*ra*) the *Rab-ul-Mal* had approached the Prophet (saw) to become a *Mudarib* for her and manage her wealth after she had heard about his competence, honesty and integrity.⁶ If one argues that the above-mentioned qualities are no more available in the contemporary world, then in this view the whole enterprise of Islamic financial system would not work.

2. Partnership *Mudaraba*: This type of bilateral relations *Mudaraba* is that the capital to come from both parties and the labor from either of them. This implies that the two parties to contribute certain proportions of the capital irrespective of whether they may contribute in equal proportions, i.e., half by each of them, and one of them to run the business, or unequal proportions. This form of joint enterprise combines the features of *Mudaraba* and *Musharaka*. And this combination is also permissible according to the classical Fiqh scholars. al-Kasani expressed the reason of the permission; "The *Musharaka* does not negate *Mudaraba*. Because if the *Mudarib* gets profit he will turn out a partner of the business and manage the *Mudaraba* accordingly, so, if the consequence is not rejected the initial cannot be disallowed⁷." Ibn Qudama also says: "if they amalgamate between *Musharaka al-Inan*, *al-Abdan*, or *al-Wujuh*, and *Mudaraba* it is valid because each one of them is valid in separate, therefore, it is also valid when it (either of them) is combined with other as its isolation⁸."

⁶ Shamim Ahmed Siddiqi. *Mudaraba Financing in Pakistan*, (Mimeographed Paper Presented in Seminar in IPS. Islamabad). 1996 p. 3

⁷ Al Kassani, *Bada'i al Sana'i*, vol.8, p.3596.

⁸ *Al- Sharhi al-Kabir*, vol.5, p.198.

3. *Mudaraba* is also recognized if one of the parties makes the contribution of capital as well as part of the work, where the labor to be from both of them. This follows that one of the two parties to have capital and participate in the management also and the other party contributes labor only. This kind of *Mudaraba* is permitted by Hanbali and *Imamiya* Fiqh schools of thought, arguing that who has no property or financial capital may work with that of the other provided mutual consent of the two parties. Ibn Qudama expressed clearly that 'if two bodies come together in the capital of one of them,' that is if the capital is from one of them and the labor from either i.e. one of them provided one thousand rupees they work on it and they share the profit this *Mudaraba* is legally valid'. This view also expressed by Ahmad because, the *Mudarib* deserves the stipulated rate of profit for his labor in the capital of someone else, and that is the true *Mudaraba*⁹. Ahmad went on also that for the labor is one of the two principles of *Mudaraba*. It is permissible that one of them to engage individually with the existence of labor as well as the principal from the other. This implies that it is permissible that the capital to be from one party and both of them provide the labor, as *Mudaraba* is also permissible if the capital to be from both of them and the labor from either party as we have seen in the second case. Zakiria M. Falih in his extensive study on this subject recommends the latter opinion for it is appropriate for the general benefit of the *Mudaraba* enterprise. He argues that the work of the *Rabb-ul Mal* with the *Mudarib* does not contradict the submission of the capital to the *Mudarib*, it is simply like if the *Rabbul Mal* gives his capital to two persons to work on it and they share the responsibility and return according to the terms of the contract. In similar way the capital owner and the *Mudarib* may work together. As it is practiced today, simple profit sharing or *Mudaraba* is the framework of the basic relationship between Islamic financial institutions and investment depositors.

C. Partnership (*Musharaka*)

Partnership is a relationship between two or more persons to engage a business venture through a mutual contract¹⁰ and distribute the profits (or losses) of the business run by all of them or by one of them on behalf of the others. *Musharakah* (partnership) is the second important mode of finance and perhaps the major component of profit and loss sharing

⁹ Ibn Qudama, *al-Mughni*, Vol.5, p.137-138

¹⁰ M.Taqi Osmani, (1998) 'Introduction to Islamic Finance', *Idaratul Ma'arif*, Karachi, p.31.

principle in Islamic banking. On the basis of several verses of the Qur'an particularly the verse (4:12) and (38:24) as well as some reports from the Prophet (saw) and his companions, jurists have justified the validity of *Musharakah* in business ventures.¹¹ Given that, these reports do not provide any details about the operational function and as to the valid terms and conditions of such partnership contracts as they came to be known in Islamic law. Mainly such terms and conditions as elaborated in *Fiqh* would be the product of *Ijtihad* by Muslim jurists.

However it is very clear from the discussion that the term *Musharaka* or *Shirkat* partnership includes all types of joint ownership and collective engagement in specified agreed business or form of work as depicted in the above chart. Practically *Musharaka* simply suggests, rather implicitly, that two or more person pool their resources due to any economic or social reasons. All partners necessarily contribute certain amount of capital and mostly participate in the management. In *Fiqh*, the concept of *Musharakah* is very broad and used in a much wider sense than is used practically in Islamic financial institutions, it is called *Shirkat al inan* or *wujuh* or *abdan*. In our subsequent discussions, however, we are concerned with only one type of *Musharaka* that which is known in *Fiqh* as *Shirkat al-inan*. For this is the most appropriate to the contemporary business operations and Islamic financial applications. The use of the term *Musharaka* in this study is in this sense of partnership. It is implicit that the purpose of the business agreement and its basic drive of the partners is to earn profit and distribute it among them or business outcomes. It means it is not an agreement for charitable purposes. All the partners are the agents and at the same time capital owners for each other, this does not mean in any case that all partners do necessarily participate in management and decision making process of the business. There are possibly sleeping partners who do not participate actively in the enterprise and hence is not an agent to anybody in this stage, as we will elaborate later, on *Mudaraba* and *Musharaka* come very close to each other. The profit will be distributed among the partners at determined and pre agreed proportions. And the loss will be distributed in proportion to the amount of capital invested.

Various combinations of capital and work

In the light of above *Fiqh* discussions we may present different options in the participation of

¹¹ Ibid. p. 59.

business operations by capital owners and active partners. This will give general view that someone to figure out the nature of profit-sharing system in Islam as far as its organizational structure is concerned.

Table 8.1

Level of the participation of capital owner and active the entrepreneur under different combinations of labor & capital		Private enterprise	
		Single a financier or capital owner	
		Active Partner	Sleeping Partner
A single worker or entrepreneur	Management	<i>Mudaraba</i>	<i>Mudaraba</i>
	With capital	<i>Musharaka</i>	<i>Mudaraba</i>

From the above table and according to the features of *Mudaraba* in the Fiqh literature we see that *Musharaka* one of f the four phases of participation, where three of them can be clearly termed as *Mudaraba* form of business only one of them can be called *Musharaka*. Therefore, although *Mudaraba* is sometimes considered as a very specific case of *Musharaka*, from the above evidences we find that opposite is also true. Thus, even this simple traditional joint enterprise can show a number of common characteristics of *Mudaraba* and *Musharaka* as an essential inherent tendency of their convergence which would be discussed in last part of this section. But, let us briefly outline the nature of the final and most modern form of business organization, e.g., corporation.

D. Corporate form of organization

The rapid industrial expansion that took place throughout the world during the last century was naturally accompanied by corresponding development in the method of finance. The development of the corporate form of organization in advanced industrialized nations has been one of the greatest factors that emanates the enormous flow of funds in the modern sense and has tremendously facilitated business activities on a large scale. The corporation is very important when large sums of capital are needed for operation. In all developed and developing economies the corporate form of business is recognized as one of the institutions that has an important bearing on the flow of savings into business; The paramount important

features of the corporation attractive to investors may be (i) the limited liability of its share holders for business debts (ii) its perpetual or permanent life and (iii) the ready apportionment of its debt and its stock into convenient units that are readily transferable.

In contrast, the liability of owners of a corporation is typically limited to the original investment while the sole proprietor or member of partnership is liable for all the debts of business to the full extent of his personal wealth, as for his original investment in the business. Investors in the corporation could hardly be expected to risk their savings under such conditions on scale essential to meet the requirements of modern large scale production. Moreover there is a need for a form of business organization that will have as permanent an existence as the business itself. This is necessary, because in case of a partnership it may break up with the death or retirement of any of its partners or its several owners. Furthermore, the partnerships' interest cannot be transferred without the consent of other partners and in any case the investment is often of a considerable size, while, the stock of the corporation is ordinarily divided into shares of convenient market value which can be transferred freely from person to any other one. Of course, the actual stability will depend on the popularity of the issuing corporation and the past distribution of shares to a limited or wide list of persons. As M. Akram Khan (1992) has clearly demonstrated modern corporation or joint stock company has retained a number of essential features of traditional *Mudaraba* including that (i) like *Mudaraba*, the joint stock company also has a division between ownership and control. Those who invest money they do not take over the day to day operation of the business, the same applies in the case of *Mudaraba* (ii) there is no restriction on the number of share holders in a public limited joint company. *Mudaraba* also has the same features.

Hence, as far as the form of the business organization is concerned it is very clear that nothing is unIslamic and there is no ready-made form or particular format of Islamic business structure whether it is proprietorship, partnership or corporation form as long as the rights and responsibilities of involving parties are clearly determined with complete mutual consent, except the general framework of Islamic injunctions which govern the eligibility of the activity, lawfulness of the subject matter, i.e., goods or services and general behavior of business ethics in Islam which the enterprise is to observe. In the next section we outline the typical principles of joint enterprise in classical Islamic Jurisprudence.

8.1.2 Convergence Tendencies of *Mudaraba* and *Musharaka*

The traditional contract of *Mudaraba* usually presumes that the *Mudarib* has not invested any thing to the *Mudaraba*. He is responsible for the management only while all the investment funds come from *Rabb-ul mal*. However as almost all Islamic jurists are in a consensus in *Mudaraba* case the entrepreneur has the right to bring his own capital into the business. However, large it may be, and he has a right to get capital from third party for *Mudaraba* or to enter into partnership with third party. This activity first will make him to work as a partner and he will get the profit share as a part of his capital's earnings as well as his work.

If we study the structure of a modern joint-stock company we will find that it is more or less some combinations of the Islamic concept of *Mudarabah* and *Musharakah* where entrepreneurs are at the same time share holders (e.g., *Musharakah*) and each share holder cannot run the business, so, combining these two modes of financing may emerge what is known as profit sharing system and serve collectively to solve the problems of *Mudaraba* in contemporary financing. In this process we see that what initially started as a pure *Mudaraba* enterprise, where capital was coming from one side and the labor or management of the fund from the other, has taken a big step towards partnership or *Musharaka*, and accordingly the right and responsibility might be amended. On the other hand in case of *Musharaka* all the partners or the principal owners cannot participate in the management of the business. practically this may be inconvenient or inefficient. And it is recognized in general as a matter of fact that all partners cannot participate in actively running the business. It is acknowledged that for the benefit of the business some of them should serve as the managers of the enterprise on the approval of all partners, while, the others would remain sleeping partners and principal owners of their share in the capital and not an agent to anyone. This is also a further step taken by the *Musharaka* form of organization towards *Mudaraba*. Keeping this flexibility of profit-sharing system in mind, it is very feasible that *Mudaraba* and *Musharaka* modes of financing to have strong tendencies of merging together. Thus, on the basis of this inherent tendency of amalgamation there are strong reasons to believe that the apparent possibility of convergence between *Mudaraba* and *Musharaka*.

In lieu to the contractual limitations of classical *Mudaraba* on one hand and the significance of *Mudaraba* for it is considered as the primary components of profit-sharing

system on the other, the contemporary Muslim scholars tried to modify it in compliance with the modern financial requirements. A number of scholastic works have been made and a rigorous attempt of demonstrating the possibility of the convergence between *Musharaka* and *Mudaraba* into common joint stock or corporation forms of organizations. The efforts aimed at resolving the incompatibility of the classical *Mudaraba* to the modern financial system. Sami H. Hamoud (1985) strongly advocated the necessity of collective joint enterprise. M. Hashim Kamali proposed two ways of pushing *Mudaraba* towards *Musharaka* or to play a greater role in financial practice and he suggested (i) joint Managed *Mudaraba*; that is enhancing the participatory role of financing, where the capital owner must have certain degree of interfering operational aspects of the *Mudaraba* financing with the *Mudarib*. (ii) quasi (*shibhi*) *Mudaraba*: This contemplates enhancing the participatory role of the entrepreneur. That is to entitle the *Mudarib* to acquire a stake in the operational capital of *Mudaraba*. According Kamali this manner of adjustment may not be entirely acceptable to the theory of *Mudaraba* as it involves transfer of liability for loss at least partially to the *Mudarib*. This quasi *Mudaraba* represents an intersection between *Mudaraba* and *Musharaka*, as it partakes the attributes of both and introduces an element of flexibility and at the same time enhances the partnership component of *Mudaraba*¹². This does not mean that the ordinary *Mudaraba* and *Musharaka* cannot work. They still normally exist. But *Mudaraba* itself may be molded into these shapes of the profit-sharing system.

In the recent practices of Islamic financial institutions *Mudaraba* has no longer confined in its traditional bilateral form but it has developed necessary significant modifications in its modern implementations. M.N. Siddiqi (1991) noted three forms of these developments namely (a) simple profit-sharing or *Mudaraba* (b) partnership which involves participation in management along with sharing in profits (c) corporations or joint stock company.

¹² M. Hashim Kamali, *Istihsan, (Juristic Preference) and Its Applications in Contemporary Issues*, (ed) IRTI. IDB. 1997, p.123-24.

Table 8.2 Convergence of *Mudaraba* and *Musharaka*

The nature of Business organization of Profit-sharing system			
Features	<i>Mudaraba</i>	<i>Musharaka</i>	Corporation/Joint Stock Company
Nature and type of Financing	Equity Financing, Trustee, Profit sharing.	Equity Financing, Joint venture Profit sharing.	Equity Financing Profit sharing
Capital Supply	Capital Owners can be any number,	All partners are capital owners, they're two or more	Any number of share holders
Management	Entrepreneurs can be any number, they may also bring their capital into the <i>Mudaraba</i> .	All Partners may not be Entrepreneurs and managers at the same time.	Specified number Entrepreneurs
Participation	Financier for his capital, but the <i>Mudarib</i> either the management only or both,	Complete participation or with the capital only	Certain specified active partners or entrepreneurs
Profit distribution	According to pre agreed proportions of the profit	According to pre agreed proportions of the profit	According to the Participation
Distribution of loss	According to the proportions of the invested capital	According to the proportions of the invested capital.	According to the capital proportions

8.2 GENERAL PRINCIPLES FOR JOINT ENTERPRISE

Most of the scholastic works on this subject focus on several points namely: the proportionality rather than fixity of the profit shares, the nature trustee of the working partner which results the liability of the capital owner for its loss, convertibility of the business into monetary currency, and rights and responsibilities of the parties, which are basically the main features of traditional joint enterprise. Thus, according to the contemporary literature these are assumed as given principles, and till recently no debate has been made on their modification in lieu to the changing circumstance of the business norms. It is the current literature, which proposes certain essential modifications for the above traditional rules in conformity with the practical requirements of the present business operations which will be discussed in the last part of this chapter. The following passages would further highlight the principles of joint enterprise in Islamic Jurisprudence.

8.2.1 Proportionality of Profit Distribution

Profit distribution involves two basic and important points: (i) the amount of the profit must be definite (known) and (ii) the rate of sharing the profit must be common part of the total profit which implies the sharing rate must be certain proportion of the total profit. And both parties must know their share of profit in the contract. Thus it is generally agreed that the profit share of each partner should be a pre agreed percentage of total profit. For *Mudaraba* is essentially a partnership of profit and its fundamental components are the association of work with capital. Any profit for either party is justified on the basis of these two components. On the same line Fiqh scholars are in agreement that profit will be distributed among the partners in the business on the basis of proportions settled by them in advance. There is a unanimity on the point that no fixed sums can be settled for any party under either *shirka* or *Mudaraba*, as stipulating a fixed amount for a partner is not allowed. While this view is unanimous among all schools of thought in case *Mudaraba* but in case of *Musharaka* only by the Hanbali and Hanafi jurists support this view. According to the jurists of Maliki and Shaf'i schools they see that the distribution of profit must reflect the proportions of invested capital. al-Jaziri observed also that all four schools agree that under either *Mudaraba* or *Shirka* the profit share cannot be settled as a fixed sum. However, the parties may on mutual agreement settle any proportion of profit in *Mudaraba* ¹³case. According to Hanafi and Hanbali the percentage should be specified clearly in the contract and it is obligatory that the share of profit to be settled as a simple proportion of profit, i.e., 50%, 33%, or 25%.

The main reasons for rejecting the fixed rate of profit are explained by the Fiqh scholars expressing that assigning a fixed amount for example one hundred currency units, to either party invalidates the *Mudaraba* due to the possibility that the profit realized may not be equal to the sum so stipulated. This argument is squarely based on the fear of that the total profit realized by the enterprise may exhaust or may not exceed the earmarked rate, in other words, there is a possibility that the profit realized may not be equal to the sum so stipulated. As a result of this stipulation the other partner may not get his due share of the profit. This is the basic rationale of the classical jurists in fear of the business may not generate such level of profit or it may generate only the earmarked level of profit for either party in both cases

¹³ Al-Jaziri, *Al-Munaqshat ul Shirka*, vol.3, p.104.

fixing certain amount for one party seems to be injustice to the other party. So according to Fiqh scholars this is illegal and the *Mudaraba* or *Musharaka* agreement will stand nullified'¹⁴

8.2.2 The Mutual Agreement of Profit Distribution

Shafi'i held the view there is no need to specify the profit share for they do not allow the divergence between the capital contribution and the profit ratio. According to Imam Nawawi "The profit and loss should be in proportion to the capital provided, whether or not the labor supplied by the partners is equal."¹⁵ Likewise, the Shafi'i school holds that 'profit and loss alike will be distributed in proportion with the capital invested, irrespective of whether business activities of the partners are equal. If they decide on any other principle, the contract is void'¹⁶. However, there is a considerable flexibility in the determination of that ratio in the view of the majority of Fiqh schools. According to them the partners may share the profit on an equal and unequal basis, for instance, a partner contributing one third of the capital of *Musharaka* may receive a half or more of the profits. Hanafi jurists held the view that it is not obligatory that the ratios of capital investment to reflect strictly on profit shares, the partners being free to decide the latter by mutual agreement, according to the terms of the contract it is valid that the capital investment of the two parties to be equal and yet one of them obtains a larger share of profit than the other'¹⁷. A claim of profit is dependent upon the conditions of settled and hence, each one of the two parties will have to claim on the share which has been settled between them as a condition of the contract'¹⁸ Kasani deliberated profoundly on this issue and went of the view that profit can be claimed either on the basis of the capital or of business effort or on account of financial liability irrespective of whether business efforts are made by both the parties or by one party alone. Hence, profit would be distributed between them, according to the conditions agreed upon. Because under partnership, for profit may be claimed by the virtue of business efforts, it is sufficient that it is stipulated. And it is not necessary that the effort is actually made. This view was agreed also by Hanbali jurists. In case of *Shirkat inan* . . . it is legitimate that both of them found their claims on profit in

¹⁴ Kasani vol. 6, p.59.

¹⁵ Nawawi, al-Majmu', vol.2, p.215.

¹⁶ al-Nawawi, *Minhaj at Talibin, Kitab al Shirkah*, p.56

¹⁷ Marghinani, vol.2 (Shirkat inan).

¹⁸ al-Sarakhsi, *al-Mabsut*, vol.11, p.157.

proportion to their capital investments, and it is also valid that they share profit equally irrespective of differences in their capital investments. So, it is argued that the claim to profit is based on business efforts and when both the parties are active in the business, it is legitimate that the share of one party may be greater than the others'¹⁹.

However, this flexibility in distribution of profit does not exist in *Musharaka* with respect to loss sharing in Fiqh literature. There is a complete unanimity on this point. Being strict to the legal maxim, "loss sharing should strictly follow the capital ²⁰contribution." This principle is reportedly expressed by the fourth Caliph Ali bin Abi Talib "The profit is to be shared as agreed upon in the contract while the loss is to be shared according to the capital contribution²¹." M.N.Siddiqi (1985) commenting this point noted it is not proper to regard the distribution of profit as analogous to the liability of loss. Profit is the joint product of capital investment and business effort. And loss is not the product of any effort. This is very clear from the terms of *Mudaraba* contract whereby the working party shares any profit but is not liable to any part of any loss. It is clear that the Shariah does not consider loss as a consequence of business operation or as a result of efforts, it regards the loss as a diminution of capital. So the Shariah does neither assign the same status to profit and loss nor has made the principle of their distribution to be the same.²² Siddiqi upholding the opinion of Hanafis and Hanbali jurists concluded that this view of Hanafi and Hanbali jurists is more forceful and persuasive, it will prove more helpful in extending the scope of joint stock business and making it easier. For a just distribution of profit under joint-stock business it is necessary to empower partners to settle any principle for distribution of profit by mutual agreement having regarded to their respective investments and abilities. If this is not permitted and the distribution of profit is made strictly reflect amounts of capital invested it will become difficult to persons with different abilities to cooperate in business enterprise, in this case the arrangement seems to be unjust to the more qualified and experienced persons, for these reasons.²³

¹⁹ Ibn Qudama, vol. p.140.

²⁰ Sayyid Sabiq, *Fiqh al-Sunna*, vol.3 p.37.

²¹ Showkani, *Neil al-Awtar* vol.5, p.266.

²² M.N. Siddiqi, *Partnership and Profit-Sharing in Islamic Law*, Islamic Foundation, 1985, p.28

²³ M.N. Siddiqi, *Ibid.*.

8.2.3 Rights and Responsibilities of the Parties

One of the most important principles in this regard is the liability for loss who will be held responsible for the loss of capital if any. Usually loss refers to that part of the capital which is destroyed, it is a depletion to the existing capital or damage that reduces the original amount of the capital. Generally the loss will be distributed in proportion to the invested capital and will be entirely born by the owners of that capital. This evidently shows that no capital owner who participated in the enterprise can escape from this loss on his proportion of the total capital. This view is unanimously agreed by all schools of Islamic jurisprudence. If there is a loss, it would be deemed as a reduction of capital and borne by the owners of capital alone²⁴. Ibn Rushd explained this principle as follows; " There is no difference of opinion among Muslims on the validity of *Mudaraba* and all are agreed that the man actually engaged in business will not be made liable for the loss of any part of capital property, provided the loss is not due to any misdeed on his part."²⁵ al-Sarakhsi has observed also under *Mudaraba* the party working with capital acquired under a *Mudaraba* agreement, cannot be made liable for any part of the loss²⁶. Ibn Qudama writes that the loss will accrue only to the party investing capital and not to the other party²⁷.

Another important aspects of the business enterprises concern the limits of freedom of transaction accorded to partners. There may not be any difference opinions about the significance of the role *Mudarib* and its right of freedom without which business activity of partnership can hardly be thought of. However the right to sell or buy on credit, right to put by the partner additional capital into the business or converting *Mudaraba* into partnership is subject to questions and call for additional conditions. In addition to that a problem may arise in connection to the right to lend money out of *shirka* or *Mudaraba* capital. The Fiqh scholars are of the view that no partner on a *Mudaraba* or *shirka* contract may lend to other persons out of the capital of the enterprise without explicit permission of his copartners or the capital-owners, nor can he invest in the business by borrowing from other parties. The borrowed capital is considered to have the status of personal capital. That is, it will belong to

²⁴ Ali Al-Khalīf, Discussion on *Shirka*, p.55.

²⁵ Ibn Rushd, *Bidayat al-Mujtahid*, vol.2, p.140

²⁶ Sarakhsi, *al-Mabsut* vol.11 p.157

²⁷ Ibn Qhudama *al-Maqdisi*, *al-Mughni*, vol.5 p.119

the borrower, if he invests it in the business he alone will bear the responsibility for any profit or loss. There is unanimity among Islamic jurists on the question of lending out of the enterprise (*Mudaraba* or *shirka*) capital. Lending is considered as unprofitable, hence it cannot be automatic right of any party to a *shirka* or *Mudaraba* contract. Hanafi jurists expressed that 'the partner has no right to do good to others on behalf of another person, if he has been told to work with his capital at his discretion, he will have the right to make all sorts of transactions except lending . . . He will not have the right to lend because it is part of doing good to others and it is not a business act'²⁸. But, usually the partners in *shirka* and the working partner in *Mudaraba* are entitled to make credit transactions in connection with business unless expressly forbidden by the copartners or the capital owners. The value of goods and services purchased on credit on behalf of the joint enterprise should not be more than the total value of the enterprise. As credit transaction resembles lending and borrowing, the jurists held the view that both follow analogously to lending and borrowing. It is very difficult to avoid credit transactions in business; if this right is denied for the working partner, it could become difficult to expand the business, for this may reduce the potential profit.

The investor has a right to inspect whether the agent is complying with the terms of the *Mudaraba* contract. In normal situations the agent is considered a trustworthy party (*amin*) with respect to the capital remitted to him, not liable for any loss occurring in the normal course of the business activities except when there is a breach of trust. The investor has a right to have a share in the profits. This is a recognized right that a share should be determined on a strictly proportional basis and there is no doubt about its legitimacy no scholar is reported to have regarded it with legal dislike. Hamoud (1985). Imam Shafi'i also mentioned similar opinion saying that if a man shows, certain goods to another and says: buy this for me and I will give you so much profit and the second man buys it, then the transaction is permitted. However, the one who has made the promise has the right of withdrawing. The investor has the right of exclusively limiting his liability for the loss to the level of capital he invested. Nabil also made the same restriction on the agents activities. He observed that Islamic law did not envisage the separation of assets of the company and those of the partners as a way of financing liability among the partners themselves and towards third parties as a matter of principle liability of the partners in all Islamic partnership except in the case of

²⁸ al-Sarakhsi, *al-Mabsut*, vol.22, p.39-40

traditional *Mudaraba*. And each partner is responsible for his share of the partnership and indebtedness, regardless of what it amounts to, or by how much it exceeds the value of his share of the partnerships' assets notwithstanding a certain number of limitations²⁹.

Let us now summarize the responsibilities of each party in the following subheading. Agent's duty is to comply with the terms of the *Mudarib*. The primary duty of the agent/*Mudarib* is to comply with the trust (*Ammana*) vested in him while conducting the *Mudaraba* activities. Agent's duty is to liquidate the *Mudaraba* business. The agent is to reconvert and evaluate the *Mudaraba* investment to money. The importance of this function is apparent, for profit is conceivable only when the *Mudaraba* investment is reconverted to its initial condition/state, i.e., money, in which the manager/entrepreneur is entitled to appropriate his share of the profits if any. The duty of the investor is to provide *Mudaraba* capital to the agent. Practically speaking the main duty of the financier is to hand over the *Mudaraba* capital to the agent-manager, without which there is no *Mudaraba*. However, the initial layout of trading is sufficient to put the operation in force. In an attempt to illustrate clearly, we may elaborate the rights and responsibilities of the parties involving in *Mudaraba* business in the following table. In this case we deal with a limited or private and bilateral form of *Mudaraba*. Where we assume there are only two individuals involve the initial contract of the business.

Table.83 Rights and responsibilities of an investor and an entrepreneur in traditional *Mudaraba*

S	Rights and responsibilities of investor		Rights & Responsibilities of the <i>Mudarib</i>	
	Rights	Responsibilities	Rights	Responsibilities
1	To make conditions as he see fit for trade	To submit the capital to working partner, or <i>Mudarib</i>	To bring his own capital into the business	work honestly in terms of a contract
2	To inspect the operation of the Business	To keep away from daily activities	To get capital from third party for <i>Mudaraba</i>	Follow the special instruction of the capital owner

²⁹ Nabil Saleh, *Unlawful Gain and Legitimate Profit*, London, 1992, p.118

3	To monitor accounts	To define the share of the <i>Mudarib</i> in the <i>Mudaraba</i>	To enter into partnership with third party	Furnish accounts as it required
4	To cancel the Contract as he feels fit.	To be liable to any unavoidable loss to the business capital	To sell and buy goods on credit	Serve for the best profitable manner of the business
5	To watch business against unfair and prohibited activity	To give the capital in cash or liquid form to the <i>Mudarib</i>	To follow the lawful customs of trade	To avoid Business malpractice
6	To limit his liability to the invested capital	To be compliant to the terms of the contract	To invest capital for <i>Mudaraba</i> with third party	To avoid all prohibited things
7	To make gifts <i>Zakat</i> or Charities from the capital	To treat justly with the <i>Mudarib</i> and to the best for business	To lend & borrow with the consent of the capital owner	Reconvert goods in cash if it is so demanded

8.3 SECTORAL SCOPE AND UNDERLYING MODES OF FINANCING

Although the widest applications of profit sharing which mostly implied by *Mudaraba* and *Musharaka* as being elaborated in Fiqh literature is to concentrate on trade, it is well-known fact that profit sharing system has been applicable to all sectors of economic activities such as; agriculture, manufacturing, services and even financial sectors in our modern time M.N.Siddiqi (1991). For the business complexities have tremendously increased the organizational structure of business firms has developed in great to cover this vast areas of business activities in a large scale. *Mudaraba* in early period was utilized mainly as instrument of commerce. That is buying and selling no matter whether travel for this operation involves in long distance or local trade: The Maliki and Shafi'i schools of thought insist that *Mudaraba* was a purely commercial instrument³⁰. They would reject a *Mudaraba* which required any manufacturing activity, on the part of the agent, For them such an arrangement would no longer be considered *Mudaraba* rather it becomes a hire contract in which all profits and losses accrue to the investor with the *Mudarib* being entitled to an equitable remuneration for his work. Although Hanafis viewed *Mudaraba* as a commercial arrangement they did a permit a mixed investment. With the existence of these Fiqh views we would like to examine the scope of profit sharing in economic activities. And in this connection we want to know how far the financial modes of *Muadaraba* and *Musharaka* are applicable to the economic sectors.

³⁰ Sarakhsi al-Mabsut, Vol.22 p.19.

8.3.1 Trade-based Mode of Financing

A considerable number of classical Fiqh scholars emphasize that the scope of *Mudaraba* is confined entirely in commerce. The Fiqh scholars (Shafi'is, Thahiris, Zaidis, Imamis, and *Ibadhis*) see that the *Mudaraba* enterprise is completely limited to trading or commercial activity. This implies that the *Mudarib* should concentrate and work only in sale and purchase dealings. So that they do not consider *Mudaraba* and do not permit for the *Mudarib* to engage investing *Mudaraba* funds in agriculture, industries, etc. However, the majority of the Fiqh scholars (Hanafis, Malikis, Hanbalis, and some of the *Ibadhis*) see that the scope of *Mudaraba* is so wide covering any business activity which is considered to induce the capital of *Mudaraba* to grow, and any economic activity which can generate profit³¹. Recent studies made some comparison between *Mudaraba* in trade and its application in industries, he observed that there is no much difference in the basic idea as long as the activity starts from cash and ends in cash, the definition of profit is very clear and the formula for its sharing is agreed. There is no *gharar* surrounding these crucial matters, what would affect the validity of the contract are the uncertainty and lack of knowledge surrounding what to be shared, the formula of its sharing or any other matters relating to the rights and obligations of the concerned parties. The kind of *gharar* which Shariah seeks to eliminate and if the elimination is not possible, to minimize it, is that which emanates from the contract, not the one that naturally attends the activity or operation. The latter ones are the part of the human ignorance and largely beyond its control. One may argue that industrial operation takes longer period of maturity than trading operation and the longer the time the more the risk. But, *Shariah* has not related the validity of a contract to the length of time involved or the level of risk involved. The length of time does not affect any of these crucial rights and duties of the contracting parties. Trading operation too, may also take long time to complete.

According to Siddiqi it is not important whether this takes the form of full-fledged partnership in which all sharers in profits may also participate in management or that in a profit-sharing (i.e. *Mudaraba*) in management is done by the working partner, and the financiers supply only capital. In reality there may be whole ranges of options, while full participation in management and no participation in management being the two extremes.

³¹ Zakariya M. Falih, *al-Salam wal Mudaraba Min Awamil at-Taisir fi al-Shariah al-Islamiya*. 1984, p.223-232.

Those scholars who went on the first view were very conscious about the implications of the concept of profit. They were carefully, trying to separate what is clearly true profit from what is ambiguous, or associates part of capital itself. They tried to show the underlying conceptual difficulty associates with the principal to be separated from the additional growth of income. In this sense al-Nawawi noted that the first condition of the *Mudaraba* activity is that it should be in trade, he expressed that "If he (*Mudarib*) receives certain dirhams for *Mudaraba* to purchase date trees or animal, or their products, and acquired the animal, or fruits of the trees, or their products and (agree with the capital owner) that their benefits to be between them it is void, because it is not profit from trade but the real capital."³² Ibn Hazm expressed also that "The *Mudarib* deserves (his reward) the profit only and it is not called profit except what is grown from sale and purchase."³³ A similar view is held by Ibn Qudama according to him the role of *Mudarib* is trading in the pursue of seeking profit through sale and purchase.³⁴ Hence, since the basic motive of the contract is to generate profit to be shared and profit cannot be generated except through commercial activity Ibn Hazm has logically concluded that *Mudaraba* is permissible only in sale and purchases.

The Fiqh scholars of the second view see that the *Mudarib* has a right to use any permissible means which may generate income and make the capital to grow. Like farming, manufacturing, *ijara* or trading for all these are ways to get profit. What is important for these Fiqh scholars are the transformation of the capital from one state to another, regardless, of the specific means of the transformation whether it is through production or commercial activity. For the change of the financial capital from one form to another is the main underlying principle of generating profit. No doubt that the last view seems to be more comprehensive than the first one, but actually the difference may not be wide. It is right that there is no profit except in sale and purchases as the first view holds, on the other hand profit is generated on the transformation of the goods and money from one state to another according to the second view but that transformation will not generate profit until the produced goods are sold to the market and the proceedings are transformed into the original form or money. Therefore, as we mentioned where else production is an indirect exchange, and profit-oriented activity can be evaluated only in its final stage, for the produced goods are for sale not for consumption.

³² Al-Nawawi, *Rawdat Talibin*, vol.5, p. 120

³³ Ibn Hazm, *Muhalla*, vol.8, p.250

³⁴ Mughni, vol.2, p. 311

The scholars of the first view are strict to the basic nature of profit generating, while the second view holds that production process also although it is longer procedure than trading, it generates profit for it ultimately ends with sale and purchase. Thus, what is important are the organized efforts that can generate profit as the ultimate outcome of the business operations.

8.3.2 Financing in Agricultural Sector

An agricultural sector is considered to be prone to natural risks, i.e., drought, floods, hail, mud slides pests, etc. these factors are taken into the decision making process in any agricultural activities. The major types of operations such as: the land preparation, planting or sowing, fertilizing, irrigation, harvesting, transportation, processing and marketing, the outputs take different shapes of financing, services and expertise, which can be carried out in different stages of a particular production. The modes of financing used to implement and agricultural operations reflect from motive of farmers to raise the yield and crop outputs of their land and to reduce the adverse effect of natural calamities and risks faced by the farmers, in order to smooth out the benefits as well as the effect of the unexpected changes of the environment and natural mishaps the farmers may use different kinds of Islamic financial techniques. According to nature of the work the purpose of the production and expectation of the farmers they use different modes of finance such as *Musharaka*, *Mudaraba*, *Muzara'a* and certain other financial modes may be used in certain specific stages *Musaqah*, *ijara*, deferred-payment sale etc. Therefore, an agricultural sector can combine different kinds of modes of financing.

As far as the case of *Mudaraba* is concerned, in spite of the existence of the above dominant trend of Fiqh view the matter was not devoid of glimpses that is. A number of classical Islamic jurists have noted the permissibility of *Mudaraba* in agricultural sector. It is reported in the form of questions in *Al-Mudawana al-Kubra* of Imam Malik as follows;

"I said if i paid to a man money for *Mudaraba*, with which he bought or hired a land and bought a crop of pairs and planted them if he makes a profit or sustains a loss

would that be *Mudaraba*; will he not be liable or an aggressor?"³⁵

'He said: yes, unless he has risked the money in a place of aggression and hostility, but if he used the money justly and with due care, he will not be liable'.³⁶

Ibn Abidin also noted that if *Mudarib* hires a land for cultivation or planting it is permissible. A-Kasani elaborated this point quoting Muhammad Al-Shaybani; 'It (*Mudarib*) may hire a land and purchase seeds to sow them in the land . . . and he may plant date trees etc. all these are permissible and the profit is according their agreement'.³⁷ From these jurisprudence considerations could be concluded that it is economically viable contracting *Mudaraba* in agricultural sector in pursue of profit and capital growth. The agricultural sector is considered the back bone of most developing economies. Hence, *Mudaraba* can be engaged in this potential sector of economy for it generates a large scale of economic advantages.

8.3.3 Financing in Manufacturing and Services

The vast expanding sector of any developing economy is the manufacture and services sectors. A large portion of the GNP of any economy consists of the total of goods and services of the economy. And developed nations realized the significance of the service sector. Therefore, it is imperative that the profit-sharing system to cover this vital area of the economy. This sector produces and sells services like education, health care, news information, communications, transportation, accommodations etc. The capital which is invested in this sector, takes the form buildings, equipments, highly skilled man power, communications network etc. Like the case of industries as Siddiqi elaborated, it is possible to wind the service-generating unit up and convert all its assets into cash. It is also possible to make assessment of its net worth without actually liquidating it in case of common joint enterprise. This valid *Mudaraba* as *Mudaraba* is not linked to producing a particular commodity and as we have seen above profit sharing can be applied to any productive ventures, irrespective of the nature of the product, degree of risk, or length of time involved. What is important is the viability of the production to generate profit and its permissibility in Shariah points of view.

³⁵ *Al-Mudawanah*, vol.5, p.119

³⁶ *Al-Mudawanah*, Ibid.

³⁷ *Badai' Al-Sanai'*, vol.8, p. 3608

Mudarabah in early period was utilized mainly as instrument of commerce. This follows that the buying and selling no matter whether travel for this operation involves in long distance or local trade. For the dominant view of Malikis³⁸ and Shafiis *Mudaraba* activity is restricted and necessarily limited to mere trading and activities related to trade. It cannot involve manufacturing function on the part of the agent. Otherwise, it would be considered as a contract of manufacture or hire. The Maliki and Shafi'i schools of thought insist on that *Mudaraba* was a purely commercial instrument³⁹. They would reject a *Mudaraba* which required any manufacturing activity, on the part of the agent. Hanafis on the other hand have no objection to *Mudaraba* if it is associated with crafts or manufacturing activities, as long as the final finished outputs are to be sold on the basis of profit-sharing *Mudaraba*. Hanbalis see that the investor and agent-manager to enter into separate contracts one of manufacture and one of *Mudaraba*. Provided that one is not a condition for the other. Contemporary scholars who evaluate the things from the risk perspectives may conceive that, it is not obvious that the level of risks of business is directly related to the length of time involved, it is not also forgone conclusion that industrial operations are necessarily more risky than trade. Siddiqi pointed out that risks were very high in case of trade caravans from Makka to the North and South as these caravans were vulnerable to attacks by hostile tribes as well as by professional bandits.

When *Mudaraba* finance is needed for an already operating industrial unit, the net worth of that unit will have to be assessed in order to ascertain the contribution of the new finances to the profits of the enterprise. This kind of calculation is not unique to industry the same problem will arise in case of a trader seeks to expand his business by inducing new capital to be obtained on the basis of *Mudaraba*⁴⁰. In this discussion we may conclude that it is an obvious fact and apparent reality, but so far not substantially elaborated, that as far as the operational nature of the profit-sharing principle is concerned that one of the unique characteristics of this system particularly *Mudaraba* and *Musharaka* associate to the scope of their function. The economic activities of the system have been undefined or unspecified in Islamic literature as it is not related to particular kind of business operation or specific sector of the economy. As long as for instance *Mudaraba* is raising, using and disbursing funds in

³⁸ Ibn Juzay, *Qawanin* p.309

³⁹ Sarakhsi *al-Mabsut*, vol.22 p.19.

⁴⁰ M. N.Siddiqi, Some Concepts of *Mudaraba*, *Review of Islamic Economics*, vol.1, No. 2, 1991, pp.21-31.

Islamically permissible ways and involved in the provision of any kind of goods and services not to be repugnant to the teachings of Islam, it is allowed. And the people on the base of this system are free to choose and operate in any sector of the economy provided that operational technique is feasible, the entrepreneur(s) feel convenient to run it and economically viable.

Table 8.4 Sectoral Scope of Profit Sharing

Scope of Business Activities of Profit-sharing system (<i>Mudaraba</i> and <i>Musharaka</i>)					
Features	Agricultural Sector	Industries/ Manufacture Sector	Trade or Commercial Sector	Services Sector	Financial Sector
Tenure	Mid-Term 6 months to 10 years	long-term 2 to 25 years	Short-term 1 month to 2 years	Short-term 1 month to 2 years	Short term. 1 day to 1 year
Type of Financing	Joint-Venture <i>Muzara'a</i> , crop sharing	<i>Istisna</i> , Project Financing	Commerce: Murabaha. Deferred- payment Sale	Service charges <i>ijara/ijara- wa-iqtina'a</i>	Financial Certificates Security intermediation

8.3.4 Underlying Modes of Financing

In this section we would like to demonstrate the place of profit sharing in Islamic modes of financing we would like to investigate whether profit-sharing system based on *Mudaraba* and *Musharaka* is basically specific mode of financing or simply organizational structure that may result the distribution of outcomes among concerned parties on the basis of their participation?

It is empirically elaborated that Islamic banking in their operation the proceeds of the deposits which are invested Islamic financial institutions through creation of an investment pool concentrate on one or combination of all Islamic modes of financing *Mudaraba*, *Murabaha*, *Musharaka*, *ijara* etc. Ahmad (1997)⁴¹. On the basis of the wide scope and flexibility nature of profit-sharing system, most of the *Mudaraba* financial institutions have chosen to operate in *Murabaha*, leasing and short term financial intermediation. It is well documented by Shamim A. Siddiqi(1996) that the *Mudaraba* companies in Pakistan which are

⁴¹ Ausaf Ahmad, Structure of Deposits in Selected Islamic Banks: Implications for Deposit Mobilization, Research Paper No.48, IRTI. IDB. Jeddah, 1997, p.25-30

working on a financial sector are mostly using lease financing as their major mode of financing, where on the average more than 70% of the operational income of *Mudaraba* has been generated through leasing business and other major source of income is *Murabaha* or trade. For instance *Tawakal* and *Ist Sanaullah* have shown that about 82% of their income was generated from trade in 1990-91. Similarly, in the same period about 94% of the operating income of the Second Prudential *Mudaraba* came through *Murabaha*. According to the contemporary literature of Islamic banking today leasing and *Murabaha* remain the main sources of operating income for *Mudaraba* in the market. Before we discuss the views of the contemporary studies about this apparent theoretical paradox of Islamic Financial operations and the Shariah position of it, it is important to review briefly the nature of these modes of financing such as: *Murabaha*, *ijara*, *Istisna'a*, in Fiqh injunctions and present practices.

1 Murabaha: *Murabaha* operation as the most important financing techniques of Islamic banking in practice is justified under the Qur'ans' allowance of trade that is buying and selling at profit. And *Mudaraba* is buying and selling at profit. The banks are free to charge any rate of profit as they wish or practically feasible. As we have mention above in the Fiqh context and earlier practice, *Mudarabah* was used mainly as an instrument of commerce. That is buying and selling either in long distance or in local trade. Both Shafi'i and Maliki see that *Mudaraba* was used as a purely commercial instrument rather than manufacturing activity on the part of the agent. Hanafi also is of the view that *Mudaraba* as a commercial arrangement, in order to carry out this kind commercial exercise based on the profit motive of the enterprise. There are certain trade-based techniques convenient in this area in Islamic Fiqh, such as, *Murabaha*, deferred sales etc. In this context it is very reasonable to recognize as one of the main techniques of substantial importance in the contemporary profit sharing financing.

In its contemporary applications *Murabaha* is an agreement where the bank purchases, at the request of the customer, a specified item required by him, and then sold it to him at a mutually agreed marked-up price. It may be divided into a business and personal *Murabaha*, the first serves the need of business firms, while the second is meant for individuals and house holds. In *Murabaha*, the bank is involved in trading to the extent it buys and sells the items required by the customer. Practically it works as follows: The customer approaches the bank

and seeks finance for an item he wishes to purchase, this may be land, building, machinery, raw material, a motor vehicle, or any fixture, or furniture, or it may be house hold items, such as, a car, furniture, etc. Instead of providing the customer cash, the bank offers to purchase the item and sell it to him at a mutually agreed mark up price which the customer can pay to the bank in either installments or in a lump sum. Both the customer and the bank know beforehand the price of the item and the mark up which the bank is going to charge. The mark up price specified in the Murabaha agreement is based on the prevailing market prices and cost of the goods and once it is concluded it cannot be changed. On purchasing the item the bank becomes the legal owner of the good, which it then delivers to the customer. When the customer receives the item, he becomes the legal owner and the debtor to the bank for the amount of the mark up price. Another form of Murabaha is "A Murabaha a Letter of credit." It is an I/c through which the bank itself imports the item required by the customer and then sells it to him at a pre agreed price. For instance, an importer contacts the foreign supplier of goods and prepares plans for their import, it approaches the bank for facilitating the imports. The bank considers the viability of the proposal and the offer then imports the goods and sells them with mark up price to the customer. The bank protects itself against any risk of loss through a guarantee called *daman al-uhda*, according to which the client offers adequate securities to the bank.

2. ***ijara* (leasing):** Without going to the details of the nature and conditions of *ijara* which we elaborated else where, it is pertinent to mention here its operational features in the modern age. *ijara* is an agreement wherein the bank leases or hires movable or immovable property to a customer against a fixed charge. In case the bank does not possess the required properties, it may purchase it, at the request of the customer and then lease it to him the customer is provided the option to purchase the item at the end of the lease period at a pre agreed price. A lease contract is a binding contract and may not be canceled before the end of the leasing period. *ijara* has a vast modern application and in the developed countries it has gained great popularity during the last decades. In Islamic economics both physical capital and labor may enter the production process either on *ujrah* with a fixed amount of remuneration or on profit basis depending on the different combinations of management and ownership. If the nature of the owned asset is such that it can produce a flow of services without being depleted the asset can be rented or otherwise given on a profit-sharing basis. Earning or *ujrah*/wages is based on selling a flow of definite services of the assets owed. Human

resources are in this sense a form of owned assets. This means that *ujrah* earners are in fact owners of lasting resources who enter the market offering the services and become subject to the law of demand and supply. The essential difference between the two categories, is however, the level of risk taking which is inherently associated with to the extends of being part of the decision making authority. There are three ways of leasing or renting assets:

- a. Leasing/renting where the lessee requires the right to sue the asset for an agreed period with or without the option of purchase at the end of that time of an agreed rental.
- b. *ijara-wa-iqtina'a* (financial lease). In this case, it is offered an option of ultimately purchasing and becoming the owner of the equipment or the property. The full cost of the property is amortized during the lease period, and the customer is given the option of purchasing the equipment or the property at the end of the lease period at pre agreed price. This is what is known as hire purchase whereas equipments or durable consumer goods are purchased by the bank at the request of the client then the client hires it on payment of periodic installments which are arranged. The price includes a fair return to the bank. The bank owns the goods until they are transferred to the hirer on payment of a nominal amount agreed at the time of the contract⁴².
- c. Rent sharing system it is mostly used by banks and house building societies or financing corporations. Under the rent-sharing arrangement, the financial institution becomes a partner and partially the owner of the property whose partly contribute the finance of its construction or purchase and receives a share of rentals in return over a period of time the co-owner of the property is able to reduce and ultimately buy out the financier's ownership of the building

The leasing may have important advantages; it associates with a negligible risk and the return from the leasing are almost certain. It is marketable on the secondary market and therefore convertible to cash on demand. Leasing helps growth in investment and capital formation⁴³.

⁴² Ibid p. 77-78.

⁴³ Ibid., p. 82.

3. **Salam & Istisna'a:** *Salam* is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in an exchange of advanced price fully paid at spot. This transaction is in fact the opposite of deferred sale and initially its basic purpose is to meet the needs of farmers who needed money to grow their crops and the feed their family up to the time of harvest. That is to sell their agricultural products in advance. This mode of transaction was also very beneficial for the business men to sell their goods in advance in order to raise cash for their business. Usually the price in *Salam* is lower than the price of commodities delivered at spot, and the difference between the two prices may be considered a valid profit. *Stisna'* is another kind sale where the commodity is transacted before it comes into the existence. It follows that the customer who is requiring an item equipment, building, or project, which needs to be constructed, manufactured, fabricated, or assembled, approaches the bank for financing, the bank offers the finance of the project and after adding its profit margin sell it to him, he can later pay the price either in a lump sum or installments. There are large basic similarities between *stisna'* and *salam* both of them involve an advance selling of goods to be delivered in a given time of future period. The difference may be only technical implementation of the two where *Salam* price may be delivered at once while in case of *stisna'* the payment may be made on instalment or the contract may still have an optional clause. However, what is important here is that since both of them are sale that generates profit they are part of financial modes under profit sharing system.

Thus, the profit-sharing system in Islam embraces all forms profit-oriented business activities including trade-based modes, i.e., *Murabaha*, deferred sale, *salam* sale etc., production-based modes, i.e., *musara'a*, *istisna'* etc., service-based modes, i.e., *ijara*, and financial-based modes of investment, i.e., stock exchanges, security exchanges etc. No matter the technical requirements of its operations determined by the nature of the economic sector it may belong as long as it is permissible according to the general financial principles of Islam. Therefore, profit-sharing system is not itself a particular mode of financing separate from the above mentioned techniques but it appears to be a catch all term and comprehensive system of financing.

Table 8.5 The modes of Finance in profit sharing system

Modes of Finance of profit-sharing System (<i>Mudaraba, Musharaka, Corporation</i>)				
	Trade-based modes of investment	Production based modes of investment	Service-based modes of invest.	Financial-based modes of investment
1	<i>Murabaha</i>	<i>Muzara'a</i>	<i>ijara</i>	Stock exchange
2	<i>Bay' Mu'jjal</i>	<i>Istina'a</i>	<i>Istijrar</i>	Security exchanges
3	Deferred Sale	<i>Musaqat</i>	Service charges	currency exchanges
4	Any Permissible contract	Direct investment	Hire purchases	Any permissible financial exchanges

8.4 CURRENT CONTENTIONS ON PROFIT SHARING SYSTEM

The concepts, *Mudaraba* and *Musharaka* formed the theoretical basis of contemporary Islamic banking. Islamic economic theorists envisioned that the investment activities of the Islamic bank would be based on the two legal concepts of *Mudarabah* and *Musharakah* alternatively known as profit and loss sharing (PLS). They contended that the Islamic banks would provide their extensive financial resources to the borrowers on a risk sharing basis. Unlike the interest-based financing system in which the borrower assumes all risks, the risk involves, according to the general belief of Islamic economists justifies the profit in the *Mudaraba*. The investor must take risk of losing part or whole of the capital, where as the *Mudarib* risks being unrewarded for his labor and-efforts in the event that the venture does not realize any profit. Nevertheless, in practice profit and loss sharing (*Mudaraba* and *Musharaka*) came to play a significantly less important role investment operations. Islamic banks generally have come to realize that PLS as envisaged by the Islamic economists, cannot be utilized substantially in Islamic financial institutions due to the risks it imposes to the bank. As a result Islamic banks have almost abandoned from these modes of financing and transformed their financial operations almost risk-free financing mechanisms. This apparent reality has raised unresolved theoretical and legal questions among contemporary Islamic economists. In this section we would like to review these theoretical problems related to the nature profit-sharing system and explanations given by Islamic economist on one hand and their critical approach to existing predominant modes of financing from the legal point of view on the other. In subsequent

sections we will try to present some conceptual clarifications and general remedies.

Although, theory of Islamic banking has made a great deal of progress in the last two decades, there is no unique and unanimous theory of Islamic banking. The major theoretical models that represent the dominant thinking in the profession have not shaped the existing Islamic banking and financial institutions. The contemporary Islamic banking system is following neither *Mudaraba* model nor *Musharaka* (two windows model very) faithfully. On the asset side of the balance sheet *Mudaraba* does not appear as a significant technique of financing, while in theoretical models it figures prominently⁴⁴. Shamim A. Siddiqi (1996) also noted the general public response to the operations of *Mudaraba* financial institutions. He has pointed out that in the initial stage of the introduction of *Mudaraba* business in Pakistan in 1981, The government of Pakistan has given many facilities for *Mudaraba* companies; The most important provision of the rules was that a *Mudaraba* was exempted from tax, provided that at least 90% of its profit was distributed to the share or certificate holders. Despite this remarkable incentive the *Mudaraba* financing companies have not shown any substantial progress. Even after the removal of tax exemption by the subsequent government through its finance bill of 1992-93, the tax rate on *Mudaraba* is still less than those applicable to other financial institutions and banks. However according Shamim one must explain why the general public has lost its confidence in *Mudaraba*?

8.4.1 Current Explanations

According to most of the proponents and observers of Islamic banking, this may happen due to several reasons. In his recent note M.N Siddiqi (1996) admits that Islamic banks have generally resorted to Murabaha financing. And according to Siddiqi, the low levels of honest and trustworthiness in the market, the poor system of auditing and accounting, lack of constant means of monitoring of business and the failure of the judiciary in helping the financing agencies in case of default by fund users, are some of the reasons for the trivial use of *Mudaraba* financing by financial intermediaries⁴⁵. It is also said that low of moral standards in many Muslim communities does not permit wide scale utilization of PLS as an investment

⁴⁴ Ausaf Ahmad, Ibid., p.30

⁴⁵ Siddiqi, M.Nejatullah, Some Economic Aspects of Mudaraba, Ibid., p.23

Mechanism. For this reason the present practices of Islamic banks show very rarely and with very careful selection, particularly where the client is very efficient manager, and experienced in the area of the business and where the project is profitable and generally a short term nature. However, the applications of profit-sharing principle (*Mudaraba*), in its traditional form, to modern banking system are seen to be inappropriate. According to Hamoud (1985) the bilateral nature of the classic *Mudaraba* may not satisfy the needs of financial intermediateness, The profit distribution after every transaction may not be fitted in the modern profit-sharing system, therefore, it is incapable of providing finance durable and nondurable consumer goods⁴⁶.

Bacha (1995, 1996) has attempted to explain why the share of *Mudaraba* financing has been negligible in over all financing of Bank Islam Malaysia. Using a series of theoretical models and several concepts used in the main stream literature of finance, he elaborated that *Mudaraba* financing is susceptible to an acute agency problem. Comparing to conventional techniques of finance he claims that *Mudaraba* contains certain features of both debt and equity financing so that their problems are thus present in *Mudaraba* financing. This is so, because, In *Mudaraba* according to Fiqh literature, the *Rab-ul-mal* should not interfere in the business and at the same time he is liable for all the losses, in this case agency problems of *Mudaraba* are more severe than debt or equity. Like equity finance, in *Mudaraba* financing, the *Mudarib* has every incentive to increase those costs which accrue to him as benefits particularly, in case of financing a new project or to establish a new subsidiary, *Mudarib* will have all the incentives to allocate, as much overhead and other cost of his original(parent) company, to the *Mudaraba* financed project or subsidiary.

Further more, the incentive to take risky projects would be even greater in *Mudaraba* as the owner of capital is to take all risk. Using some numerical examples, Bacha shows how *Mudaraba* financing in its traditional form cannot be attractive to any Islamic bank in the contemporary world. Bacha asserts that the main problem with *Mudaraba* financing is that the *Mudarib* does not share any loss. He noted that once this provision is revised and the *Mudarib* is forced to take part of the "brunt," the agency problem of the *Mudaraba* finance would be minimized. He pointed out in today's world specially in the corporate sector. It is hardly

⁴⁶ S.H. Hamoud, Islamic Banking, p.230-234

desirable that entrepreneur or *Mudarib* to be exempted from sharing any loss⁴⁷. Waqar M. Khan(1985) also raised the question PLS application in the Modern Islamic Financial institutions, and in the comparison of Interest-based system after he established the superiority of the former for lenders as well as the borrowers, Waqar Khan answered this question in terms of costs of informational asymmetry involved in PLS techniques. He argued that debt minimizes the information costs while, PLS techniques due to its high information cost turns out to be inefficient as compared to interest based debt servicing⁴⁸.

The issue of information cost has been greatly exaggerated by Waqar as Fahim Khan noted it, Rejecting the Waqar's thesis of information asymmetry, Fahim Khan (1995) has tried to find explanation for the PLS application deficiency beyond this issue. He sought his explanations from two aspects such as; financial and fiscal structure of the concerned economy and the existence of what he called bad products beside the good products⁴⁹ According to Fahim Khan one explanation may lie in the economic structure which may have bias in favor of interest-based system rather than a PLS mode of financing. The tax structure is often described as the hindrance to PLS techniques, Shamim Siddiqi also agrees that the income tax department of the government agency is responsible for the general set back of *Mudaraba* financial institutions, in Pakistan. Since the interest rates are deductible expenses, the replacement of interest-based financing by PLS will increase the tax liabilities for the capital users' referring to the Modigliani and Miller view that the only advantage of debt financing vis-a-vis equity financing is the tax saving generated by the deductibility of interest from taxable income⁵⁰.

The second explanation put forward by Fahim Khan lies in the context of a well-known phenomenon of bad products deriving out good ones. The existence of an inferior products and effectively absence of a superior product is possible on various non economic grounds, including short sightedness, that makes economic agents unable to see fully the economics of the phenomena under the consideration. Fahim Khan listed several kinds of the consideration,

⁴⁷ His argument is based on that in the old days it might has been justified, without giving any reason. But, perhaps the simplicity of the business operations and Mutual trust of the Muslims.

⁴⁸ Waqar M. Khan, Towards Interest-Free Islamic Economic System, 1985. See also Fahim Khan, Essay Islamic Economics, 1995, p.120, 239

⁴⁹ Fahim Khan, Assays in Islamic Economics, 1995, p.240.

⁵⁰ Fahim Khan, Ibid. p.24.

such as the followings;

- (i) The convenience or aversion to effort argument: Providing finance on PLS basis require constant vigilance and evaluate projects more thoroughly. This will result in increased cost that bankers will have to balance against prospective returns that could be earned by making more efficient use of funds.
- (ii) Security of a scarce commodity, for capital is scarce and storable. there is a tendency to reserve capital away from risk as far as possible and entrepreneurs also if they become scarce they may prefer to use capital on interest, i.e., a fixed charge rather than to share resulting profits. Accordingly as long as the option of interest fixed, return is available, PLS techniques will remain insignificant.⁵¹
- (iii). Demand for consumption Loan: The availability of this scheme is perhaps the most powerful argument for the existence of the interest based-system and for rejecting the PLS financing. As there is no concept of PLS applicable to the consumption loans which is financed on the basis of interest rates, this possibility of earning interest on consumption loans prevents capital owners to seek PLS ventures.⁵²

Ausaf Ahmad (1997) has supplied the explanation of the non-popularity of participatory techniques is that Islamic banking in its early stages of evolution had to rely on the professionals and managers who had been trained in the conventional banking. Since risk minimization is a respectable and established principle of conventional banking, These professionals preferred those Islamic Instruments of finance that were closest to the methods of finance used by conventional banks. As a result Islamic financing techniques like *Mudaraba* and *Musharaka* which seem to be more risky were avoided. Secondly Islamic banks had to compete with the conventional banks were forced by the fierce competition to pay their depositors a return on their deposits that would, at the least, be comparable with the rate of

⁵¹ Ibid, p.243

⁵² Fahim Khan, Ibid, 1995. p.244.

interest paid by the conventional banks. Thirdly, Islamic banks were established in an economic atmosphere characterized by high inflation and interest rates, that was not considered the conducive for undertaking long term investment. Therefore, Islamic banks turned towards short term financing that would also give high returns. This is reflected in higher frequency of Murabaha than that of *Mudaraba* in the financial operations of a number of Islamic banks, as a result of various fixed return techniques of financing such as cost-plus financing (Murabaha) and leasing (*ijara*) which are more prominent on the asset side of Islamic banks'⁵³. Shamim Ahmad Siddiqi(1996) who has extensively studied this subject in the context of Pakistan concluded that the main problem faced by *Mudaraba* financing institutions is to generate funds to be utilized in profitable ventures and *Mudaraba* companies and they are not getting any enough subscribers from the general public. There could be many reasons for this reality, including (i) the large number of *Mudaraba* companies chasing limited number of potential subscribers, and (ii) relatively riskiness of the business compared to the prevailing fixed and predetermined rate of return from the conventional financial institutions⁵⁴.

8.4.2 Raison d'etre of Contemporary Islamic Financial Institutions

Today there is about 200 interest free financial institutions operating worldwide with rapidly a growing rate, and as far as the development and practical operations of Islamic banks is concerned their success is internationally recognized. However, as number of Islamic banking theoreticians noted one of the main concern lies with the very vital point of their identity by libeling Islamic or non-Islamic. We find two approaches of tackling the problem firstly an apologists approach (1983), Tantawi (1992), Sudin (1997), who see the difference of the Islamic banking and conventional financial system to be merely in legal and moral context not economic one and Islamic banking system may use the existing or market rate of interest for fixing their profit rates. Secondly the idealists approach who see the Islamic financial system as a certain conceptual and ideal norms or models without elaborating their economic rationale, practical applications with the harmony of their legal consistency. The second view sees that what have been implemented so far of financial techniques are different from what had theoretically been visualized. Hence, the contemporary economists of this approach reject

⁵³ Ausaf Ahmad, Ibid p.33

⁵⁴ Shamim A. .Siddiqi, Ibid. p.6

the present predominant modes of financing in complete for their imperfection, Shahid (1997) Fahim Khan (1995) M.N.Siddiqi (1987), Abdallah Said (1996). According to this view even some of the short term financing techniques of trade-based modes may not be acceptable, for they do not comply with the conceived ideal model of Islamic system. And they considered them as *riba*, *gharar*, *zulm*, which are unjustified and prohibited in Islam.

Perhaps S. H. Siddiqi (1996) has made the strongest criticism the present modes of profit-sharing techniques such as; loans with service charge, mark up (*Murabaha*), Leasing, hire and repurchase. He has highlighted the weakness of these modes on the base Shariah injunction and its objectives and that they are stained with interest rather replacing it. To him the element of interest is creeping into the new system and has also been allowed to be perpetuated by adopting these modes of financing. While some of these modes could have been permitted as a transitory measure, it appears that the banks have sheltered themselves in a comfort zone by persisting with the modes of financing against which genuine reservations about the permissibility, exists in Shariah law. The result is the new system adopted under the banner of Islamic banking have become even more exploitative than the interest-based system. It is also appreciated that all this is nothing but injustice which is strictly prohibited in Islam. The worse thing is that all these injustices are continuing unchecked under the cover of Islamic system of banking⁵⁵.

Attia also wrote about the conceptual perspective of the issue that 'the difference between *Murabaha* and interest-bearing loan was rather legal and not economic. The detailed justifications of *Murabaha* as it is practiced by Islamic banks depends on the degree of risk that is taken in financing a commercial transaction. The risk involved here is also represented mainly by the time lag between the purchase of goods by the bank and their resale to the customer. If this period is long enough to expose the bank to risk, then there is a real difference between this scheme and the interest-bearing loan and the bank is justified to add a profit margin to its cost in proportion to the risk it is undertaking. But, as it is now practiced when the purchase and sale are completed simultaneously, in such a way that the risk element is minimized for the bank, this mere formality without substance does not justify the

⁵⁵ Shahid A. Siddiqi, A Model Islamic Banking is the Need of the Hour, Horizon, 1996, p.7-9.

application of *Murabaha*⁵⁶. Hussain Kamil of the Faisal Islamic Bank of Egypt (FIBE) acknowledged this similarity between interest and Mark-up (*Murabaha*). According to him the mark up could be slightly higher or lower than the prevailing interest rate, but the difference between them, generally would not be large. It has been argued that the mark up profit margin techniques in trade and rent are nothing other than interest by a different name. Abdallah Said also highlighted that:

"In fact, from an economic point of view, there is indeed no substantial difference between mark up and interest. The main difference between the two is a legal one, the basis for interest is a loan contract, while, mark up or rent is founded on sale or lease contracts. These legal differences do not seem to make the profit margin in *Murabaha* much different from the fixed interest on a loan . . . therefore, a change from an interest-based system to a mark up based system is merely a change of the name, leaving the substance intact."⁵⁷

In this context he raised a question of moral concern about the permission of *Murabaha* mode of financing by expressing: "If Islamic law can allow *Murabaha* financing as it is practiced under Islamic banking then the question is there any moral basis for not allowing fixed interest on loans and advances?"⁵⁸ In similar view Siddiqi also succinctly summarizes in one sentence "For all practical purposes this will be as good for the bank as lending on a fixed rate of interest"⁵⁹. The historical CII. report has also shown highly critical to the economic implication of the *Murabaha* activity: "There is a genuine fear among Islamic circles that if interest is largely substituted by mark up under the PLS operations, it would represent a change just in a name rather than in substance. PLS under the mark up system was in fact the perpetuation of the old system of interest under a new name."⁶⁰ On the basis of these apparent similarities between interest and *Murabaha* M.N.Siddiqi expressed a strong objection to the deferred payment based commercial activities in general and argues in favor of excluding the instrument of *Murabaha* from Islamic banking altogether by saying: "I would prefer that *bay'*

⁵⁶ Gamal Attia, "Financial Instruments Used by Islamic Banks", (Kamali, Istihsan. p.124)

⁵⁷ Abdallah Said, Islamic Banking and Interest, Ibid., p.93.

⁵⁸ Ibid.

⁵⁹ Siddiqi, Issues in Islamic Banking, p.129.

⁶⁰ CII, Consolidated Recommendations, p. 97, 121.

mu'jjal (*Murabaha*) is removed from the list of permissible methods altogether. Even if we concede its permissibility in legal form, we have the overriding legal maxim that any thing leading to something prohibited stands prohibited. It will be advisable to apply this maxim to *bay' al mu'ajjal* in order to save interest free banking from being sabotaged from within."⁶¹

Despite, this general explicit reservation about the Islamicity and economic importance of *Murabaha*, we have seen that there is a clear permission of sale including *Murabaha* and *ijara* (leasing) which are considered as the basic substitutes of *riba* on the Shariah point of view regardless of the fixity or variability of the generated profit. Moreover, Islamic banks have utilized it extensively in their financing activities. Nearly 76% of their business operations are based on this short term trade financing. *Murabaha* together with leasing modes of financing the figure may show above 90% of over all investment activities by the virtue of their predetermined return and relatively risk free nature.

8.4.3 Conceptual Misgivings and Practical Misuses

Technically *riba* is a contractual increment reviewed by a lender from a borrower over and above principal (Maududi 1950). Therefore, the presence of an advance contract on the return on capital is considered the distinctive and unique characteristics of interest in Kahf (1995). While almost there is a consensus among Muslim scholars the objection of the fixed return, the difference between contractual return on lending and contractual return on sale-based financing was not spelled out in the literature under the review. Thus charging any guaranteed return on financing was (considered) illogical, irrational, and unjust"⁶² (Uzair 1954, Siddiqi 1983, Chapra 1985, and F.Khan 1987). In traditional norms of financing interest charged on the loan is related to the principal and its maturity. Islamic economists argue that if the loan is for such a purpose it is not of concern to the traditional bank what cost of the goods may be to the client, their main concern is to obtain the currently prevailing interest rate for similar advances in terms of risk and maturity. In this case the client may not know beforehand the cost of his loan. While in *Murabaha* method the client would know the total cost of the goods he wants to purchase. In the short term this division on an interest rate may not be significant.

⁶¹ Siddiqi, *Issues in Islamic Banking*, Ibid., p.139.

⁶² Tariquillah Khan and M. Kahf, *Principles of Islamic Finance*, IRTI, IDB, 1995, p.45

it is also noteworthy that in general Murabaha activity is short term nature. Sudin Harun also has pointed out the theoretical confusion related to the basic *raison d'etre* of Islamic banks that is the relationship between market interest rates and the profit-sharing and marks up ratios of Islamic banking. Some scholars have acknowledged that in no way, could Islamic banks ignore the element of interest in their operations⁶³. Sudin referred to Sami Hamoud the proponent of modern applications of Murabaha mode of financing, claimed that there is no known way of avoiding the link between interest rate and the profit margin in Murabaha, as long as the Islamic banks are operating within an environment where they coexist with traditional banks⁶⁴. This intimate relationship with interest rates affects not only the ratios of financing activities but also the rate of return to depositors.

The linkage between the interest rate and profit sharing and mark up ratios, however, remains a contentious issue Volker Neinhaus, for, "instance made a bold suggestion that the calculation of profit-sharing ratios by Islamic banks must be based on the market rate of return"⁶⁵ It is also asked whether it is wrong for Islamic banks to use interest rates as a benchmark in fixing their profit-sharing and mark up ratios. The banks which are worried about their customers may find their products unattractive if the financial consideration differs from the products of the conventional banks. They are also concerned that adequate rewards must be given to their depositors, at least comparable to those received by depositors at conventional banks. The Islamic banks who are in favor of using an interest rate as a benchmark will hold to the opinion which says that the interest rate is just a mathematical device it measures the relationship between two quantitative variables. The percentage or figure has nothing to do *with halal or haram*. *Halal* factor remains *halal*, whether it is measured as a percentage or otherwise. Similarly *haram* thing remains *haram*, whether it is measured as a percentage or not. Further more it is argued that whatever, Allah (swt) permits man cannot prohibit⁶⁶. Then the question is why all these theoretical critiques and conceptual inconsistencies of the subject are present at least in the minds of Islamic economists. In brief it seems that the crux of the problem arises from two aspects of the subject firstly the existence of certain conceptual misgivings about the theorized view of *riba* doctrine and its proposed

⁶³ Sudin Harun, Profit-Sharing: Questions that Need to be Answered, New Horizon, February, 1997, p.10.

⁶⁴ Hamoud, Sami Hassan, Murabaha Modes of Finance, Islamic Economic Studies, December, 1994

⁶⁵ Volker Neinhaus, Profit-Sharing, The Journal of Research in Islamic Economics , 1983.

⁶⁶ Sudin Harun, *Ibid*, p.11.

alternative in the contemporary studies, in other words, the absolute equality of the fixed rate of return to *riba* in Islam and its replacement to a variable rate of return based on profit sharing system, secondly, the existence of practical misuses of the concept of sale and *Murabaha* in particular. We would try to discuss in precise, these two aspects in below.

I. Conceptual Misgivings of Contemporary Studies

Some of the challenging questions that have arisen in the contemporary Islamic economic theory include: Islamic banks have tended to avoid taking risk and often devoted their resources to safer modes of financing such as *Murabaha*, *ijara*, and *Bay' bi daman ajil*, and they have become reluctant to enter the more risk-oriented modes of *Mudaraba* and *Musharaka*⁶⁷. H. Siddiqi pointed out that if we carefully examine the modus operandi of the above-mentioned modes of finance, we will find that some of these resemble interest while others, although they are termed *riba*-free, cannot be expected to contribute to the achievements of the socio-economic objectives of Shariah. The reason according to him remains that in most of these modes, risks are practically not shared by the banks in the ratio of funds employed in the business. A similar view is expressed by Abdallah Said: 'financing on the basis of risk sharing with which the theoretical model of banking is essentially identified does not seem to be practically realized'⁶⁸.

In fact these basic questions have yet to be properly addressed and precisely illustrated. It might be thought that after the combination of capital and entrepreneurial skill the system will operate smoothly in Islamic frameworks, and it will keep itself out of a *riba* sphere automatically. As we mentioned above in terms of organizational structure there is no particular form of Islamic business organization which determines the Islamicity of the system. Combination of capital and entrepreneurial skill may take vast number of lawful forms and different kinds of acceptable organizational shapes in Shariah, as long as the rights and responsibility of each party is defined and the distributions of the outcomes are mutually agreed by the concerning parties according to the prevailing actual returns. As far as the scope of the activity of the profit-sharing system is concerned there is no particular economic sector

⁶⁷ M. Hashim Kamal, *Istihsan*, Ibid., p.114.

⁶⁸ Abdallah Said, Ibid, p.91.

specified for the profit-sharing system. We have seen that most of the classical Fiqh scholars have emphasized that *Mudaraba* activities are based on commercial trade, and as we have seen above it is also applicable to agriculture, industries, services and even financial sectors in our modern time. Moreover, the nature of the business activity determines the appropriate modes of finance that could be adopted.

This large scope of *Mudaraba* in particular and joint enterprise in general essentially determines the essence of profit-sharing system. There must not be confused between the organizational structure and technical operations of the business. Where the organization could be *Mudaraba* and *Musharaka* the operational technical modes could be based on *Murabaha*, leasing, *Istisna'* etc. Table 5 gives some hints about this, for instance, in the commercial sector we have a number of trade-based modes of finance according to the nature of the business, the prominent among them and perhaps the most appropriate one is *Murabaha*. There is no objection that *Murabaha* or deferred sale to be economically beneficial and convenient technique for carrying out the business operations. Therefore, Since all economic sectors can be brought under *Mudaraba* or *Musharaka*, profit-sharing system is not specific mode of financing, it embraces all financial instruments ranging from those characterized by fixed rate of return such as leasing, and *Murabaha* to those associated with unpredictable yields such as *Istisna* and investment projects. Hence there is no parallel correspondence between *Mudaraba* and renting. But every profitable activity may be brought under the framework of *Mudaraba* principle. Despite, the obvious fact envisaged by the classical *Fiqh* scholars, we see that the contemporary Islamic economic writers continuously put doubts on leasing and trade based financial modes of financing, as these are, in their view, conflicting with the basic ingredients and principles of profit sharing.

II. Misuse of the *Murabaha* Mode of Financing

The dominant negative impression made by the Islamic economic writers and Islamic institutions over the concept of *Murabaha* or *bay' al-muajjal* perhaps they might have seen certain kinds of distorted practice of *Murabaha* in certain countries, i.e., Pakistan. Kamali (1997) quoted Geiraths who wrote:

"The basic difference between the mark up and interest is that the former is

theoretically linked to real goods transaction and the latter to a financial transaction. But when the bank avoids any participation in the transaction of real goods, it fortifies the claim that it is performing *bay' mu'ajjal* or Murabaha. In practice, fictitious transactions existing only on contract paper are made use of to back up credit transactions on a mark up basis, this are specially very common in personal loans, the supplier and the client is the same individual, i.e., the client sells an item to the bank for example his car and buys it back at a mark up price, the bank authorizes him to continue to use the car, while the payment is deferred and made installments. It is then, stated that in the vast majority of cases, mark up has substituted what was formerly known as interest, working in remarkably similar way "following the letter of Islamic injunctions but hardly its spirit"⁶⁹

The most common mode of mark up financing being used by Pakistan is the one mentioned at serial No.5 of IIC Report (1982) which reads as under; "Purchase of movable or immovable property by the banks from their clients with a buy back agreement or otherwise." But, the practice followed is that a client sells his goods to the bank for cash and simultaneously buys back the same goods from the bank at higher price (mark up) payable at a future date either in a lump sum or installments. Usually this kind of mark up retains all attributes of *riba* transaction. It is merely a trick or *heela* to commit *riba*. If we further elaborate the nature of its operation, the reasons of objections might become clear.

1. For instance, A has certain kind real goods and it is in need for money, he sells his goods for cash to B (bank) without delivering the real goods to the bank, at the same moment he enters another contract with the bank of purchasing that same good from the bank on credit but at higher price, i.e., mark up. In practice the goods have not been sold A has received only loan equals to the price of the his goods, and B the bank has given out a loan with certain rate of interest. This may not be new *heela* the people were using similar business since, long centuries. For instance the person who gives loan, i.e., 10,000 dirhams were to sell to the borrower goods of 4000 dirhams at the price of 5000 dirhams as a part of this loan. In another way the *riba* users were to include nominally a commodity in the loan contract for

⁶⁹ Geiraths, "Pakistan: Financial Products", in Wilson, Islamic Financial Markets. quoted by M.Hashim Kamali, *Al Istihsan*, Ibid.,

instance the one who wants to get cash of 100,000 dirhams for 120,000 dirhams to be paid after a given period of time used to sell goods at 120,000 dirhams, to the borrower on credit and then repurchased them from him at 100,000 on cash⁷⁰.

It is very clear from the above examples that basically this transaction is purely a loan contract and neither the objective of A was to sell goods nor the intention of B was to purchase them. The role of the goods in this transaction is simply used for cover of this loan transaction, and perhaps they can do so many times selling and repurchasing the same goods, if A wishes through this manner to acquire more cash and hence accumulate debts on him. There is no any economic benefit to be derived from conducting this transaction if the goods are the subject matter of the transaction, instead it may involve at least the cost of transaction, which the seller is to incur. On the other hand simply selling to buy back will never add any value or additional price to the commodity. So, other things remain the same this exercise is not as a matter of fact a way to generate profit, hence, it is not viable to be used as a mode of finance, for it will increase only the inefficiency and dead way loss to the society at large.

2 This kind of transaction as we find from the teachings of *Sahaba*(ra) as they reported from the Prophet (saw) its prohibition was very clear. It is reported that a woman came to Aisha(ra) and said: "O' The Mother of Believers! I had sold a boy (slave) to Said bin *Arqam* for eight hundred dirhams on credit and repurchased him for six hundred dirhams on cash' Aisha (ra) said to her: "How bad is what you purchased and how bad is what you sold! Verily his (Said bin *Arqam*) *Hajj* and *Jihad* (strive for the cause of Allah) got spoiled, save he repents (return from it)⁷¹."

Imam Shawkani commenting on this statement of Aisha(ra) wrote; "In this there is an evidence for the prohibition of selling on credit and repurchasing it at a different price on cash before actual possession of the first price (was concluded). But if the driving motive is to get cash at present and make repayment of more than its (original price) after some days through trick or manipulation, verily that is the prohibited *riba* which will never become permissible by using *heela* and invalid manipulations and this is the form of sale in '*Dinah*'⁷²." Ib Qayyim

⁷⁰ Fazlul Ilahi, *Wassail al Wiqaiyah Li al Riba al Muharrama* 1988, p.129

⁷¹ *Sunan al Dar ul-Qudn, Kitab al Buyu' hadith:212*, vol.3 p.52 (Ahmad)

⁷² Imam al Hajjar al Asghlani, *Nail al Awtar*, vol.5, 317.

asked with astonishment' what problem of *riba* be eliminated in this misuse and *heela*⁷³. Ibn Taymiyah also expressed the prohibition of this *heela* "This is not permissible for it is *riba* by the consensus of *Sahaba (ra)* and Majority of Muslim scholars⁷⁴." The economic implications of selling and purchasing of the same commodity we have elaborated it in Chap.5,6 and substantiated the rationale of the prohibition of the two transactions of the same sale. The Prophet (saw) has very clearly mentioned that no sale and deferment in a transaction, and he prohibited that two conditions to be combined in one sale contract.

In fact the most studies show that the buy back form of Murabaha is being used in Pakistan as the prime mode of financing conforms with this case as we illustrated it in an example. And for this obvious reason the late prominent Islamic banking Nawazish Ali Zaidi termed that Islamic banking system in Pakistan practically appears to have lost its credibility, According to Zaidi some of the major inherited prejudices are recorded (i) banks cannot trade on their own account, (ii) banks deal in documents and not in goods. The position now is that the bulk of financing by banks in Pakistan is being done on the basis of a mark up basis which is viewed nothing but interest⁷⁵. In this context, S.A.Siddiqi expressed an unfortunate situation of affairs which if it is allowed to continue, even many innocent Muslims may develop doubts about the feasibility, practicality and usefulness of the Islamic system of financing'.⁷⁶

The acceptable form of a buyback transaction according to Shariah is basically *rahan* or securitization. Suppose A requires cash, he sells his goods, i.e., a car to B with an agreement that A will repurchase his goods from B before the agreed date and A delivered the goods at the contract and the goods are transferred into the possession of B. In this case A would repurchase the goods from B but at the initial price level only that is the rates and amounts stipulated in the first transaction. And the transaction practically turns *rahan* or *bay'ul-wafa'*. In this case A will receive his goods when he returns the same amount of money. If A fails to repurchase the goods by the agreed date the sale becomes the final. While this consideration may end in either ordinary sale or *rahan* the increase in price of mark up transaction is purely *heela* of *riba*. In this way the practice of mark up in its present form

⁷³ Ibn Qayyim, *I'lam al Muwaqi'in*, vol.3, p.125.

⁷⁴ Sheikh al Islam: Ibn Taymiyah, *al Majmu'ul Fatawa*, vol.29, p.431-432.

⁷⁵ Nawazish Ali Zaidi, Islamic Banking in Pakistan: A Review of Progress and Problems, Pakistan Banker, July-December 1991, p.16-17

⁷⁶ S.A. Siddiqi, *Ibid*, p.8

would be dubious susceptible to *riba* like *bay' al-einah*.

8.5 RECONSIDERATION OF PROFIT-SHARING SYSTEM

As we have mentioned above, we find that the traditional *Mudaraba* has the following short comings; (a) the *Mudaraba* is bilateral form where the *Rabbul mal* used to frame rules and conditions for *Mudaraba* operations, place of the activity and goods as well as the people with whom to be dealt. *Mudarib* was working under the supervision of the *Rabbul mal* who used to formulate the working principle of the *Mudaraba* contract. (b) *Mudaraba* works were so simple commercial activities. All sorts of its operations were known to both parties, where the details of the techniques and the framework of the matter were familiar to *Rabbul mal* as well as the *Mudarib*. (c) any deviation from the common norms or prescribed regulations including providing the *Mudaraba* fund to another or trading with other people not mentioned in the contract was considered to be violation and as a result the *Mudarib* was liable for reimbursement of the principal in full along with profit if any (d) the traditional *Mudarabah* requires profit distribution after every transaction unlike the modern profit-sharing practice the *Mudarib* is bound to convert all *Mudaraba* business into cash to determine the profit in each period. In fact it would not be imaginable in case of common joint enterprise that all the existing assets of the *Mudaraba* to be liquidated simultaneously at the end of the financial year nor for the common working partner to refund the capital to the owners so that the surplus value or resulting profit can be shared in the manner described in case of private *Mudaraba*.

8.5.1 The Nature of Common Joint Mudaraba

With these facts, it is very clear that traditional private *Mudaraba* principle may not satisfy the needs of financial intermediateness. This justifies the rationale of common joint enterprise. Emphasizing this point Hamoud pointed argued that the traditional *Mudaraba* is incapable of providing financing for durable or even and nondurable consumer goods. *Mudaraba* in its traditional form essentially depends on personal relation relying on the two parties' mutual trust and integrity which could be easily identified.⁷⁷ Therefore, the existing *Mudaraba* as

⁷⁷ Sami H. Hamoud, *Ibid.*, p.137

adopted by financial institution has undergone a significant modification to cope with the modern business operations. The private *Mudaraba* was restricted to two parties which cannot be extended beyond a bilateral relationship between the owner of the capital and the active partner in the capital. The joint enterprise involves an interwoven multipartite relationship which characterized by a number of privileges that would be impossible to be operated within the framework of private *Mudaraba* due to its stringent conditions which are inherent therein. This enterprise may constitute two main parties (i) investors or capital owners or financiers which may take any number with different levels of capital (ii) the active partners or entrepreneurs which may be also any number. There may not be any personal relationship between the entrepreneurs and capital owners. They may not even know each other. According to the terms of the enterprise, there may be a third party which plays the role of intermediaries between the capital owners and entrepreneur. This joint stock or common *Mudaraba* is the primary form of business financing as practiced by the Islamic banks.⁷⁸ Kahf (1995) has highlighted the fundamental inconsistency between the classical private *Mudaraba* its contemporary operations (i) the classical *Mudaraba* is based on one to one relationship between the owner of capital and the entrepreneur, while contemporary Muslim writers have the view that *Mudaraba* has numerous capital owners and entrepreneurs.", i.e., the bank (ii) the classical *Mudaraba* which is mixing or combination of the personal capital of the *Mudarib* with *Mudaraba* capital is an exception. However, it has become the fundamental rule, as the Islamic banks work with their own capital share together with the depositors money (iii) using *Mudaraba* money for making other *Mudaraba* contracts is also an exception to the classical form but in modern times this has become predominant rule of *Mudaraba* which has given rise to an innovation. Al-Khaddab (1997) in his recent studies on *Mudaraba* concluded that the present methods of financing in Islamic banks demonstrate that *Mudaraba* in its traditional Fiqh context has no existence in Islamic banks.⁷⁹

But being strict to the traditional interpretations of *Mudaraba* injunctions in the context of its bilateral form may create conceptual problems in the minds of modern readers. Where as we have said earlier the rights and responsibilities of the two parties -the common active partner and investors have been significantly modified to cope with the requirements of this

⁷⁸ S.H.Hamoud Ibid.

⁷⁹ Muhammad Sharafuddin al-Khaddab, *Nidamul Mudaraba fi'l Fiqh al-Islami*, 1997. p.111-117.

new situation. The role and responsibility and even rights of the capital owners and entrepreneurs which are now called common active partners or common entrepreneurs may be different from that of the private active partner. This and certain other related points will be discussed in the following subsections. The most important features that distinguish a common active partner from a private active partner as elaborated by a number of contemporary scholars; Sami Hamoud (1982), Al-Khaddab (1997) Hashim Kamal (1997) concentrated on: stipulations (conditions) liability and the distribution of the profit. We will discuss the Fiqh teachings on these two important points in the following sections.

Table 8.6 Common Joint Enterprise.

Level of the Participation of capital owners and active Entrepreneurs under different assumptions.	Common Joint Enterprise	
	Unlimited Investors/ Share Holders	
	Active investors	Sleeping investors
Entrepreneurs(s) participate only in Management not Capital in the Enterprise	Quasi Mudaraba enterprise	<i>Mudaraba</i> Enterprise
Entrepreneur(s) Participate in both Management and Capital in the Enterprise	<i>Musharaka</i> Enterprise	Quasi <i>Mudaraba</i> Enterprise

8.5.2 The Role and Freedom of Entrepreneur

The capital owner in private *Mudaraba* according to the general Fiqh teachings may impose on the *Mudarib* his own conditions in terms of place, kind of the business or the people to be associated with as well as the duration, on the other hand if the investor requires the agents' guarantee against eventually that the investment is lost in part or totally such an investment does not qualify as a *Mudaraba* contract. For *Mudaraba* is necessarily a combination of business activities conducted by the active worker as a customary practice of the merchants and that was the practiced norm at that time. Although these measures are justifiable valid and allowable in case of private *Mudaraba*, the situation in regard of the common joint enterprise seems to be different, due to the regulatory controls required for the common work which renders impossible for impositions of such restrictions at individual level on the active partner or the managing entrepreneur. The individual interference in the management of *Mudaraba*

will drastically affect the efficiency performance of the whole enterprise. Even in the case of bilateral *Mudaraba* such interventions are considered undesirable for that may prevent the *Mudarib* from performing his normal duties, hence, such restrictions are considered null and void. For, the *Mudarib* manages the *Mudaraba* and as a principle he participates the *Mudaraba* with his work efforts and expertise, he should have the necessary freedom in the management of the venture and independently to make all related decisions. The *Mudarib* is expected to be competent and have authority on the business enterprise which gives a full freedom to invest and use the capital providing different options to the financier including the nature of business to be engaged, the duration of the venture and places where the *Mudarib* could conduct the business. According to Abu Saud; "[The *Mudarib*] must have absolute freedom to trade in the money given to him and take whatever steps or decisions that he deems appropriate to realize the maximum gain, any conditions restricting such liberty of action vitiate the validity of the act"⁸⁰

Therefore it seems to be inevitable that common active partner should be empowered to determine the conditions which conform to the nature of the general *Mudaraba* or common joint enterprise. This means that common active partner enjoys full independence as much as regards the stipulations which the investor, in his capacity of being owner of the money were able to impose on a private active partner. But instead the capital owner in this context will merely express his choice and preference on the face of available options set by the entrepreneurs or capital managers he is unable to impose his view. This is perhaps the most peculiar feature of common joint *Mudaraba*, where, the *Mudarib* enjoys complete freedom to conduct the *Mudaraba* as he sees fit, he may travel with capital, engage in partnership with others or give the capital to third party for *Mudaraba*, he may use it to buy any kinds of goods from anyone at any time, or sell the *Mudaraba* goods in cash or credit. He is free to hire anyone or any thing and manage the capital in the interest of capital as he sees economically feasible and Islamically permissible.

8.5.3 Responsibility of Common Active Partner/ Entrepreneur

The general view of the classical Fiqh scholars show that the *Mudarib* should not be made

⁸⁰ Abu Saud, Money, Interest, and *Qirad*. in (Abdallah Said) Ibid. 1996.

responsible to the depletion of the capital or its loss as long as there is no negligence, mismanagement or deliberate action from the side of the *Mudarib*. But, the common active partner, corresponding to this complete independence of decision making in the management of the fund, bears the responsibility of safeguarding it from loss and guaranteeing the principal amount plus agreed percentage profit within the terms of the contract. The liability of the active partner for the capital delivered to him for the purpose of investment is deemed to be an important matter in practice. According to Hamoud this constitutes, in its reality, the determining factor of the success of the common active partner's worker. As far as the liability of the common active partner is concerned, it is argued that the common partner's situation is parallel with that of the common worker who is serving at the same time for different people on a fixed wage known as in Fiqh terminology "*ajir al-Mushtrak*." As a result of this analogy the common active partner also may be governed by the same stipulations which have been determined in general in spite of the existence of different opinions. The scholars of this view argue that the two situations of a common active partner in common joint enterprise and that of "*ajir al-Musharak*" is the same.⁸¹ It is well known that a private worker hired by a particular person for specific professional work for a fixed amount of a wage is considered a trustee for the thing he has in his custody, and he is not liable if the thing entrusted to him perishes without deliberate cause from his part or negligence. But, the liability of a common wage earner was in the beginning the subject of the conflicting opinions in the Fiqh literature.

Some of the classical Fiqh scholars argued that the "*ajir al-Musharak*" is not liable just like a private worker or "*ajir al-khas*". But, Abu Yusuf maintained that the "*ajir al-Musharak*" is liable (for the loss of property in his custody), save where the thing perishes by a matter which cannot be provided for or avoided⁸², which are as elaborated by al-Kassani like; fire obstinate thieves. Abu Yusuf maintained that an *ajir al-mushtrak* is liable save for what is overwhelming (beyond the control), i.e., which cannot be evaded. Ibn Rushd also elaborated that the essence of Maliki school is that the "*ajir al-Musharak*" is liable regardless of whether he works for wages or not, he argued that Ali and Omar maintained that craftsmen must be held liable, although the latter differed from Ali on the score⁸³. This may be included

⁸¹ Sami Hamoud, *Ibid*.

⁸² Al-Zaylai, *Nassb Ar Raya Liahadith al-Hidaya*, vol.5 p.134.

⁸³ Ibn Rushd, *Ibid* vol.2 p.232.

the natural disaster or any unforeseen economic political or social disaster and which have direct consequence to the profitability of the enterprise⁸⁴. Shattibi the traditional jurists and argued that the craftsmen must be held liable he rationally explained the fundamental issue that the nature of the interest being that the people need the services of craftsmen, and as such they have to have the items, in most cases, in the custody of the craftsmen, more frequently they have to part with their custody: had they not been adjudged liable and owing to the dire need of their services either of two things would have happened namely: (i) abandonment of craftsmanship which would prove to be detrimental to the interest of the people or (ii) to work without being held liable they may claim the property in their custody perishes or lost by the virtue of deterioration of moral values and existence of cheating. The common interest dictates that the common worker to be held liable. That is the meaning of his (Ali's) statement; "nothing safe guards the interest of people except that⁸⁵."

The common joint *Mudaraba* necessitates that *Mudarib* to accept different fun from the public-various partners and provide a number entrepreneurs participating in the enterprise with their expertise. This new situation makes the *Mudarib* to be liable for any loss. In Fiqh literature if the *Mudarib* provides the *Mudaraba* fund to another person or mix it with other funds in case a loss arises in the hands of the second *Mudarib* he will be responsible and *damin* or liable for this loss. If the second *Mudarib* realizes profit the *daman* rests on the first *Mudarib* answerable to investor, this is the view of Abu Hanifa and Zufar expressed that he (the first *Mudarib*) will be liable by merely giving the *Mudaraba* fund to another *Mudarib*, it is the same whether he worked on it or not, if the fund gets loss before starting any work even then the first *Mudarib* will be liable. This is the dominant view in Hanafi school where providing the *Mudaraba* to another is considered kind of transgression.⁸⁶ Shafi'is Malikis and Hanbalis also agree on that the liability for loss in this connection rests on the first *Mudarib* as a result of his transferring *Mudaraba* fund to another.⁸⁷ In this perspective also the common *Mudarib* is liable for guaranteeing the capital, because in case of common enterprise, the *Mudarib* will work with number of entrepreneurs and various managerial expertises.

⁸⁴ al-Kassani, Ibid, vol.4 p.210.

⁸⁵ Ash-Shattibi, *al-I'tihām*, vol.2, p.119.

⁸⁶ *Al-Mabsut*, vol.22,, p.98, *Tabayin al-Haqā'iq* ,vol.5, p.63, *Al-Bada'i*, vol.6, p.69.

⁸⁷ *Mughni al-Muhtaj*, vol.2, p.314, *Al-Mughni*, vol.5, p.43

Moreover, it is well known that there is a clear recognition of Islam the principle of individual responsibility. The person is answerable for his deeds, decisions and choices. Every person is liable for his own deeds and legally he is the one who must bear the burden or costs and get the benefits of his decisions. It is reported that the Prophet(saw) said "the hand is responsible for what it has taken until it returns."⁸⁸ This *hadith* makes obligatory upon the individual to return what he receives of properties of others irrespective of receiving that assets through usurping, borrowing, trust, renting or any other financial dealings. Thus, for the individual must return what he takes without legal possession, it implies that he is liable or responsible for its return. However, the Fiqh teachings also recognized the liability of guardians, parents, teachers or bosses upon the actions of their children, students or subordinates respectively. The Fiqh scholars have elaborated the responsibility of *ajir al-mushtrak* (common worker) for the works of his 'trainee'. For instance if something is destroyed in the hands of a student or trainee of a carpenter or a smith, the liabilities will rest upon the carpenter not the student. The compensation of the destroyed or lost thing will bear the carpenter or the smith rather than the student according to the limits of their customary partnership or prescribed by the boss.⁸⁹

The majority of jurists did not differ on the issue that an active partners who give the *Mudaraba* to another active partner in the *Mudaraba* will be held liable in case a loss is suffered; but if the profit is realized he will get his share according to the stipulated terms of the contract. In this forgoing discussions we may crystalize that the concept of liability holds in common active partner analogous to that of the common worker on wage or "*ajir al-Musharak*" The way the modern Islamic banking operates also confirms this view, for usually the bank guarantees the capital that it invests. Seeking *Shariah* grounds for this guarantee, the recent studies demonstrated three explanations (i) it is on the basis of cooperative insurance (ii) the banks is doing so on generosity and gift from its side (iii) the bank gives this guarantee on the basis of that it is common active partner or worker. Al-Khaddab has highlighted in his discussions on this points, he demonstrated that the consideration of the bank a liable to the capital loss on the basis of this cooperative insurance may not be conforming with the nature of the contract of *Mudaraba* as there is no rule showing opening an account for *wadi'ah*

⁸⁸ Subula Salam, vol.3, p.67

⁸⁹ Wahab Suhaili, '*Nahariyat al-Thamman*', p.257

investment on the basis of insurance. Then, reconfirming the above proposal he asserted, in fact the bank is working on investment operations on the basis of agency for the capital owners or on the basis of being common worker, so guaranteeing the principal on account of this is according to Khaddab near for the actual practice⁹⁰. And this view is considered the most appropriate and respectable. The bank gives the realized profit to the capital owners without fixing what it received in proportion to total profit. In this sense the bank is considered as *ajir al-mushtrak* or common partner/worker. And it has taken the fund to trade on *ujra* and given the remaining to the others. He made the observation that the modes of business transactions in Islamic banks are relying on the consideration of the bank as an *ajir al-mustarak* or agent on remuneration⁹¹, rather than the classical *Mudaraba* mode of financing.

8.5.4 Profit Distribution Under Common Joint - Enterprise

It is needless to mention that partnerships and any kind of business organization are set up primarily for sole objective of generating additional benefits and wealth through joint participation, then distributing the profit among share holders according to their shares and capacity of their participation in the business. Nevertheless, as the forgoing discussions advanced in relation to the profits of a private *Mudaraba* the jurists consider profit to be a safeguard for capital; this means that they were concerned about the safety of the capital, which is the basis on which profit rests. Therefore, if the principal is not safe, there is no any profit to think of or considered for distribution. The subject of the distribution is the additional value generated by the business enterprise over and above the original capital. Thus, the meaning of the profit as stated by the author of *al-Mughni* is: "the surplus to capital, and that if there is no surplus there is no profit we do not know any difference (among Fiqh scholars) in this regard⁹²." Thus if there is no surplus or profit nothing to be shared. The same meaning was cited in *Tabyeen al-Haqaiq* "that profit is subordinate to capital, and profit is not safe if the principal is not safe⁹³." Generally jurists agree that the 'actual outcome of the business to be determined finally at the termination of the enterprise. A final settlement is possible only at this time. Before, arriving at a profit the *Mudaraba* venture should be

⁹⁰ M. S. al-Khaddab. Ibid., p.112

⁹¹ M.Sh.Khaddab, Ibid, p.117

⁹² Ibn Qudama, Ibid vol. 5, p.51

⁹³ Al-Zayli'i, Ibid, vol 5, p.54.

converted to money and the capital should be set aside. Ibn Rushd writes: 'There is no difference of opinion (among jurists of Islam) on the point that the party working with capital acquired on *Mudaraba* would take his share of profit only when all the capital invested in the enterprise had been translated into cash when there is a loss and he should continue his work in the business until profit is achieved which first of all be utilized to offset the loss incurred'⁹⁴. Ibn Qudama also argued that an active partner will not be entitled to take any thing from the profit until he delivers the capital to its owner⁹⁵. Al-Nawawi also expressed the same notion that, "any profit acquired or collected by the investor before his capital matures and the capitalist recovers his capital is suspended. If he (investor) had received the capital then the sharing of profit is valid, otherwise it is void, because the profit is surplus to the capital and cannot be realized until the principal is safe"⁹⁶. According Hamoud the view of the jurists regarding the safeguarding of the capital was purely practical, they did not consider that the profit has been realized save when the capital has been reconverted into its original state, i.e. monetary terms, which must be possessed in the same units of standard value as which it was paid.⁹⁷

There is, however, a difference of opinion on whether it is legitimate or not to share out any profit that appears before the termination of business, and if it is shared, whether any profit that is shared out is wholly and permanently becomes the property of the possessing party or only partly and temporarily, in other words when the claimant of profit receives any profit so shared before the termination of the business is it mere temporary accrual or actual share that confers permanent ownership?⁹⁸ According to the majority of classical Fiqh experts profit is recognized and its ownership is proved only after the settlement of accounts and capital principal has been repaid to the capital-owner⁹⁹. Hanbali jurists are of the view that the working partner in *Mudaraba* becomes the owner of his share of profit as soon as profit accrues to him, but this ownership is fully established when profit is shared out after final accounting¹⁰⁰. The jurist's discussions on this point have focused extensively on the

⁹⁴ Ibn Rushd, *Ibid.*, 141.

⁹⁵ Ibn Qudama, *Ibid.*

⁹⁶ Al-Baghdadi, *Ibid.*, p.31.

⁹⁷ Sami H. Hamoud, *Ibid.*,

⁹⁸ M.N. Siddiqi (1985) *Ibid.*, p.28.

⁹⁹ Ali al-Khafif, *al-Shirkat fil Fiqh al Islami*, p.86.

¹⁰⁰ *Ibid.*, p.86.

maintenance and complete restoration of the principal. Whenever there is a matter of profit distribution. The parties entitled to profit from the business can claim their share of profit only when those who supplied the original capital have had their investment returned to them in full, whether in actual terms (as cash in hands) or in the form of legal transfer.

The Fiqh scholars have envisaged that for the existence of profit the restoration process of capital is very basic prerequisite. However, the restoration notion does not essentially calls for termination of the business. This process can take place regardless of whether the distribution of capital is given in cash to the owner or in legal form. That is to enable the capital owner to raise his share of ownership or spend or save it or reinvest it by entering into a new agreement with the same party or parties. This is de jure restoration in which the principal is not actually handed over to the capital owner but it is fully put under its control and disposal for this actually becomes part of his capital. According to the recent studies of this issue the legal transfer of the capital and its incremental growth from time to time is practically feasible from the stand point of business efficiency and the convenience of transactions. Most of the business transactions in the modern age are done with money deposited in banks, where, the amount of money that exists in a person's bank account is possessed by him exactly as the amount that he has in hand though this possession is de jure and not de facto. And if a person enters into a *Mudaraba* contract with a bank it would be sufficient, as far as the concluding of the agreement and the distribution of profit is concerned, the original principal amount is credited to his account, and the bank will use it according to owner's wish¹⁰¹. An answer for question recently raised in this connection states that "liquidation actually is the principle for attaining the profitability of the *Mudaraba*, because through this only the determination of the principal is possible. Then the expenses would be figured out and the net profit subject to distribution would be determined. However, since, *Mudaraba* in the Islamic banks becomes linked to scheduled periodical fixed time and continuous in operation for its collective nature hence an estimated liquidation or evaluation, would become necessary alternative to the actual liquidation of each time. For referring to the actual cost is a legal principle in many practical interpretations of Fiqh injunctions."¹⁰²

¹⁰¹ Siddiqi, Ibid., p.36-7.

¹⁰² Bank Dubai al-Islami, *Al-Mudaraba*, No.2, 1996. p.19-23, The Resolution of Fiqh Council Jiddah also confirms this answer

The next important question is among participants of the enterprise who is entitled to profit and on what ground, in other words what determines the right to claim profit? . There is a general view that entitlement to profit is primarily due to at least one of the following three elements namely; ownership, work, liability to loss or guarantee against risk. The Fiqh scholars have thoroughly discussed these factors that determine the right to claim the profit Al Kasani of Hanafi school provides a rational arguments for the underlying reasons of entitlement to profit and states that "the rule in our view is that entitlement to profit is either due to the wealth (*mal*) or due to the work (*al-amal*) or by bearing the liability for loss (*daman*). As for entitlement due to wealth it is obvious, because profit is a growth in wealth and belongs to its owner. It is for this reason that the *Rabb al-mal* in contract of *Mudaraba* is entitled to profit and likewise the partner(*sharif*). In the case of *daman* (liability for bearing loss) if the *Mudarib* were made to bear the liability for loss he would be entitled to the entire profit (of *Mudaraba*) this due to his *daman* and it is the *al-kharaj* (out come) of *daman* as the Prophet (saw) stated that '*al-kharaj* is in consideration of liability'. Thus, if the liability for bearing the loss falls on him the *kharaj* belongs to him too".¹⁰³ Nearly a similar view but in case of *daman* expressed by Ibn Qudama of Hambali school stating that "In our view, *daman* is the basis for entitlement to profit in *Shirkat al-abdan* (work partnership). The acceptance of work involves *daman* . . . and provides entitlement to profit. It is therefore, similar to the acceptance of wealth in *Mudaraba*. The worker through his work is entitled to profit it is, thus, like a *Mudaraba*."¹⁰⁴ In this case the concept of *daman* is acknowledged as the basis for entitlement to profit. In this forgoing juristic deductions we find that there are at least three reasons for entitlement to profit: capital/wealth, work, and the liability for bearing loss. However, we see that the combination of *daman* with either wealth or work increases the level entitlement to profit in which as Kasani observed the assigning the work as well as *daman* to the *Mudarib* may entitle him to the total profit. But this seems to be extreme case where the *Rabb al-mal* the owner of capital will gain nothing. Ibn Qudama acknowledged also the work and *daman* may go together in *Shirkat abdan* similarly in *Mudaraba*, although that may not necessarily deprive of the other partner or capital owner the right of entitlement to profit. Putting these two views together we find that *daman* usually goes with the ownership. However in partnership contract and business dealings these two factors may be separated

¹⁰³ Al-Kasani, *Badai' al-Sanai'* vol.7, p.3545

¹⁰⁴ Ibn Qudamah, *al-Mughni*, vol.5, p.7

where *daman* may sometimes go with the work like *Ajir al-mushtrak* (common worker) and sometimes independently established borne by third party outside the enterprise, for instance, insurance agents. As for liability, money is guaranteed by active partner, he becomes entitled through setting the guarantee versus *al-Kharaj*. In the opinion of Ibn Qudama a guarantee entitles man to a profit as it is evident in participation of the enterprise .

Examining the business forms on the basis of these considerations, it becomes very obvious that in case of proprietorship, ownership, work, and liability may concentrate on one individual provided that he may not enter in insurance contract, but if he ensures his business from an insurance agency, he would gain profit on due to the first two grounds, while the liability for the loss resulting from the considered risk wills rest on the insurance company. However, in case of the partnership the entrepreneur could be entitled to profit for his work alone, or acquire more profit if he also takes the responsibility of the guaranteeing the principal against a defined risk. So, guaranteeing both profit and capital he would be entitled to higher rate of profit. Similarly if the responsibility of the guaranteeing against capital loss falls on the capital ownership, it is very reasonable that he should be entitled to higher profit rate. But practically, it is appropriate that the working party to take the responsibility of guaranteeing the capital than the *Rabbul mal*. For the individual is responsible for his own actions and decisions or choice preferences. If we closely examine the relationship of the investors and the common working partner, we would find that the collective capital belonging to numerous financiers jointly organized their fund by the active entrepreneurial partners enjoys protection, where the active partner becomes, as we mentioned above, liable for the capital loss unless there is natural disaster or general economic crises beyond his control, on the basis of the Fiqh maxim "No liability for what its avoidance is not possible"¹⁰⁵. Hence, given the active partner is competent entrepreneur who works in common joint enterprise or corporation for numerous capital owners with the existence of insurance against any threat beyond his control, then there is no reason to believe that fixity of profit in advance creates problem.

¹⁰⁵ Sh. Mahmoud Hamsa, *Al-Fara'id al-Bahiya fil Qawa'id al-Fiqhiya*, p.62

8.5.5 Profit Sharing and Predetermination

In general the pertinent question in Islamic business activity is the 'source of return' and the 'nature of the debt contract' rather than its fixity and variability of the rate of return. However, the predominant view in the current literature regards the proportionality of the rate of profit between the owner of capital and the entrepreneur as the most important condition for the validity of *Mudaraba*. Nevertheless, as we have seen in the preceding chapter the assumption of the predetermination or the fixity of the rate of return has been excessively relied upon, not only as a necessary condition for the validity of *Mudaraba* but, apparently the sole criteria for differentiating profit from *riba*. Some of the contemporary Fiqh scholars see this view as an extreme position not justified by the Shariah principles. They see that fixity of the rate of profit by the owner of capital will not invalidate the *Mudaraba* contract, if it is mutually agreed upon. They are also of the view the continuation of *Mudaraba* and its periodical valuation, according to the method of sharing the realized profits. Although, someone must be very careful about giving general permission to the practice of commercial or investment banks because, that permission make banks to misuse financial modes which may imply accepting certain kinds of *riba*-based activities, however, as far as the point of profit distribution and liability of the entrepreneur is concerned the concept of fixity and variability in the context of risk and certainty must be carefully deliberated and revised on the light of modern business complexities and Islamic principles of finance. Hamoud suggested that keeping the continuity of the business operation. It is appropriate that the division of the profit to be effectively periodical i.e. on annual basis just like joint stock companies and the method is devised to pay periodic return to the investors on certain specified dates. At the end of each year the computation will be made of the profit realized with the view of allocating them proportionately to the capital set aside for investment, regardless of such money belongs to the investors or is the common property of the investors and the common active partner. In general, there is a similarity between this application and professional partnership where one partner works but the other does not work, the profit is, nevertheless, to be shared by both parties. According to Hamoud the same thing applies to the financial company, where entitlement to profit is not related to the existence of growth of the financial property but is based on mere availability of the growth for the owner's disposal. He concluded his proposal that the main lines of the common joint enterprise as a collective system which characterized by flexibility; as an aptitude to satisfy the objects and requirements of modern investment. It

is multi source capital which by nature is dynamic and progressive.

Moreover, the reality of our modern time necessitates that the rate to be fixed for the weaknesses of Muslims in their moral values and increase of cheating and dishonest behavior among societies. Sh. Abdul Wahab al Khallaf a prominent Shariah scholar (ra) held the view " If a person provides i.e., a thousand pounds to a merchant man or property dealer to make it business and pay a fixed amount of fifty pounds per annum to the capital owner, I see this to be a *Mudaraba* and a partnership between two parties where one of them is participating in his capital and the other in his labor or even both, and the profit which obtained by the merchant (active partner) is profit of the money or the property and labor together, otherwise the other partner may misappropriate it"¹⁰⁶. The contemporary Fiqh advisory boards of Islamic banks also confirm this view, where it is permissible that Islamic banks and financiers or active partners to stipulate in their contracts a fixed amount entitled to the investor or the entrepreneur. In this connection a question has been raised whether it is permissible for the two parties to decide that above certain level of the profit to be for either party, in other words 'is it permissible that the *Rabbul mal* to agree with the *Mudarib* (bank) on that, if the profit exceeds certain percentage i.e. 15% per annum this increase would be for the *Mudarib*? The answer given in the first seminar arranged by *al-Baraka* Islamic bank expressed that this condition is permissible in Shariah as long as the profit is divided as the result of the defined/calculated proportions agreed upon in the contract.¹⁰⁷ In a seminar the participated Fiqh scholars expressed permissibility of this stipulation in Shariah as long as the profit is assessed and distributed according to standard accounting procedures on the basis of static expectations and as long as the investor is ready to bear the loss if any.¹⁰⁸ The view was justified, because, it is in case profit exceeds given level the stipulation does imply to complete the total profit.

Therefore, profit-sharing is a matter of distribution hence, it may associate with *gharar* but it cannot be subject to *riba* at all. Thus there is no conversion of profit into *riba*. The question of fixity and variability of profit rate is related to *gharar* context which is, as we have

¹⁰⁶ Sh. Abd al Wahab Khallaf, *Liwa'ul Islam Magazine*, Issue No.11,195, or *Al Halal Wa Haram Fil Mu'amalat al Bunuk*, Tantawi, *a-Ahram*, 1992, p.22.

¹⁰⁷ Resolution No.4, Bank Dubai al-Islami, *Al-Mudaraba*,. No.2,1996. p.23

¹⁰⁸ Shariah Resolutions, The Second Conference on Islamic Banking, Kuwait, March 21-23, 1983

elaborated in the preceding chapter extensively tolerable and completely different from *riba* sphere. It is also pointed out that since profit arises from combined function of both capital and labor and it is expected that both of them are getting their reward from profit not from the principal capital there may not be any harm whose ever reward is fixed. And there may not be problem how the yield or outcome is distributed among input factors. It may depend on the terms of contract and nature of the business activity, entrepreneur's characteristics, integrity and honesty or organizational structure of the enterprise. Given these circumstances whether it is feasible to fix the reward of the capital or that of the labor or even both is a matter of distribution as long as it is referred to the return rather than the principal or as long as the return is considered with the level of activity's outcomes. We have discussed in detail the basic sources of return in our lengthy investigation for the determining factors of "excess value" in Islam and rationale of the prohibition of *riba* and the permission of profit. From these discussions we have concluded that profit is based on natural trade of different goods and services and production process is prerequisite for it as long as there are real transformation process which generates value added. So profit is nothing except in actual return or increase of value without reducing other's property or value.

The Muslims are free to make conditions in their financial transaction and they have to comply with their stipulated measures once they decide with mutual consent. If the common active worker offers condition or the financier put it forth and both parties mutually agree to provide a fixed amount of the profit annually with the guarantee of the principal it must be fulfilled. It is reported from Amrin Bin Auwf that the Prophet (saw) has expressed "The Muslims are bound by their agreements unless they hold a permissible thing as prohibited or prohibited thing as permissible".¹⁰⁹ There is general agreement among Fiqh scholars on the legal maxim in this connection which states that the agreed conditions must be observed to the maximum possible. It is not necessary that the stipulated condition hold advantage all the time. Shafi'i holds this view that stipulation must be fulfilled even though it may not be some times beneficial.¹¹⁰ Complying with the agreed principles is more beneficial for acquiring small gain.

Therefore, if it is intended for investment it must be drawn in terms of the

¹⁰⁹ Tirmidi,

¹¹⁰ Al-Mhaddab, vol.1, p.359. Mughni Muhtaj, vol.3, p.84

economically viable financial modes including common joint *Mudaraba* or equity constituted of capital owners or ordinary share holders preferential share holders and salaried or profit sharing entrepreneurial services. This may create an efficient secondary market operations based on different kinds of shares and security certificates. Where ordinary shares may have a right to whatever surplus or residual income is left after the fixed claims and contractual obligations are met. Muhammad Muhsin (1992) have scholarly elaborated the various possible schemes of priorities which may be arranged for the distribution of profit among share holders with respect to their responsibilities and capital share.¹¹¹ The profit distribution is internal matter which is agreed upon between the parties at the time of issue of such shares. The management of the corporation and those who supply capital agrees on the terms of the issue that the latter will associate it purely as a sleeping partner without interfering absolutely in the management of the business or having any voting rights or participating in decision making. Compensating the dissatisfaction faced by the holders of these shares in keeping away from the process of decision making inside the corporation, they are provided priority and secure return. Because, it is the active participants who decide the feasible return that goes to the inactive share holders on the basis of given business circumstances. However, whether the rate of return to preference shares is fixed or variable, it should be with the considerations of the actual return on investment and with the general consent of the ordinary share holders. Thus the difference in profit distributions and its fixity or variability may not associate with any problem as long as these two conditions are observed. As Muhsin Khan has observed "Business, may require capital for only a part of a brief period of employment or it may want to offer a permanent stake."¹¹² The diversity in business needs may also coincide with the diverse circumstances of supplier of capital. Some may seek permanent partnership and are willing to and capable of assuming risk, others may desire to part from liquidity only for a short period. Thus, the issue of a variety of shares to cater to every sort of taste ultimately helps the business in attracting funds for its own needs.¹¹³ Therefore, the financial institutions based on Islamic principles must offer diversified forms of profitable options with different business returns, maturity, rights and responsibilities for instance, some contract may be permanent, others may be temporary, some may carry voting rights others may not.

¹¹¹ Muhammad Muhsin, (1992). Assessment of Corporate Securities interms of Islamic Investment Requirements. in Sh. Aboud Ghazali, et al (eds.), An introduction to Islamic Finance, p.192.

¹¹² Muhammad Muhsin, Ibid.

¹¹³ Muhammad Muhsin, Ibid.

8.6 CONCLUSION

1. Islam has not prescribed a particular form of business organization for financial enterprises. There is no specific format determines the legal position of business conduct in Islam. As far as the structural set up is concerned any form of business arrangement is permissible as long as the rights and responsibilities are agreed and mutually defined by the participants. Hence, Business organization in Islam can take any of the contemporary forms proprietorship, partnership and joint stock or corporations.
2. *Mudaraba* and *Musharaka* as the basic components of profit-sharing system are very flexible and modifiable to cope with the business complexity of our modern age. Both of them have inherent tendencies of integration to form common joint stock enterprise or corporation without losing their essential features.
3. Profit-sharing in Islam is (*Mudaraba* and *Musharaka*) are applicable to all economic sectors i.e. trade, agriculture manufacture and services. It applies to all kinds of profit-oriented business activities. Hence, it is not independent mode of financing parallel, as may be presumed, with *ijara*, *Murabaha*, *stisna'* and other financial techniques.
4. We have elaborated in the preceding chapters that the necessary condition of profit is the conversion or transformation of goods or asset from one state to another through production process, such as, manufacturing, growing, or through simple commercial transactions. In fact, this criterion serves as the basic indicator of the difference between profit and *riba*. In this sense fixity of profit is subject to *gharar* to the extent the actual return deviates from expected level. However, the fluctuations of the profit rate taking into account where the risk of uncertainty and gain from the business are fairly distributed, would reduce the *gharar* to negligible level.
5. There is a great difference between *Mudaraba* to be invalid and the prohibition of *riba*. The invalidity of *Mudaraba* when the profit is fixed in advance does not mean necessarily the contract to turn out into *riba*. The invalidity of *Mudaraba* due to the

fixity of the rate of profit does not convert the originally *halal Mu'amala* into *ribawi* transaction. Although *Mudaraba* is considered invalid in this case the Fiqh scholars consider its outcome to be permissible which must be distributed according to the prevailing business norms, where *Mudarib* would be regarded as worker and he gets a remuneration equivalent to market wage rate and the owner of the capital will get the remaining. There is no indication in Fiqh literature that the return from invalid *Mudaraba* to be equivalent to prohibited *riba*.

- 6 However, the fixity of the rate of return in Islam should be determined by the real indicators of the actual economic outcomes. It is not volatile so that it may vary with the slightest changes in the market performance for Muslim financiers are expected not to be so parsimonious to capture a minute change of profit levels. At the same time it is not permanently a given rate of return under whatever the economic situation on the ground may be, for this may harm the investors during the economic recession. The *hadith* of the Prophet (saw) is very relevant in this context. It is reportedly expressed that the messenger of Allah (swt) forbade the sale of the crop of a grove for some years and he told that some allowance should be made for loss suffered through a sudden calamity¹¹⁴." Perhaps this teaching of the Prophet indicates a balancing measuring between the above extremes.

¹¹⁴ (Muslim: *Ma'arif al-hadithi* 521) English Translation, p.357

CHAPTER 9

GENERAL ECONOMIC BEARINGS AND POLICY IMPLICATIONS

This chapter presents the economic implications of the theory of *riba* in its integrated form of excess value which has been presented in earlier chapters. How these interpretations of *riba* and profit are applied in economic policies, what kind of application can be concluded in the context of efficiency & resource allocation. Equity and income distribution and stability, as well as controlling inflationary pressures and preserving monetary value will be discussed. We will comparatively study the impacts of a conventional term of interest, profit and profit sharing and the prohibited concept of *riba* in Islam, according to the interpretation of the term in this research. The main points of the arguments in this chapter may be formatted in the following manner. Section 9.1 outlines the implications of *riba* on the economic efficiency and resource allocations, trying to remove some of the apparent points of contention between conventional perceptions and contemporary Islamic economic conceptualizations. Section 9.2 outlines the equity and income distribution on the light of this discourse and its implied measures. Section 9.3 elaborates some of the inherent causes of economic instability and alternatively Islamic precautionary measures. Section 9.4 presents the inflationary problems and current thinking. It will briefly review the major sources of inflation and the present paradoxical situation of restraining it. Although there are almost general agreements on the demand management policies being the significant causes of inflation, the proposed general indexation schemes. Section 9.5 examines the nature and conceived legal impediments against indexation. It aims to resolve the present conceptual deadlock arises from the inconsistency between the demand for indexation in order to maintain the original value of loan contracts and the prohibition of *riba* in Islam.

9.1 EFFICIENCY AND RESOURCE ALLOCATIONS

The allocation efficiency of an interest free-economy has been an area of major concern for the Muslim economists. While reviewing the contributions made in this field, one has to bear in mind that full fledged Islamic economy does not exist in the present literature. Many of the proposed advanced in the available contributions are yet in the nature of a hypothesis rather than definitive conclusions derived from observed behavior of an Islamic economy. The

existing literature focused on demonstrating with repeatedly strong assertions that demand for investment at a given expected rate of profit will always be higher in an Islamic economy compared to other economies. Since the investment is one of the most important determinants of the rate of growth, it flows that an Islamic economy would have pronounced growth orientation. However apprehension is some times expressed that savings which are essential for capital formation and economic growth would be discouraged in an Islamic economy because, of the prohibition of an interest rate. Some of the Islamic economic writers have gone further to the extent of recommending that all savings will cease at a zero rate of interest. It is argued the people have positive time preference and hence unless the interest rate is positive the positive time preference cannot be transformed in to negative. However, in a system based on Islamic principles, the saver will continue to get a return on his savings the only difference according to IIC reports would be that instead of being fixed in money terms the return would be variable. But still this intuitive suggestion may not answer the problem. Probing further into this matter, it can be argued that the fact of variability of the return on saving including to the extent of incurring losses may discourage saving. Moreover, in the situations of inflationary pressures the savers in Islamic economy face a double uncertainty to the extent of the reduction of the nominal yield as well as the real value of their principal¹.

9.1.1 The Contemporary Thinking

There are no doubts that profit to be the main criterions for the allocation of financial resources. It is the decisive factor in determining the sources of a new project serving as the rate of evaluation thus the rate of profit represents a mechanism of allocation of resources which is the sole drive for effectiveness and efficiency in any economic enterprise. As the real participation of capital in the production process, Islamic or unIslamic or otherwise, definitely yields return from Islamic perspective. This return is preferred in Islam not to be predetermined but a common and proportional share in the actual or estimated realization of profits. We argue in this context that profit determines the efficiency of resource allocation without linking its rate to the existence of risk and uncertainty we assume risk as cost, and we are talking something above all costs including any expected risk and uncertainty which may be paid as an insurance premium. The decision of participating in new projects is

¹ Ziaudin Ahmad et.al (eds.), Fiscal Policy and Resource Allocations in Islam, IIE IU. Islamabad, 1983, P.7.

controlled by the profit rate alone, as this rate rises then the chance that the project, regardless of its size will receive financing or participation in financing increases. Abdil Hamid Ghazale (1994) asserted also that the rate of profit is not only relatively more efficient in the allocation of resources but it also more effectively limits the development of monopolistic tendencies. Islamic system can practically achieve justice for both the saver and the investor in profit sharing system as neither of them gets before hand by guaranteed or fixed return they both share the risks and results².

One of the objections raised against interest-free economy is that it will not be able to bring about an optimum allocation of resources, the reason given is that the interest is price and like any other price it performs the function of allocating scarce loanable funds among the infinite users such funds in an objective manner on the basis of ability to pay the price. This view is based on two assumptions; the absence of the interest rate the demand of loanable funds would be infinitely large and there would be no mechanism of equating demand with supply, as a result of this assumption, it argued that the financial resources will be used inefficiently to the detriment of the society. It is also assumed here that the interest rate is so a successful mechanism in allocating resources optimally and that profit cannot perform the function efficiently. However, the analysis of capital in western economy rests upon an unrealistic assumption of existence of certainty or perfect foresight holding this is the interest rate equilibrium always equal to MP_k . In this unrealistic analysis, any possibility of a "zero interest rate" existing in equilibrium in a real world is conditioned by an acute scarcity of capital. This can be realized only if the availability of capital is assumed to be unlimited. Being not so, the alternative puts forward a gloomy picture which is the possibility of a zero equilibrium as Samuelson assumed in the case of very severe depression, or an ensuring economic choice in using scarce capital, without interest which to some economists would lead, for sure to an economic catastrophe. Conventional theories postulate a positive relationship between saving and interest rate. By implication it is argued that saving would be zero in an Islamic economy where an interest rate must be zero. Syed Nawab Haider Naqvi observing the matter from saving perspective argues that given positive time preference, zero interest rate will lead to negative saving³. Nademul Haq and Abbas Mirakhor (1985) have

² Abdul Hamid Al-Ghazale, *Interest vs. Profit*, IRTI, IDB, 1994, p.22.

³ Naqvi, S.N. Haidar, *Interest and Resource Allocative Efficiency in Islamic Economy*, in M.Ariff (ed.) *Monetary and Fiscal Economics of Islam*, ICRIE, KAU, Jeddah, 1982, p.75-95.

observed the problem from an investment side while ignoring the saving condition. They claimed that under profit sharing techniques the level of investment will increase because of elimination of interest will allow the firms to invest up to a level where marginal productivity of investment becomes equal to one. According to this view the investment is to be undertaken until the return or profit on the last unit of money invested becomes zero. Waqar M. Khan (1985) shares also this line of argument. Precisely, the main contention is that the profit-sharing techniques mean zero interest which equals to zero-rate of return on the investment. Therefore, investment operation can continue under profit-sharing system until its marginal productivity becomes zero. Fahim Khan replied to this situation to be untrue. According to Fahim (1995) a profit-maximizing firm will continue investing until the marginal productivity of capital becomes equal to the opportunity cost of capital which represent the rate of return on alternative opportunities for investment of comparable nature, otherwise, investing the capital where it gains a lower return is inefficient and shows waste of resources⁴. During the operation it is recommended to evaluate the investment by using expected rates of return, but the proportions should be distributed according to the actual rate of return. According to Ghazali, the view of elimination of interest to a mean zero rate of return, lumps together two contradictory and totally different issues "elimination of interest" when the alternative (i.e., profit) is available and zero an equilibrium rate of interest. The incompatibility of these two criteria is manifest and there is a clear difference between the two. Ghazale argues that Islamic economics has not eliminated the rate of interest on the theoretical and practical levels to induce this zero equilibrium as this would in a fact amount to real waste of acute scarce resource, i.e., capital. Instead Islamic economics proposes profit as an alternative to interest, on the other hand the eliminating of interest does not mean at all eliminating a return on capital and extending it to those who need it in free of charge⁵. Each successful act of productive enterprise takes the society forward as its resources are transformed into objects of greater value as the increment in value produced (profits) accrues to the entrepreneur in the first instance the entrepreneurial skills are directed to where it is expected to be maximum where the need of the society is high. In this way the real rate of return or profit determines the allocation of resources rather than *riba*.

⁴ Fahim Khan, *Essay in Islamic Economics*, Islamic Foundation, 1995, p. 92

⁵ Abdul Hameed al-Ghazali, *Ibid*, p.23.

Thus, Islamic economists have a common view that profits to be the main factor which controls the allocation of financial resources, it is considered the decisive criterion in determining the success of a new project serving as the rate of evaluation, thus, the rate of profit represents an effective mechanism and efficient allocation of economic resources. Someone may wonder to see that even Islamic economists recognize though, in capitalists economy, both profit rate and interest help allocate scarce capital resources effectively if not efficiently. In Islamic economy where the interest rate has no legitimate role to play, the question of efficiency in resources allocation in Islamic economics will need for clarification. The search for an alternative mechanism is by no means over. Many Islamic economists believe that profit sharing would provide such a mechanism in the absence of the interest rate. It is so because investment in Islamic economy refers to the committing of capital resources to productive uses, although in recently investment is often related to the rate of profit rather than to the rate of interest, where in the conventional theories of investment assign interest to capital factor and profit factor to enterprise. Further more, since the concept of profit sharing in Islam is so attached to the existence of joint enterprise, the question of distinction between capital and enterprise has got considerable attention in the Islamic theory, nevertheless, in a realistic point of view, both capital and enterprise are subject to the same reward, namely profit. Hence, there is nothing un-Islamic about drawing a line between the two not only in theory but also in practice. Uzair is of the view that capital cannot be treated as a separate factor in Islamic economy and that it should be merged with enterprise, capital being the physical manifestation of enterprise.

Islamic economists emphasize that what makes the profit-sharing permissible in Islam, while interest is not, is the variability of the return which is in the form of a ratio and not the rate of return which is predetermined. Profit and profit sharing are thus legitimate in Islam. Islam while it strongly condemned the concept of *riba* the profit seeking has been at the same time encouraged, but through exchange. In economic literature the postulation of profit maximization, as understood to consist with both normal and abnormal profits in the sense of the equation condition $MC=MR$. in both instances. In this narrow mathematical sense the profit maximization principle can be considered as neutral. But, Islamic economists on the basis of this principle of profit maximization are value-loaded in capitalist philosophy, they perceive that the assumption of profit maximization has no place in Islam. They contended that profit maximization cannot be an important motive of private enterprise in an Islamic

framework. So, to them profits with moral goals are the moving forces of the private sector in Islamic economy. Zubair also argued that the pure competitive economy may consequently lead to monopoly. He asserted that the model of competitive economy in secular economy is based on the desire for self entitlement disciplined by competition which by virtue maximizes the social product through the invisible hand of self interest makes the free enterprise system both efficient and equitable as also primitive of growth. Uzair argued that the model of perfect competition tends to destroy itself the model ignores an important gesture of profit, as however small the profit might be it multiplies as more and more units of the product are sold which by this profit multiplication process must eventually hang perfect competition by the noose of its making⁶. Each firm can increase its output without changing the price of the factor or the price of the product or the marginal product of a unit of a factor where the firm is making some kind of profit and increasing this profit is to increase the scale of its activities. This would make some firms large enough to be able to influence the price at which they sell the product or buy the factor

9.1.2 Further Developments

As far as the notions of efficiency and resource allocations, equity and income distributions are concerned it is pertinent to keep in mind certain natural considerations of economic phenomenons which perhaps establishes the basic foundations of price theory in Islamic economy, such as: (i) difference in proportions of endowment resources, (ii) difference in skill, capability, intelligence and knowledge of people, (iii) difference in the cost of production of goods and services, (iv) difference of preference and taste of consumers (v) inter-temporal discrepancies of wants and economic resources. In chapter five we have concluded that both *riba* and profit or according this research what we call excess value is basically an exchange phenomenon. Both *riba* and profit could be clearly assessed exclusively in the context of exchange in its broad sense. Where, in this context of resource allocation someone may refer to the entire of what we have established in chapter five, we would like to reaffirm our previous argument on the difference of *riba* and profit not only in a legal point but purely an economic point of view. Given the above economic situation with deep concentration of the

⁶ Zubair Hassan. Profit vs. Secular Reading Microeconomic in Islamic Perspectives 1991 P: 243.

role of *riba* and profit, one can easily understand the role and economic function that each would perform.

i. Profit as the vehicle of efficient resource allocation

In case of profit-based economy, profit by nature associates with trade and why people trade? It is due to the difference in their endowments, skill, costs of production and difference in their human taste. It is an established fact that people benefit from the variety and differences of resources. It is also natural truth that no one would have every kind of resource or can do all kinds of works efficiently but he would have desire for every beneficial good or service, it is given that some different parts of land hold different resources, and human capacity has its own natural limitations, someone to perform certain task efficiently requires that one to become specialists in that particular work or production. This is perhaps, essential for efficiency in production.

We all know that specialization and labor division lead the economy towards efficiency let us see this in three levels. Production consumption and exchange. In each economy agency specialize in the field which he can do the best and factors of production are employed in such a manner they can produce their optimum level of production. As generally each individual or economic agency can specialize only a single economic activity, i.e., in production of goods or services, it is fair to expect that each one produces only a single commodity or services that which he can do his best, in terms of quality quantity or cost reduction. If all economic agencies are working in this manner then economy is efficiently functioning. Assuming that each commodity or service produced is normal and permissible in Islam which satisfies a specific kind of want or need. Then the more its quality is improved the more it would satisfy its corresponding demand and that is what efficiency in production implies. Any successful act of productive enterprise takes the society forward into greater as its resources are transformed into objects of greater value. As increment in value produced (profits) accrues to the entrepreneur in the first instance, entrepreneurial activities are directed to where it is expected from maximum reward. And we know that profit would decrease with the increase of competition among firms. Therefore, the entrepreneurs can increase their reward (profit) through improving their efficiency of production, either in cost minimizing or quality improvement or expanding their variety of their production. If an economy is growing in all

these directions simultaneously, this is a significant indication for economic development and better resource allocation as far as the production efficiency is concerned. The basic driving motive of all these is seeking for more profit, where each firm is not producing the goods or services to consume it, but to exchange or trade them to those who need it through the exchange of goods and services among societies where each one is producing or supplying something in order to acquire a variety of things, is the way of generating higher welfare and economic well-being. Simply if each specializes what he can do relatively in efficient way would imply that each has something to sell in order to purchase many things produced different individuals or economic agents.

We have assumed that each good or service satisfies a particular demand or need, while the wants are unlimited, so each individual desire numerous kinds of goods and services, in which the more goods and services he has, the more his welfare would be or welfare will increase, where specialization demonstrates that each individual has specific production or service to supply. The consumer's desire will increase as the quality of that good increases, but if each consumer uses only his own good or service his very existence may get in danger rather than to think about welfare. Therefore, each one can improve his welfare by consuming more different goods instead of one single good or service. Thus the consumer who has access to more different kinds of goods or services are relatively better than the one who has access to only small number of them. Then each consumer to maximize his utility should get access to most available goods and services but with proportionately less quantity than if he were to have only few. As specialization is the essence of efficiency in production and resource allocation and utilizing variety of commodities and services, these are essential to welfare optimizing. The exchange of goods and services is an indispensable mediator of production and consumption, which channels the goods and services to their use. Production itself is considered, as we have mentioned earlier, indirect exchange for producing certain goods undergoes different kinds of transformation process, and channeling them to their best use through trade is the second stage of exchange, since producing a bulk of goods without directing to their utilization implies wasting of resources. Thus we may conclude that profit is the basic motive of the whole exchange activity and it serves as the essential economic spirit that determines the efficiency in resource allocation. Profit is feasible as long as the natural differences exist in endowments, opportunity cost, skill and capability and human preferences or taste. So profit based economy is basically market economy.

Each economic agent may choose to engage the services and economic activity which he feels easy and with efficiency or hired in return for other goods and services which he has no but others have. So he will spread his own one in large number of consumers or producers where all will raise their welfare. Through market process and all will gain something or at least will not lose anything. Without exchange it is impossible or difficult each to survive individually. But in mutual exchange all will raise their well-being. That is only through exchange of different goods which is the actual trade of profit generating one.

ii. Efficiency of financial intermediation

Financial intermediaries increase the efficiency of the financial market. Islam strongly recommends efficiency in every aspect of human activity. Suppose the bank which operates on the base of *Mudaraba* and *Musharaka* modes of finance in its investment may have limited application on the liability side. However, the bank has an ability to minimize the total risk by spreading their investments to a large number of clients on the asset side. The large the portfolio and investment spreading the lower the risk would be other things remain the same. But, there may be higher risk of concentrating the *Mudaraba* fund to single *Mudarib*, this may be due to diminishing marginal capacity of entrepreneurship, analogous to diminishing marginal productivity of labor. One can infer from here that the productivity of the enterprises increases at declining rates as more and more capital is invested at a single entrepreneur. Thus, it is obvious that a rational *Mudarib* will demand capital to the extent his total profit is maximized or at least he retains a profit rate that matches the prevailing market wage rate. It is observed that with the increase of efficiency, skill and experience of the *Mudarib* the production may increase and risk may be reduced and as a result profit would increase. However, the productivity and managerial capacity of the entrepreneur have its own natural limitations. In addition to that the production variation is considered as we mentioned above as the way profit maximizing on the part of the firms and the means of economic well being on the part of the whole society. Therefore, the portfolio of resource allocation and investment diversification seem economically the best option that leads to efficiency in financial diversifications and risk minimizing. Studies on this subject show that although the bank may not be able to make excessive profit, but there is no priori reason that it will not

make a comparable return⁷. The scholars writing on the theory of Islamic banking argue that Islamic financial system based on *Mudaraba* and *Musharaka* to be efficient and suitable instruments for the banking system for the following advantages.

- It is consistent with financial intermediary nature of the bank by simply selecting a suitable entrepreneur and investing its funds with him and both parties share profits or outcomes in pre agreed proportions and according to the terms of contract.
- It is capable of being utilized for varying periods of investment with different entrepreneurs, at various volumes, allowing the bank to choose a whole spectrum of varying degrees of risk and return.

However, in case *Musharaka* a number of advantages over *Mudaraba* case would be realized namely; the possibility of a moral hazard may be reduced for the entrepreneur should be making his own investment as well because, in this case he is required to contribute capital also as a prerequisite of the enterprise. Similarly the problem of informational asymmetry too, would be reduced as the bank also has a right to interfere in the management of the project in which it has invested. The bank is able to invest largely because the clients owning large stakes in the business will not put the finance in a risk. It is possible to do *Musharakah* for long as well for short periods in different sectors of the economy. The bank may select from a large number of finance seekers, such parties with which the bank may not need to get involved in the management hence the bank may do only the financial intermediation

iii. Riba as the Root of Scarcity and Inefficiency

The adopted interpretation of *riba* in this research as we have elaborated in chapter four is simply selling something in exchange of itself at higher price. And as it may appear from its basic definition, it negates the principle of price theory, where pricing something in relation to itself it is essential that the value should be the same for it is simply two equal parts of the same best. Where in each commodity may have different relative price with any other good, it can have only single price in respect to itself in given period of time, provided that its value content or quality remains the same in that period. In this context, the concept of *riba* implies

⁷ Fahim Khan, Essay in Islamic Economics, *ibid*, p.93

that any thing that is produced should be either consumed by the producer or sold in terms of itself at a higher rate. For instance, if a wheat producer sells on *riba* he is expecting more wheat to be returned to him. And a similar will be the case of a gold producer to sell for more gold, etc. Each one is producing to sell his production or resources in order receive more of the same things. It will have unimaginable economic implication. Someone may think this to be an unrealistic situation which has no any existence in the practical life. But he may wonder when he realizes that this is the fact and dominant features of modern economic system. Before, we try to think what strange economic implications this situation might have. It is very important to note here the truth that mentioned by the Prophet (saw) before fourteen centuries. It is related to Abdallah bin Masud that the messenger of Allah (swt) said:

"However, plentiful (flourished) the *riba* (economy based on *riba*) may be, its end is want and scarcity." (Musnad Ahmad, Ibn Majja and Baihaqi)⁸.

Someone, may ask how does *riba*-based economy generate scarcity and wants? The commentator made the observation that if the word *Aaqibathu* which is occurring in the original text is taken to a mean ultimate end of the Hereafter, it is the general believe of the Muslims that everyone will see with his own eyes that the people who had made immense gains through *riba* will rise as paupers on the Last Day and the wealth they had so acquired will prove a curse on them. However the *hadith* is supposed to signify more than that which it may imply. However much value an individual may add to his wealth through *riba*, it will ultimately avail him nothing and he will end up in actual poverty. The superficial observers may find it hard to believe this, but those who are capable of taking deeper view of things will understand the fact the common experiences about the people who live on *riba* seldom they enjoy a real peace and happiness which are the chief advantage from the wealth⁹.

But the basic question is how does economically the concept of *riba* in practice generate want and scarcity How can be explained this in the advancement of modern conventional economic theories? To answer these questions is to elaborate the truth of the above divine theory in simple microeconomic terms. We may mention here few of them. In

⁸ Maulana Mohammad Manzoor No'mani, *Ma'arif al-Hadith*, English Translation by M. Arif Kitwe. (Hadith No. 512) Vol. iv, *Darul Isha'at*, Karachi, 1983, p.349.

⁹ Maulana M. M. No'mani, *Ibid*,

the context of the above naturally given circumstances, if each individual or producer or endowment owner sells what he has for more of itself and do not accept any good for its substitution, it means that ultimately each commodity will accumulate to those who discover or acquires the resources and it will continue to accumulate it until they possess the whole available resources of that particular kind of resource. Suppose in case of gold mining, if those who acquire the fields in the beginning want to own it forever not only their own resources but to have the command over the gold resources of others. They will start to sell gold in exchange for gold at a higher rate. They will ever receive more gold. And the more gold they acquire the more they will give on *riba* and on the other hand less gold will remain for the borrowers, hence their repayment power will be weaker which will make the lenders to increase the price or the rate of *riba* in order to acquire more and more gold. This process if it will continue indefinitely, ultimately it will exhaust the whole existing gold assuming the total gold endowment is limited. If each economic agent behaves in this manner and hold the ownership of his initial resources, it is very reasonable to expect that resources particularly most dear and durable ones sooner or later will accumulate into the hands of small opportunist individuals of *riba* users. These absurd economic activities would perhaps generate certain kinds of abnormal situations to think of few we can note here: While on one side there would be bulk of resources are to accumulate, on the other side there would be whose resources are reduced significantly or totally deprived by *riba* users. On one hand as the law of diminishing marginal utility teaches those who concentrate the resources in their hands will suffer with disutility assuming that they are directly consume that accumulated wealth. The law conveys that with every increase in the stock of a commodity its marginal utility diminishes, and with every increase in stock that someone already has the less welfare he may derive from it. Therefore, with the increase of accumulating of the same commodity the welfare that an individual may gain from it would be decreasing. While *riba* users would suffer with their lust for collection of wealth, which holds in single good and lack of variety, the other part of society would suffer scarcity of precious resources. These phenomena inject the roots of scarcity, wants and mis allocations of resources into the economy as whole.

In case of profit the resources flow from where they are in plenty to where they are scarce, from where they are relatively idle or less productive to where they are productive and usefully utilized, while, in case of *riba* resources actually flow in the reverse case, from where they are in scarce and dear, to where they are already concentrated. In this way the

economic resources although they seem to be very much when they are concentrated in few hands without utilizing properly the scarcity in general and want for variation in both haves and have nots would be the inevitable consequence.

9.2 EQUITY AND INCOME DISTRIBUTION

It is noted that the effect of the prohibition of *riba* on the distribution of income and wealth deserves much attention and more detailed study that have been made so far. In Islam equity must be used in a well-defined framework, Islam encourages the flow of financial capital by eliminating *riba* which leads to concentration of wealth and hoarding by insisting on the use of credit instruments by postponing the debt when the user is in strained circumstances, by ensuring that the lender gets back his principal suffering no loss and protecting the borrower at the same time as the return of the principal should cause loss to none'. In this sense the interpretation of equity in Islam must be very meaningful. Money is considered purely as a means of exchange with no intrinsic value of its own. Unless money is translated into production process and transformed it into really value-added process, it is considered immoral and unjust to pay a premium for it. Therefore, it is suggested that equity in monetary dealings must be identified in terms of purchasing power and not merely in terms of units of money. Therefore, the profit sharing if it is properly implemented can be the major vehicle of augmenting growth and capital formation. We have seen above the mis allocations and inefficiency that associate with *riba*. In this section we would like to focus on the relationship between equity of income distribution and the prohibition of *riba*. It is to point out that *riba* contract constrains the economy rather than expanding it which in turn decreases the level of employment, at the same time squeezes size of the entrepreneurship, in the economy and leads to scarcity and depression. The section will also summarize the strategies of achieving distribution goals

9.2.2 Income Distribution

Naturally growth requires capital formation investments which in turn depends on savings channeled into the productive sectors of the economy *Mudaraba* and *Musharaka* if they are fully implemented can be the major vehicle augmenting production and capital accumulation, these techniques require only entrepreneurs who may provide capital with some positive

earnings. *Musharaka* and *Mudaraba* techniques can finance only production not consumption. Therefore, they may not generate any demand pull inflation in the economy. *Mudaraba* & *Musharaka* techniques require the capital owner to share the profit with the user. They provide equal opportunities to all entrepreneurs to apply and seek for financial resources from financial institutions. They are required to be credit worthiness and collateral as interest-based system, since the capital owner shares profit with capital users, there is a greater chance better income distribution out of the profits perhaps than even wage system. Distribution has been one of the most controversial issues in economics on which views of economists, philosophers and socio-political proponents have varied very widely¹⁰. At one extreme are those who believe that our primary problem is production. On the other extreme are those assert that to determine laws which, regulate the distribution, is the principal problem in political ¹¹economy. The reason for this is that the nature of the issue inevitably involves value judgements which the traditional economists shun. The approach in Islamic economics since, it is inherently based on value judgement it does not feel shy of penetrating this vast and relatively virgin field of economics. The discussion of distribution is closely related to rights of individuals in society. These rights in person and property, provide the ground rules of the economic behavior which in turns determines the distribution of income and wealth among individuals. The Islamic economists emphasize that the concept of individual freedom in Islam and ownership rights are fundamental to the determination and achievement of the desired pattern of distribution.

No doubt that Islam considers man as the best of God's creations and treat him as His viceregent on the earth in this capacity he has granted him certain rights and has prescribed certain responsibilities for him. Numerous articles and dissertations have been presented in this issue in which thoroughly is discussed about the nature of these rights, responsibilities and their distributional implications. Zubair Hassan elaborated the Islamic concept of ownership as a part of general view of (*ammanah* trusteeship)concept.¹² For everything in the universe belongs to Allah (swt) and He delegated these proprietary rights to mankind under specified terms. Thus the nature of the ownership in Islam is that of trusteeship and is subject to the

¹⁰ Munawar Iqbal,(ed.) Distributive Justice and Need fulfillment in an Islamic Economy. IIIE, n.d. p.3-24.

¹¹ Recardo, David, Principle of Political Economy, in Pioro Sraffa (ed) Works and Correspondings of David Recardo. 1951 p.5

¹² Zubair Hassan, Distributional Equity in Islam, in M. Iqbal (ed.) Distributive Justice and Need Fulfillment in an Islamic Economy, IIIE, n.d., p.25-50

terms of that trusteeship. Anaz Zarqa discusses this issue at some length¹³. According to him there are two kinds of productive assets; The first are public utilities such as, large streams, bridges, land around the town left for common use, banks of streams, etc. Secondly some kinds of natural resources are entrusted to the society at large. Four kinds of such resources have been mentioned by Prophet (saw) water, herbage, fire and salt. Other things which have these properties also have to be included by implication. Any thing which is not involving much human efforts and costs in its exploitation should be included, like, natural meadow, forests, and some minerals similarly Rivers' embankments and public paths may be considered.

Ahmad Mustafa and Hussein Askari seem to extend the scope of public ownership to all natural resources they discuss the opinions of various schools of thought on the issue of the ownership of land and conclude that wasteland, the natural components of cultivated land and in fact the natural resources and their productivity are similar to *fai* in being a free gift of Allah (swt). Therefore, all Muslims should share equally or equitably their ownership. Distribution is generally considered from two perspectives, functional distribution and personal distribution of income Islam has provided guidance for both of these aspects. Most of the Islamic economists consider Islamic goals in distribution to be distributional equity. However, this is an abstract term of distributional equity could mean a different thing to different people, ranging from everyone should have an equal share or everybody should be given according to his contribution to everybody should get according to his need. The question is in these various theories of distribution where the element of distributive justice stands in Islam. It may be summed as follows; (i) Guarantee of fulfillment of basic needs for all, (ii) Equity but not equality in personal incomes, and (iii) Elimination of extreme inequalities in personal income and wealth.

9.2.3 Implication of Riba to Income Distribution

It is well-known fact that individuals, with no capital, cannot enter in business class under interest-based system the only option open, for them, is to seek for becoming wage labor, profit-sharing system has its own tools to meet the capital needs of people with entrepreneurial

¹³ Anas Zarqa, *Islamic Distributive Schemes*, Ibid, p.159-180.

capabilities and skill but not have at all or sufficient capital through this they can generate income and contribute economic growth. Since the growth essentially requires capital formation which stems from savings channeled into the productive sector of the economy, which if accompanied its function by competent entrepreneurs will increase the productivity, employment generation and elimination of poverty. In interest-based system individuals with no capital cannot enter into business class, so no hope for them to become capitalist they have to seek only for becoming wage labor. If capital is scarce in the economy, they may not get employment opportunities for long period. *Mudaraba* is mainly for meeting the capital needs of people with entrepreneurial capabilities, but with no capital, through this, they can generate quick income and grow economically, similarly those who have skill and small capital not enough to stand alone in business activities can join together and make *Musharaka*¹⁴. Perhaps deep understanding of the nature of *riba* owes someone to figure out its economic implications for income distributions.

In conventional economy the major criterion is to assure about the return of the lenders capital with stipulated interest. This implies that the investment goes along with those who are well off, having initial wealth which is sufficient for the repayment of the principal capital and interest. The mechanism of interest-based system of lending spontaneously leads to channeling the bulk of financial resources to rich people, thus multiplying their financial power and permitting them to widen their economic activities to an extent which far exceeds their own wealth. On the basis of our earlier elaboration about the implication of *riba* on resource allocation, the great mischiefs of *riba* in this respect of income distribution are also apparently self evident. Through *riba* based on economic process the wealth or economic resources will concentrate in few hands and with the increase of this wealth concentration would be mostly at the expense of large majority of society. Consequently, the scarcity of capital resources would increase its cost, the rate of *riba* - which would further aggravate the situation. In the case of interest-based economy, the cost of capital largely depends on its scarcity. Further more as we have been arguing in all along, the concept of *riba* has nothing to do the productivity of capital. The more scarce the capital, the higher will be the rate of interest which would speed up only the concentration of the wealth in few hands. On the other hand as the scarcity of this essential factor of economy increases the demand of the people

¹⁴ Fahim Khan, Ibid, p.94.

for it would be correspondingly irrespective of the rate of *riba*. In this way the *riba*-based economy may put the nation into kind of a vicious circle and largest part of the society would be lead to perpetuate this desperate situation of poverty and destitute.

9.2.4 Strategies for Achieving Distributional Goals

To be precise, the salient features of the Islamic strategy for achieving the desired pattern of income distribution are furnished in different seminars and research papers, i.e., Zia-Din Ahmad has demonstrated a number of prescriptions for achieving a just socioeconomic order in the society which require a collective effort of public and private participation in the policies in order to reorient and reformulate for ensuring the desired objectives that are to promote work ethics and direct the efforts to productive economic activities in the pursuit of material benefits together with spiritual aspect of the people¹⁵. Sanctity of property rights and free pursuits of profits and bounties of Allah, establishing institutional arrangements for factor markets to perform efficiently and equitably in a diversified manner of resource utilizations. The seminar of Distributive Justice and Need fulfillment held in Islam may be summarized here.¹⁶ Islam utilizes the institutional approach in its distributive scheme. Market as an institution is allowed to play a significant role. Re-distributive measures are no doubt important in the Islamic strategy for achieving the desirable pattern of distribution, but according Munawar Iqbal, they have been overemphasized in the literature of Islamic economics to the neglect of other basic measures. Islamic strategy relies on measures which work through exchange as much as, if not more than the measures which involve transfers. Measures such as prohibition of *riba*, promotion of profit seeking and profit sharing, correcting ownership, equality of opportunities, employment, just wages and, prohibition of certain trade practices etc. All these have direct implications for distribution of income and are no less important in realizing the Islamic distributive ideals than the re-distributive measures.

However it is supplemented by other institutional arrangements, to correct some inbuilt tendencies in the market solutions which may generate excessive inequalities, these institutions

¹⁵ Zia-udin Ahmad, *Islam, Poverty and Economic Distribution*, Islamic Foundation, UK. 1991.

¹⁶ Munawar Iqbal, *ibid*, p.21.

include *awqaf takaful maniha* inheritance and elimination of interest etc. Islam prefers decentralized structure of re-distributive measures, it requires one to look after the need of his near relatives, his neighbors his locality and then the society at large in that order. Even Zakat is to be preferably spent in the locality from which it has been collected. Islam uses a hierarchy of compulsory and voluntary, permanent and temporary measures which lend flexibility to the system. Islamic Shariah has declared some of the schemes as permanent and compulsory such as, *Zakat* participation in the ownership of some natural resources and the system of inheritance. There are additional resources which are brought into uses if and when needed. The permanent resources would normally insure that the distribution does not deviate too much from the desired pattern while temporary resources are there to take care exceptional circumstances.

9.3 ECONOMIC INSTABILITY

The strict and absolute prohibition of *riba* constitutes one of the cardinal features of an Islamic economy. This prohibition naturally eliminates the loan market in its Islamic context as a means of income generating mechanisms. The question stability of Islamic economy as recently took the attention Muslim economists Muslim economists in their contemporary writings over emphasized, the smooth functioning and long-lasting economic equilibrium to be the natural characteristics of Islamic economy. The built-in forces of Islamic economic system tend to enhance its stability. Although dissenting remarks are expressed in many of the recent research papers on the superiority of the system to the conventional one in respect to the financier and user of capital R.Khan (1983), it is theoretically articulated that the profit-sharing system assures in large degree of stability and more equitable compared to *riba*-based economy. It has been shown that application of this system makes the financial institutions more stable than the interest based one Zarqa(1983) and Muhsin Khan (1987). It is theoretically asserted that financial system based on profit sharing techniques enables the economy to efficiently absorb any shocks to its asset position Mirakhor & Zaidi (1987). According to Zarqa there are at least four reasons to believe why an Islamic economy may be considered to promote economic stability namely: Investment, speculation, corporation and international finance. While many economists seem to agree that debt financing is the major factor of destabilizing investment in capitalist economies, Islamic economists in logical sense have not demonstrated the built-in factors that would maintain the stability of Islamic

economy. It seems that still there is ongoing debate whether abolishing *a riba* element would essentially lead the economy towards stability.

9.3.1 Inherent Instability in Conventional Economy

In conventional economy although the analysis of some of the Post-Keynesian economists clearly pointed out that the institution of interest as one of the main causes of financial instability which leads to recession or stagflation. They articulated that capitalist economy is inherently unstable and unless it is regularly fine-tuned by the government millions of its citizens would be unemployed. Their solution to these problems ignores this issue and assigns an active role to the government institution through its monetary and fiscal policies. Though only capital and financial valuation aspects of investment decisions have been considered in earlier works of Klacki (1935,1968), Miller and Modigliani (1958, 1961) theorem, but, they have been particularly emphasized recently by Gordon (1962),Tobin (1982), Minsky (1975, 1982). For the last two decades Minsky has been working on the problem of financial instability in the capitalist system. He has specifically identified financial and capital valuations to explain the built-in stability crises of advanced market economies. Minsky has rejected the neoclassical position that capitalist economies are inherently stable and the actual large business fluctuations experienced are results of either by exogenous shocks or by human errors. He asserts that the financial arrangements in advanced capitalists economies are inherently unstable, since investment is closely related to financing process, therefore this instability is transmitted into investment.

Minsky as for Keynes has demonstrated that systematic instability and financial crises are an inherent feature of modern capitalist economy, which results securing the means of production through debt creation. In order to produce goods business must acquire physical assets. To the extent that such assets are financial, external structures of financial liabilities are created. Business decision-makers must, therefore, determine how much of the firms expected income and liquid assets, can be committed to make future payments. Minsky maintains that a modern capitalist economy is based on a pervasive system of short-term financing of long term capital assets. Under such a system of financing debt is repaid when due by issuance of new debt, i.e., refinancing would be continuous process, if the expectation of future cash-flows and interest rates remain optimistic. But as it might happen if the

expectations turn out wrong or expected in pessimistic perspective then refinancing would be very difficult and attempts to acquire cash would bring the asset values below their original prices or even below their current cost of reproduction, this would make the whole investment activities to cease and bring down income and employment¹⁷. Recently the French economist and Nobel Laureate Maurice Allais has scholastically advocated in looking back more than two centuries of disorders of all sorts that have accompanied conjectural fluctuations and at the repetitive sequences of period of expansion and recession in the past, one should consider that the two factors which have significantly accentuated them, when they have actually set them in motion, are on the one hand the *ex nihilo* creation of money via the credit mechanism along with the long term financing of investments with funds borrowed on a short term, and on the other hand the absence of an economy of a stable unit of account enabling both effective economic calculus governing the future to be carried out and the fair settlement of financial contracts between borrowers and lenders. These two factors could nevertheless readily be put right by a comprehensive monetary reform which would, if not eliminated conjectural fluctuations, would at least considerably lessen them. A careful study and close examination of theoretical principles behind the main causes of stability crises of market economies in the Islamic point of view, we would find that probably the following factors would carry a considerable weight (i) dichotomy in debt commitment and actual productivity (ii) continual revisions of contracts and debt refinancing (iii) financial speculation (iv) unreasonable money creation through a credit mechanism.

9.3.2 A dichotomy in Debt Commitment and Actual Productivity

The recent studies on the subject show the gulf between the rate of interest and the expected rate of return on investment reflects from the degrees of inability to make a sound judgement (bounded rationality) on the part of either side of contracting parties. According to Minsky the fragility of the financial system depends on the relation between contractual commitment (which is essentially interest linked to the principal on debts) and the cash flows from real investment operations (which are essentially profits) that is the similar treatment of actual investment activity planned to generate flow of profit or tangible services and any debt contract in respect of its ultimate use.

¹⁷ Minsky, H.P., (1977), *An Economics of Keynes in Perspective on Money*, in Weintraub ed., *Modern Economic Thought*, Oxford Blackwell.

The basic idea of the Minsky (1982, p.xvii) is that "the relation between cash receipts and payment commitments determines the course of investment and thus, employment, output and profits." Chishti (1985) interpreted the problem that the fixity of financing terms, vis-a-vis the uncertainty of profits to be mainly responsible for the gap between cash flows and payment commitments. But one thing is important to be added to this scholastic view, it is not only due to the uncertainty of profit and fixity of interest in terms of advanced commitment, but, what perhaps is responsible for the problem is that most of the financial operations seem that they have not been directed and planned for generating actual value-added return (profit). The contractual commitment has not been concluded in the light of feasible profit in other words the required cash repayments seem to be totally dissociated from the actual return. While the profit is practically a discretionary result, the payment commitment is continuous flow essentially linked to the principal capital regardless of the actual outcomes of the investment. Consequently as it is elaborated above, under traditional financing some times the gap between cash flows and payment commitments becomes so wide that it produces a chaos in the asset market when many units try to sell their assets to generate cash in order to meet their commitments. According to Chishti it is the spread between cash flow (i.e., profit) and payment commitments (i.e., interest payments) which is the main source of instability investment. It is also obvious that the real source which generates this gap is the fixity of the dated payment commitments in isolation from actual return. Thus, instability and financial crises are the inherent features of modern capitalist economy.

In simple elaboration when the rate of interest is not linked to productivity of investment activities, as it is in most of the times, it is highly probable that the cost of capital would be above the real return of the economic productivity. For instance during the inflation period the lending agents put the price far higher than the rate of inflation, for the inflation greatly reduces the real load of debt. Moreover, monetary theorists urge that if the inflation or deterioration of the local currency continues in other words if confidence in a currency continues to erode a large and prolonged increase of interest rates would be required to stabilize the situation. However, since company accounts are kept in nominal terms, profits may appear, although in real terms losses occur which will have to be met. According to Allais the purely fictitious profits induce which may seem justified to those who make them, but which if they are satisfied may place the enterprises in a difficult situation if not to bankruptcy. On the other hand when deflation occurs, the weight of investments, which may

have been fully justified when the investment decisions had been made, may become unbearable and make it impossible for the economy to operate correctly, i.e., farmers who borrowed at a high nominal rate of interest in inflationary circumstances and who are today in great hardship because of the slowing down of the inflation. And this is the case too, of many developing countries which because runaway inflation has stopped, can no longer pay the interest of their loan.

This gap can be eliminated to a great extent, if not at all, through the elimination of *riba* in Islamic economy. More specifically if the terms of financing are linked with the profit rate, the chaotic condition which make the investment as the most unstable component of GNP, may be avoided. The alternative method of Islamic financial system for the above situation may arise from the fact that to the extent the capital resources are channeled into productive investments, such investment could be expected to generate a stream of returns at least sufficiently repay the cost of the investment fund. The elimination of asymmetry between the fixity of interest rates on one hand and the uncertainty of actual profit rates on the other, is considered the essential characteristics of Islamic financial system which distinguishes it from the traditional financing system. Islamic financing arrangements make the payment commitments a function of income flows, because the financing terms adjust according to the changing conditions such that the ratio of cash flows to cash commitments remains relatively stable. This provides a built-in stabilizers to reduce the volatility of investment in Islamic financial system. Thus the justifications of the profit and the rationale of abolishing *riba* become clear, this will make the economy to follow only profit rather than *riba* the nature of *riba* transaction is inherent to predetermination as it fixes proportion to the principal rather than to the output. While profit is the increase of the outcome of transformation and productive business which cannot be fixed ex ant, on the other hand *riba* is certain and a fixed rate of the principal essentially predetermined.

9.3.3 Continual Revisions of Contracts and Debt Refinancing

The forgoing nature of debt makes the worse the burden on the borrower when the circumstances change for the worse. Whenever there is a possibility of reopening the contracts several things may happen. If the market rate goes down and refinancing is possible the debtor may try to take advantage of the lower market interest rate call back and redeem

some or all of his bonds or convert debt into an equity, whenever possible. The equity is permanent or long term financing which can cope with the changing market conditions. Some empirical works (Mitchell 1987) show that the increasing uncertainty about the future nominal interest rate caused the decline in debt maturity. And USA managers moved away from long term debt to avoid rolling over the debt at highly uncertain and back of continuity in debt relations this is not without cost on the part of the debtor specially if it gets to the refinancing of a loan, which brings about uncertainty up to the nature of future terms of contract, this uncertainty in future business conditions may induce the debtor to liquidate through the depletion of his resources, as much as he can, of the present value of these resources to meet any urgent demand. This is a manifestation of opportunism and volatile to an economic situation. The debt-based system is in the nature of a rule in the sense that it is fixed at the time of contract determined substantially uneconomic factors, while the profit-based system is in the nature of discretion in the sense that the real rate of return is to be determined by purely economic circumstances that take place and changes with the change of investment outcomes. Since debt requires regular predetermined interest payment where an actual situation fluctuates. Business difficulties may create a pervasive situation on the cash flow of firms, forcing reopening the contract in such a manner that makes the debtor to either forgo what would otherwise be some further profitable venture or sell some of its existing assets to meet liquidity requirements, or borrow further and may be at a higher interest cost. Because, unless there is assurance of debtors' future capacity of repayment and complete guaranteeing of social institutions in his willingness to fulfil his future payment obligation, no further loan would be available for the borrower. Normally creditors are willing to accept a certain probability of default and its dependence of the amount of credit extended. The increasing the level of the indebtedness increases the probability of default in external and internal reasons, which in turn increases perhaps progressively the rate of interest. However, given infinite repayment capacity of the debt inevitably sooner or later will be reached a level where no increase in the contractual interest rate can compensate the lender for the extra risk of nonpayment results from a further increase in the level of debt¹⁸. This, would be the turning point of down a fall term of business cycle and the beginning of more panic economic situations.

¹⁸ Ernst Bainsperger, Credit, New Palgrave Dictionary of Economics, 1987, p.715- 17

When the owner of funds gets into partnership on the basis of profit sharing there is a low chance requirement for reopening the contract even if the expected average gross rate of return changes. For the entrepreneur there is a strict relationship between the rate of repayment and expected rate of return for the lender the actual return to his investment will be in accordance with the property rights in the equity finance. We have elaborated in elsewhere, that Islam has laid down very clear principles on financial loans and credit mechanism. Contracts in Islam have fixed terms of responsibilities and rights. If it is an investment contract, the rights depend beside the principal capital on the actual return that would be generated. If the contract is loan or sale transaction, it should be concluded once and for all.

9.3.4 Financial Speculation

In an advanced capitalist economy with a sophisticated financial market, the volatility of investment is largely because of speculation rather than productive changes¹⁹. With respect to this deliberate relation, Minsky classifies business firms into three groups, namely, hedges, speculative, and ponzi. For hedge units cash flows are expected to exceed payment commitment on outstanding debts in every period. For speculative units, cash commitments on debt exceed cash flows from regular operations for only some periods. For ponzi units cash payments exceed cash flows for almost all near term periods. During the booming economic growth and tranquility the prices of capital assets tend to rise, and portfolio preferences shift gradually towards more speculative and ponzi schemes of investment. This kind of unproductive business would raise the interest rates and make the economy very sensitive to interest variations for the cost of short-term debt in financial structure increases and weight of cash in portfolio declines. As a result profits tend to decline and interest rates to rise which turns some hedge units into speculative units and speculative units into ponzi. When many speculative and ponzi units find it difficult to meet payment commitments with cash flows, they issue more debt, which becomes increasingly more difficult to meet payment commitments by emitting more debt, ponzi/speculative units start selling out their assets. However when many units resort to generate cash by selling out their assets, it causes general decline of asset prices. If the price of capital assets falls to the level of their costs or even

¹⁹ Salim U. Chishti, *Relative Stability of Interest Free Economy*, *Journal of Research in Islamic Economics*, vol.3. No.1, 1985, p.3-12.

below, new investment activity may tend to exhaust. And this consequently would drag the economy into general depression. This very low level of investment may put pressure on profit to rise and increase of investment operations may recycle new round all over again.

This dramatic situation is, in fact, vividly elucidated by Allais in his treatment of speculation and credit: In a market economy it is normally necessary and highly desirable that anticipation about the future should be made and that economic agents should act thereon²⁰. Thus, speculation as the choice between present and future in its very principle may be reasonably useful. However, as Allais has lucidly demonstrated, it is very different matter if one can buy without paying or sell without owning. If economic agents can buy shares, because they are bullish, and finance them by borrowing from banks against the security of shares, then share prices would rise immediately. Whoever, purchases under such conditions will see share prices rise the next day and this increase has expectations and induce him to borrow far more so as to purchase still more. The rise induces rises again and again and only paper will get multiplying. People get more and more rich in more and more easily. There is no limit to such a rise for it is sufficient only to expect the rise and its continuation, for share prices to reach hitherto unattainable heights. Share holders feel ever richer, but so long as they have not sold the shares they hold, their profit exists only on paper, however powerful the drive might be, such a process cannot continue indefinitely. But, sooner or later certain operators, the more clear-sighted ones will realize that share prices have become unreasonable, according to all criteria, they will begin to sell. As soon as the fall starts borrowers who have speculated on the rise will have to fulfil their promises to pay to meet their commitment they will have to sell part or all of their other assets, thus generating a downward pressure on prices. These difficulties will lead to a loss of confidence in the whole economy. Banks may resort to restrict credit and this restriction in turn will create new problems due to the contraction of the money supply of banks as a result of this restriction²¹.

²⁰ Maurice Allais, *The Monetary Conditions of an Economy of Markets, From the Teachings of the Past and to the Reforms of Tomorrow*, Eminent Scholars' Lecture Series No.1 IRTI.IDB, 1993, p.19.

²¹ Maurice Allais, *Ibid.*

9.3.5 Excessive Debt Creation Through Credit Mechanism

Although, the volume and complexity of credit transactions have grown immensely over the last centuries, perhaps the act of extension and debt creation or lending and borrowing, as such, are probably as old as human society. Credit and debt have always posed some special and crucial problems of understanding for the economists beyond those associated with the production trade and consumption of ordinary goods. The credit market is seen to be essentially a market for inter-temporal exchange. Something is given up in the present in exchange for something else or itself in the future or vice versa. In conventional credit system the future repayment typically includes a compensation in excess of the original payment that uses the interest which represents the relative price in the market for inter-temporal exchange, based on the assumptions of Consumer Time Preference and opportunity cost in terms of capital productivity. A basic question arising with any credit transaction concerns the mechanism which ensures that the debtor will meet his future commitment of payment obligations. In the words of Allais, "basically, the credit mechanism gives rise to an ex nihilo creation of means of payment, for the holder of the loan, the bank considers the later repayment as available cash, where as the bank has simultaneously lent out the greatest part of this deposit which, in turn, whether or not it has been deposited in a bank, itself is considered as available cash by its recipient which in each credit. Therefore, there is monetary duplication Banking activity rests therefore, on exchanging promises of the bank to pay at a given date against promises of the borrowers to pay at later dates subject to the payment of interest." Whereas the raising of "real savings" by banks to enable them to finance productive investment is basically useful, but creation of "false money" by creation of money is on the other hand, basically harmful, both from the point of view of economic efficiency which is undermined by the price distortions that it may generate and from the point of view of distribution of incomes which it distorts and renders inequitable²².

Through means of the credit mechanism, new means of payment are constantly being invented in interest-based economy which amounts to the creation of new purchasing power with no effective counter part other than promises to pay in the future, a mechanism which goes under the fallacious name of asset mobilization or monetary transformation but which

²² Maurice Allais, *Ibid.*

finally results only in enriching some at the expense of others. These new means of payments are created by mere book keeping entries generates price to rise and effectively cause inflation and instability. Public opinion is very sensitive to the issue of money or its increase supply by the state to finance its expenditure. It is also extremely sensitive to the use of the credit system to finance the investments of enterprises and households by creation of money. Because in both cases there is an increase in the money supply and ultimately inflation. And experience shows that whenever inflation once started, always accelerates; settlement dates arrive and debtors can only meet their commitments by borrowing still further²³. Banks are then faced with two unfavorable and unavoidable alternatives: either to accept the defaults of their debtors and lose all hope of recovering their claims, or to make new loans facilitated by new creations of money, and so give their debtors the incomes whereby to fulfil their commitments. Allais have clearly propounded that the present organization of the credit system, whose historical origins were quite contingent, is totally irrational, and that for at least following reasons: (i) the irresponsible creation or (destruction) of money by the decision of banks and individuals. (ii) the high sensitivity of the credit mechanism to conjectural fluctuations that generates the following undesirable situations, (i) the basic instability which it generates, (ii) the distortion of the conditions of maximum efficiency (iii) the ensuing distortion in the distribution of income.

The increasing the level of the indebtedness increases the probability of default in external and internal reasons. However, infinite repayment capacity would be ultimately exhaust. A limit will be reached where no increase in the contractual interest rate can compensate the lender for the extra risk of nonpayment results from a further increase in the level of debt. According to the Islamic financial system the elimination of *riba* and *gharar* will take care of checking completely or most of speculation behavior. The exchange system of Islam is very simple and transparent, clearly figuring out and specifically defines the rights and responsibilities in connection to the terms of contract, goods, and the responsibilities of the involving parties.

²³ Maurice Allais, Ibid.

9.4 INFLATION PROBLEM AND CURRENT THOUGHTS

Inflation is considered as a very complex phenomenon as it generates durable multidimensional economic problems. During which owing to inflation, money fails to adequately perform two of its most important traditional functions: as a store of value and as a reliable standard for deferred payments. The chances of economic growth are also reduced due to inflation. Although precisely the primary target of monetary policy and its policy implications is subject of controversy among economists, it is generally agreed that high and variable inflation is costly in terms of either the allocation of resources or long-run growth in output or both. It is almost accepted that money is not neutral in the short run for monetary policy has transitory effects on a number of real variables including output and unemployment. There is however imperfect understanding of the nature and magnitude of these effects their time frame and means by which monetary impulses are transmitted to the rest of the economy. Although there has been much discussion concerning the cause and cure of the persistent inflationary trend that has characterized the economies of most nations and extensive analysis and empirical studies of the subject have been carried out where three broad theoretical explanations for the phenomenon of inflation have emerged namely; a demand-pull hypothesis, the cost-push hypothesis, and the structural hypothesis, but no one of these three can exclusively explain inflationary process, for an upward trend of general price level is nether wholly understood nor readily controlled²⁴. However, there is a common view that the government's demand management policies fiscal as well as monetary policy to be a major contributor. That is the monetary expansion, which takes place as a result of raising public expenditure often through deficit financing or bank financing, or as an impact of foreign remittances. Moreover it may be the result of devaluation which in itself is the consequence of a number of domestic constraints and international exchange distortions²⁵. Monetary policy serves as the primary source of inflation with lags of uncertain duration and varying strength. It can make it difficult or impossible for any central bank to control it on period for period basis²⁶.

²⁴ Peterson, *Income, Employment and Economic Growth*, 5th ed. 1984, p.458.

²⁵ S.M. Hassanuz Zaman, *Indexation of Financial Assets: An Islamic Evaluation*, Research Monograph Series - 4, IIIT, 1993.

²⁶ Paul R. Masson, et al, (1998) 'Can Inflation Targeting be a Framework for Monetary Policy in Developing Countries, *Finance & development*, IMF, March, p.34-36.

One of the major objectives of monetary system in Islam is considered as the stability in the value of money to enable the medium of exchange to be a reliable unit of an account or justice standard of deferred payments and stable store of value. The importance of stability in the value of money for the whole economic transactions is hardly to be over emphasized. There is an unequivocal stress of Islam on honesty and fairness in all human dealings and the adverse effect that inflation tends to have on social justice and general welfare. Inflation implies that money is unable to serve as a just and honest unit of account. It makes money inequitable standard of deferred payments and an untrustworthy store of value and enables some people to be unfair to others even if unknowingly stealthily eroding the purchasing power of monetary assets. It thus imposes a welfare cost to society by reducing the efficiency of the monetary system. According to Umar Chapra, it tends pervert values rewarding speculation (discouraged by Islam) at the expense of productive activity (idealized by Islam) and intensifying inequalities of income (condemned by Islam). Moreover, Inflation conflict with a *riba*-free economy because it corrodes the fundamental *raison d'être* of social justice, inflation undoubtedly does injustice to the *riba*-free lenders by eroding the real value of *qard hassan*.

According to Chapra, it may be suggested that in the current worldwide inflationary climate the Islamic imperative of social of socioeconomic justice could be satisfied by indexation or monetary correction of all incomes and monetary assets including *qard hassan*. Proper monetary correction would, however, require the indexation, not of income, or monetary assets but of purchasing power, which is determined by the consumption and investment pattern of individuals. Reducing the liquidity in the economy is some times desirable, it also be advantage in the view of Allais (1989) who considered the monetization of debts to be a contributing factor to the instability of the present monetary system²⁷. Usually during the inflation credit expands to abnormal limits. Milton Friedman has exposed the fallacy of the statement that inflation is both desirable and inevitable in developing economy. He asserted that no virtue in impoverishing some people and enriching others in order to get some arbitrary determined increases in the amount of investment or saving through inflation.²⁸ It is obvious that inflation is not desirable at all because it is a tax on poor people who can

²⁷ Maurice Allais (1989), "From Depression to Prosperity" *Le mond*, Paris, 27 & 29 Jun. quoted in the above reference.
²⁸ Cited by Terborgh Palyi and quoted by Paul R. Masson, et al *Ibid.*, p.34.

least afford it. Terborgh Palyi describes inflation as a brutal process as it falls, with special severity, on those least able to bear the burden of it. He also considers the inflation as economically disruptive as it generates continually shifting strains and stress in the market. It is observed that some of the inflationary costs are sticky and respond slowly to inflation, others move it with. The adjustment of prices to changing costs is jerky, irregular and it may be added to the prevailing tardy situation. Profit margins on individual products and services tend to be chronically more or less out of line with normal standards, the whole margin-structure remaining continually off the balance." Economic development may not by itself associate with inflation. If economic development is a health-giving exercise there can be no place for inflation in it. Inflation usually is considered as the symptom of mismanagement of the economy. Inflation in general penalizes the downtrodden and benefits the rich people and the government. In this point Palyi has elaborated it further;

"Inflation is robbery on a national scale, a surreptitious levy on liquid income and wealth, raised in a haphazard fashion with no regard ability to pay, no respect for rule of law, for equity and justice. It penalizes the saver especially and an honest producer while the lucky operator and the political manipulator may reap unearned rewards."²⁹

Inflation means an erosion in real value of money, the real value of money like the value of any commodity is determined by its demand and supply if the supply of money increases more than the demand for money the value of money will fall, signaling a rise in general price level.

9.4.2 Inflation as Monetary Phenomenon

It is quite evident that in a money economy inflation is a monetary phenomenon caused by excessive growth of money supply. This is in conformity with the quantity theory of money which explains inflation better than any other theory. Laliwala has argued in his paper that the trade unions, traders, smuggler corporations, scarcity of agricultural goods etc. is not responsible for inflation. Hence, as he asserted, neither cost-push nor demand pull descriptions of the process of inflation explain the aetiology of inflation. Prices of goods are affected by

²⁹ Terborgh Palyi Ibid.

the demand for goods and goods cannot be demanded without money, which the people can acquire only by contributing to the production and output. It then follows that people cannot produce or generate inflation because they cannot have money except by producing goods. Laliwala argued that it is thus, only government and the central bank that have free access to money by simply printing it without having to contribute to total output. By this way inflation is the result of the government's attempt to invest more than the available savings warrant. Money supply in excess of the demand for money which is the consequence of investment exceeding saving results in rising prices, because it is through a rise in price, thus, the demand for normal money in both into equilibrium with the expanded money supply. Thus, information is a monetary phenomenon. Excess of investment over saving, and hence inflation occurs whenever, the government attempts to increase the rate of investment in excess of the normal rate of investment or to reduce the rate of unemployment below the natural rate of unemployment or to peg the exchange rate at a level lower than the equilibrium exchange rate through fiscal and monetary means.³⁰

9.4.3 Indexation as a Remedy for Inflation

Indexation is one of the major effective policies for dismantling the effect of inflation and price souring. The study of indexation as a method of reducing inflationary pressures comes within the scope of monetary measures. In respect to the loan operation it is stressed in Islamic law, the borrower to undertake to return the equivalent or the likens things to the lender. However the interpretations of returning the liken or *mithl* of the principal loan seems to be the point of contention between contemporary Islamic economists and *Fiqh* scholars. The same statement is used in completely opposing views by the modern economists where Rafiq al-Misri, Munawar Iqbal, Sultan Abu Ali, A. Mannan, Arif, and Salim Chishti are in favor of indexation while Umer Chapra, Kahf, N.Siddiqi, A.Jabbar, and Hassanu Zaman have opposed it, the Council of Islamic ideology Pakistan as well as the Judgement on interest (*riba*) of FSC also has given an opinion against indexation.

Undoubtedly the adverse effect of inflation can hardly be exaggerated, economists generally believe that if inflation its high level may dry up investment in public utilities and

³⁰ Jaferhusen I. Laliwala, *Inflation in Muslim Countries: Implications for an Islamic Economy*, Monetary and Fiscal Economics of Islam M.Ariff 1982, p.269-70.

encourage hoarding and speculation by discouraging interest in socially desirable channels. It may also lead to flight of capital which may cause a decline in the overall real income in the economy, and may adversely affect distribution of real income among different groups of society, mainly to the detriment of fixed income groups. All these factors create a situation that is not desirable in Islam or any other economic order. Here the question arises, should not the loss caused to the employees be compensated by the employers and the one caused to the creditors by the borrowers, for both are obliged to return the agreed purchasing power to them? The economists who are in favor of general indexation argue that the efficiency of the economy, like that of the equity, requires that the long term commitments to be respected and that neither creditors nor debtors be despoiled. It is therefore proper that all contracting parties are mutually protected against variations in the purchasing power of money. Because these fluctuations favor certain social groups to the detriment of others, and generate inequity which in the long run becomes ethically unbearable and intolerable³¹. The requirement of efficiency coincides here with those of equity. The recent studies of the subject in Islamic perspective have listed a number of cases which call for some sort of mechanism to protect their real value, namely, (i) General public savings particularly people of low and middle income groups who want to put aside something for planned future expenses and precautionary rather than investing them. (ii) fixed income groups, i.e., g employees (iii) long term loan contracts for the inflation is instrumentally destructive to the market for long-term contracts, including investment contracts, foreign loans, and payment of *mahr mu'ajjal*, etc. (iv) sale on credit basis because deferred payment would lose their value due to inflation even if it is charged a higher price that may not be sufficient in inflationary situation (v) *qard hassan* the most underpinning reason of poor general public response to the principle *qard hassan* is attributed to the existence of inflation which deteriorates the value of the loan and inflicts losses to the lender. However it is argued that Indexation of *qard hassan* should not be compulsory for considering this loan as *sadaqat*.

B. Arguments in favor of indexation

The problems which call for indexation affect all financial obligations and economic transactions. Since, inflation does inversely affect the allocation efficiency of the economy,

³¹ Maurice Allais, *Ibid.*, p.32

equity, stability and economic growth, it is recommended in order to improving or protecting these crucial matters of the economy that indexation is indispensable. Indexation is considered as a scheme to link the nominal value of any deferred payment to a suitable index of the purchasing power of money.³² Allais advocated for compulsory indexation in real terms of all future commitments particularly all credit loans and all fixed term wage contracts beyond certain period of time which could reasonably be taken to be a year, according to him this mechanism alone will ensure that the economy operates according to the requirement both of efficiency and equity³³. But, he sees that cash balance would not be indexed for its indexation may lead to hoarding of money which may harm the efficiency and equity of the economy, so non indexation of cash balances corresponds, in his view, to a necessity. These indexation procedures would apply equally to tax schedules whenever they are fixed in nominal terms as is the case of progressive income tax. They would apply, too, to the balance sheets of enterprises which would have to be revalued each year. Iqbal noted also that indexation is considered mostly in three areas of the economy indexation of wages and salaries, indexation of taxes and transfer payments and indexation of debts and other deferred payments. It is suggested that indexation would be legally compulsory for all loan and credit contracts but. The contracting parties would be entirely free to choose how to apply that principle. For example, a firm issuing a loan in the form of indexed bonds might offer the subscribers a given interest rate or certain repayment arrangements. It is also argued that the indexation of wages for fixed terms would follow the same principles, subject to the condition that wages could be freely determined at levels ensuring the effective equilibrium of the supply of and demand for employment. Allais advocated that 'were such system to operate, it would tend to rule out any distortion of prices and incomes. It would enable both the efficiency of the economy and the equity of the distribution of incomes to be maintained'³⁴. In Shariah points of view indexation is recommended on basis of the following arguments, (i) justice and fairness as corner stone of Islamic economic system. The indexation is a scheme to avoid or at least reduce the exploitative measures results from the inflation. (ii) it is an established principle of Shariah that, no damage or harm should not be born³⁵ and nor any should be inflicted to someone(*la dharar wala dhirara*). Sine inflation causes loss to the real value of money, it is argued that indexation provides correcting or preventing measures against such

³³ Munawar Iqbal, Pros and Coins of Indexation, Mimeograph Paper Presented Seminar held in Jiddah, April, 1987.

³⁴ Maurice Allais, Ibid., p.33

damages. (iii) using standard and fair measures, the importance of giving fair measures in exchange contracts is hardly overemphasized in shariah. This encompasses all measures of value, and in modern economies money is the accepted yard stick of measuring value. Since, the inflation disturbs the reliability of this basic instrument, it is argued that sort of correcting measure must be devised as the requirement of the basic spirit of Islamic Shariah (iv) fulfillment of contract obligations is another fundamental principle of Islam and it is considered as one's part of belief. So, indexation allows to safeguard both the letter and spirit of the contract and therefore it is desirable³⁵.

C. Arguments against indexation

For different kinds of indexation have been proposed by both secular and Muslim economists which face different objections and criticisms. In general it is pointed out the fact that a better policy would be to fight against Inflation not that which resorts to indexes. It is said that "an economy with a stable currency, is to be preferred to an economy resorting to a system of over all indexation." Suppose in case of the comprehensive indexation proposed by Maurice Allais has been objected that indexation of wages and salaries would inevitably generate inflation. It is also raised the objection that indexation in real terms of all forward commitments would place an unbearable burden on firms, households and on the state. In case of state it is true that under present circumstances the burden on the state could be increased if it had effectively to redeem in real terms of the amount it had borrowed. However, in economic terms the real interest rates would be lower, and if the state is unable to reimburse in real terms what it has borrowed, this means that the expenditures which it is incurring are unproductive or unjustified, and that they amount to an absolute wastage of the nation's resources, a wastage to which at the end should be put in the interest of everyone.

Islamic economists and Shariah scholars who objected indexation as a solution to inflation has supplied numerous reasons based on Shariah points of view. The objections raised in this connection are mostly related to loans. Chapra held the view that indexation to be temporary sedative for the pain of inflation particularly for fixed income groups of the society and asserted that it is not possible to find any support from the Shariah for the

³⁵ Munawar Iqbal, Pros and coins of indexation, Research paper presented seminar held in Jiddah, April, 1987, p.19

indexation of financial assets³⁶. Zaman who intensively researched on the subject for about five years has strongly opposed about the concept of indexation and has come up with the assertions that indexation is neither economically beneficial nor rationally justified, nor Islamically acceptable³⁷. The main arguments of the opponents of indexation may be summarized as follows;

- i. Indexation induces flight from risk capital: It is argued that indexation tends to induce savers to shy from risk capital. But the proponents have responded that it is the inflation rather than indexation which forces the savers to go into non- productive economic activities, i.e., mortgages, money, gold, etc.
- ii. Indexation violates Islamic law of indemnity, Hassannuz Zaman argued that indexation falls under the purview of the Islamic law of indemnity which requires that damage is to be redressed, but at the same time lays down the conditions for such redress. And it violates many of the redressing conditions³⁸.
- iii. Indexation is similar to *riba*: This is considered one of the most serious and fundamental objections to the idea of indexation. It has been argued that indexation involves an assumed positive return on loans. Hence it is equivalent to *riba al-nasia*. In fact this objection has led a number of Islamic economists and jurists to oppose indexation of loans.
- iv. Indexation is unjust to borrowers: Some of the Islamic economists and jurists argue that indexation amounts to gross injustice to the borrower, Chapra (1981) considers indexation to be very unjust. Ghazi (1996), came to the conclusion that it is the borrower not the lender who is being wronged in the question of indexation.
- v. Indexation Involves *gharar* and *Jahli*: It is argued that Islamic Shariah necessitates the contracts should be very concluded in very clear terms, rights and responsibilities

³⁶ Chapra Towards just monetary system, Islamic foundation UK. 1985, p.42.

³⁷ S.M. Hassanz Zaman. Indexation of Financial Assets: An Islamic Evaluation, Research Monograph series' - 4. IIIT. 1993.

³⁸ S.M. Hasannuz Zaman, Indexation - An Islamic Evaluation, JRIE, vol.2, No.2, 1985. p.43.

should be precisely defined and the involving parties should be well informed the terms of the contract without any ambiguity. Some of the Islamic economists maintained that in indexation to the extent of liability is not known *ex ante* and it is known only on the date it becomes due. Thus, it is argued that both *ex ante* and *ex post* indexation involves an element of *jahl* or *gharar*.

9.5 INDEXATION AND THE PROHIBITION OF RIBA

In fact, the concern of Islamic economists and juristic scholars about the viability of an indexation hypothesis is mainly based on the orthodox belief of *riba* doctrine, which suffers as we have been emphasizing all along in this research from serious misconceptions about fundamental nature and economic rationale of the prohibition of *riba* on one hand and the short comings of the proposed schemes of indexation on the other. The proposed indexation schemes do not fulfil the requirements of Islamic Shariah or they are not thoroughly justified on the light of the abolition of *riba*. In other words the problem of inflation has not been substantially analyzed on the light of the theory of *riba* in Islam. However, it is argued that although Shariah has laid down the basic principles, it has not given any details about the inflation leaving them to be decided in the temporal context Akram (1998). Thus, the Islamic economists have not been able to find out a solution to this problem. All suggestions about indexation have met with rejection on the ground that it directly clashes with established principles of the *riba* doctrine. Where accepting indexation is equated with accepting *riba* in another name. The question of inflation and apparently the need for hedging against it with consistency of the Islamic injunctions of finance, as Akram Khan noted it, calls for much bigger exercise than the present one. It is hoped that the Muslim scholars to accept this challenge and try to the hypothesis on the Islamic theory of international inflation³⁹. Sayid Tahir (1987) has scholarly highlighted that the *ahkam* for indexation are to be sought in the context of the *ahkam* for *riba* in the Qur'an and Sunna. The understanding of the first is the prerequisite for proper understanding of the later.⁴⁰ Mozer Kahf held the view that indexation would violate the Islamic prohibition of *riba al-fadl*. Zubair also finds indexation to be

³⁹ M.Akram Khan, Islamic Economics: The State the Art. A Second look, (Mimeograph) IIIIE extension lecture series, IIU Islamabad, April 1,1998 p.8.

⁴⁰ Sayyid Tahir, Indexation of Loans and Debt for Inflation in Islam. (Mimeograph) Forwarded to Journal of Research in Islamic Economics, Jeddah.

against Islamic principle and it has no any basis in Islamic Shariah.⁴¹ With few exceptional views indexation the general orthodox believe of Muslim scholars is that indexation is irreconcilable with *riba*. Examining this traditional comprehension on the light of our earlier interpretations of *riba*, this chapter is trying to examine the matter from a legal point of view, and critically to investigate the validity of this traditional believe. It is probing seriously whether accepting any kind of indexation means accepting *riba* or in other way round, preserving the existing thinking of ignoring the inflation induced erosions of monetary values in loan contacts implies perpetuating *riba*, while we have to still strive for its elimination in form and letter rather than in substance and spirit, for more, probably not years but centuries to come. The paper presents firstly juristic interpretations of the problem, pointing out certain conceptual inconsistencies associates with *Fiqh* discussions. Secondly, It outlines the direction of rethinking in order to formulate a consistent view of indexation in the framework of *riba* prohibiting rules. Thirdly, it discusses the present options and proposed schemes for indexation. Finally it concludes with qualifying conditions for a feasible index.

9.5.1 Juristic Interpretations of the Problem

No doubt that Islam has laid down a standard principles for justice and fairness and repeatedly emphasized the importance of these fundamental concepts for economic dealings of the people. Where as a matter of principle in Islam, the Qur'an strongly urges the people not to eat the properties or rights of others unjustified or unlawful (4:29 and 2:188) and to give just weight and measure and not to defraud others of their possessions (7:85 and 11:84-85). Allah says: "Give full measure, when you measure, and weight with even scales" (17:35). He commands also: "Weigh with even scales and do not cheat others of what is rightly theirs" (26:182). He further orders: "Give just weight and full measure" (55:7-9). Qur'an explicitly says: "Woe to those that deal in fraud, who, when others measure for them, exact in full, but when they measure or weigh for others, defrauds them" (83:1-3)

However, the contemporary Islamic scholars have apparently placed heavy reliance on a letter rather than spirit of these established Islamic principles and views of classical Muslim jurists. One may seek guidance from the *Fiqh* literature regarding whether a thing having no

⁴¹ Judgement of Interest(*riba*), FSC.IRTI, IDB,1995, p.137.

value of its own is considered as money in Shariah in early days of Islam or subsequently the problem of inflation and deterioration of monetary value are similar to our present reality. If their similarity is confirmed how it was resolved. Reviewing the existing *Fiqh* literature on this issue one may wonder to find number of opinions and eventually conflicting views and diverse interpretations of the same existing Shariah injunctions in the present state of art. *Fiqh* scholars have almost common conviction in objecting any compensation for the erosion of the monetary value. The current studies of the subject as far as the indexation schemes of loans are concerned show two major reasons for its objections on the Shariah point of view⁴²:

- i. Islamic jurists maintain throughout the centuries as a matter of principle that fungible goods must be returned by its similarity or the like (*mithl*), based on apparent meaning of *ahadith* of the Prophet(saw). Therefore, any scheme which involves payment of a greater amount of the commodity lent amounts to *riba* and hence unacceptable in Islamic economy.
- ii. It is unjust and exploitative for the lender to insist on getting a compensation for erosion in the value of money post facto, while he is not prepared to get a lower amount when the value of money appreciates. In other words, why should the lender alone be protected against inflation while the borrower is not similarly protected against deflation⁴³.

Perhaps, the main rationale of the first objection stems from their juristic assumption of equating money or currency with a commodity. It is because of this reason that the *Fuqaha* insist on the return of the same commodity if it is available, irrespective of the fact whether the price of it has increased or decreased. On the basis of this context it is interesting to note that Islamic *Fiqh* Academy, formed 1983 under auspices of the OIC in its session held at Kuwait 1988 has also disapproved indexation.

Undoubtedly, there is no difference of opinion among jurists that any increase stipulated to be paid on the amount originally lent is *riba* and is prohibited. The jurists also applied this principle in case of a loan taken in dirhams and dinars. The jurists are generally

⁴² Munawar Iqbal, *Ibid*.

⁴³ *Judgement on Interest (Riba)*, FSC, IRTI, IDB, Jiddah, 1995, p.141.

in a consensus on the point that if the coins' value increased or decreased, provided that their circulation did not completely come to an end or stagnant, the borrower has to pay the same number which he borrowed at the time of contract⁴⁴. But, Jurists were holding strictly the terms of the contract as far as the nature of estimation is concerned. Ibn Qudama has substantiated this point asserting that the loan should be returned according to the agreed estimation at the time of the contract, he expressed that "if dirhams were lent out by counting they will be paid back by counting and not by weight. Similarly in case they were lent out by weight they will be returned by the weight and not by counting⁴⁵." However, If the value of money increases or decreases should the borrower pay still the same amount or number in nominal terms at the time of the contract or the value of the money would be considered? There are different views on this issue according to the majority of *Fiqh* schools of thought "the amount which was agreed at the time of the contract should be considered. But, Zaila'i noted that if a person borrows certain amount of *fulus* or token money as a loan and then it became stagnant or it was devaluated, he would be liable to pay the value at the time of contract or the time of the collection⁴⁶. According to Abu Yusuf and Imam Muhammad the opinions of classical Muslim jurists can be summarized as follows;

- a) If the amount lent is in the shape of dirhams, i.e., silver) or *fulus* the repayment must be in dirhams of same quality and in the same unit of measurement.
- b) If the lent commodity (meaning both quality and quantity) is available and useful, though guarantee at its back removed, the same will be returned without an objection. However, if the lent commodity is no longer available or has not remained current and useful, the repayment will be made in similar quality and quantity, keeping in view the time when it was lent.
- c) In respect of the loan of a commodity it should be returned in the same kind and quantity, irrespective of any change in its price at the time of returning the loan.

⁴⁴ Ibn Abideen, *Tambeeh al-Raqood fi Masa'il al Nuqud*, vol.2, p.62

⁴⁵ Ibn, Qudama, *Al-Mughni*, vol.4, p.356-357

⁴⁶ Tabyeen, *Al-Haq'iq*, vol.3, p.143.

From this apparently similar treatment of commodity and monetary units the contemporary scholars have taken its generic literal meaning and interpreted the above principles to be equally applicable if the payment is taking place under the circumstances of barter, demonetization, debasement, devaluation or revaluation, remuneration, compensation or indemnity, irrespective of any change in its relative value in terms of other goods or currency. The learned scholar M.Ghazi has emphasized that if money is a valuable commodity, or loan of an enduring institution, the same will be returned irrespective of any change in market conditions. Ghazi, in his paper on 'Indexation and Inflation: A Rejoinder from Shariah Viewpoint' stressed that there is no difference in this respect between paper money and real money. Moreover, he asserted that paper money is real money. According Ghazi everyone agrees that whether paper currency or real, all are medium of exchange they represent power to purchase on a given date'.⁴⁷ Because, 'the borrower who borrows a paper money, in fact, acquires certain amount of value, changeable to certain amount of utilities in terms of goods or services. He thus, acquires a value for purchase and the lender gives away the same amount of value or utility which must be returned in equal standards. It may be also pointed out that the council of Muslim Jurists working under World Muslim League Makkah, has also ruled that "the currency notes are to be considered real money for all practical purposes."⁴⁸ In this respect the Council maintains the position of paper money is exactly like gold and silver⁴⁹. Justice Taqi Osmani also argued that since the necessary condition of *mithliya* is the equivalence in magnitude or number not in the value hence, the similarity required in paper money is also the similarity in quantity and amount rather than its purchasing power. If the discrepancy in exchange value of goods (dates) is rendered useless and completely ignored, then that of the money also should be neglected and disregarded.⁵⁰ In another place he asserted the "Shariah injunctions which prohibited *riba* have specified with complete precision and clarity that the considered subject matter of *milth* is equivalence in quantitative number not value (purchasing power). Thus, there is no any reason left for arguing that its meaning to be specified on the basis of "*urf*" (social norms or customs) "⁵¹ This

⁴⁷ Mahmoud Ahmad Ghazi, Indexation and Inflation: A rejoinder from Shariah Viewpoint, Pakistan Banker, January-Jun, 1993, p.113-117.

⁴⁸ M. A. Ghazi, Ibid.

⁴⁹ M. A. Ghazi, Ibid.

⁵⁰ See Taqi Osmani, (H. 1415) *Buhuth fi Qadaya Fiqhiya Muasara*, Ibid, p.174.

⁵¹ Taqi Osmani, Ibid, p.189. This view was expressed as a response to an impression given by certain economists that the meaning of the term *mithl* should be specified in the context of social customs and cultural practices.

similar treatment of commodity money and paper currency which is the generally accepted view and current dominant opinion among the contemporary Islamic economic writers and *Fiqh* scholars, have raised certain fundamental inconsistency and shaky decisions to be concluded in most seminars and discussions on this issue. The contradicting reasoning of the objections of the subject is apparent from the report of the IIC which states that;

"Under a system of indexation the liability of a borrower to the banking system would be adjusted in money terms to reflect the change in the value of money, as measured by a price index during the period the borrowing remained outstanding . . . Indexation may constitute a favorable factor for the growth of savings in an inflationary situation by preserving the real value of money savings⁵²."

Zia uddin Ahmad (1989) a prominent scholar and pioneer in Islamic banking and finance was closely observing the wavering situation of decision taking on the issue and he noted that "the deliberations of the Council appear to be heavily in support of indexation. But suddenly a Shariah notion of currency was found to obliterate a logical conclusion of their deliberation on the subject" and the Council adopted the following view;

" Under Shariah currency transaction are not treated differently from the commodity transaction in as far as lending and borrowing are concerned, the basic principle is that the same quantity (units) should be returned as was borrowed even though the price of the commodity may have changed in the mean time. For example if one maund of wheat has been borrowed, the borrower will have to return one maund of wheat even though the price of one mound of wheat may have risen from Rs.30/- to Rs. 50/- per maund, or fallen to Rs.15. Similarly if the borrowing consisted of a specified amount of money say Rs.1000 the borrower will have to repay the same amount of money even if the value of rupees in terms of other goods and services may have changed⁵³."

Perhaps this fact of the conflicting opinions was realized in the Seminar on 'The Position of Indexation in the Shariah' organized jointly by Islamic Research and Training Institute (IRTI) of Islamic development bank Jeddah and IIIE Islamabad. Although the participants reaffirmed

⁵² IIC, Report, Ibid.

⁵³ IIC. Report, Ibid.

the general believe of *Fiqh* scholars that the Islamic injunctions on *riba* have clearly defined the meaning of *mithliya* as the similarity in number or quantity rather than the value or price⁵⁴ and the participants expressed their view that paper money is similar to dirhams and dinars, which their static condition against their value/price fluctuations are agreed upon. But on one hand they admitted the short comings of the present Islamic economic state of art particularly in this issue on the other. Therefore, they endorsed that there is a need to concentrate on the issue of real and nominal money which might contribute to arriving at a clear judgement of the legal position of number of theories. They recommended that a comprehensive discussions of the concepts, scope of *riba* and wisdom of its prohibition are needed, particularly in the context of its bearing on indexation and its contemporary relevance. It is also pointed out that Islamic economists held mutually conflicting views on the Islamic approach to price stability in the context of a market mechanism in Islamic system, the issue which requires a critical examination of the subject in order to arrive at a conclusion fully accords with the letter and spirit of the Islamic teachings on the concerned subject.

9.5.2 Towards Consistent View of Indexation

The current discussion on the subject in relating the values of *dinar* and *dirham* or *fulus* to their purchasing have been confused by Muslim economists who have mixed up the concept of intrinsic value with exchange value. While *Fuqaha* applied the concept of intrinsic value in both goods and monetary values, the contemporary Islamic economists tried to generalize the criteria of purchasing power and apply it in goods as well as monetary currency. As a result, this confusion has led them to distinguish between real and nominal values. All goods including commodities as well as paper currencies are concerned real money in terms of purchasing power.

Probably they for get to take into account that the value of commodities or bullion money is represented by its contents and value in use, while the value of paper currency is represented by official commitments, rather than its physical content. In fact the point of confusion of Muslim economists lies with presumable equal treatment of *Fiqh* literature towards intrinsic and exchange values of goods and monetary instruments. The classical *Fiqh*

⁵⁴ Taqi Osmani, (H.1415) Ibid., p.191-92.

scholars have not ignored the concept of purchasing power. But, *Fuqaha* have considered the intrinsic value of things to be the standard principle. In the discussions of the majority of *Fiqh* scholars we can find that there is no separation between intrinsic value and purchasing power. Perhaps the reason was that in their period the evaluation of things, i.e., fulus and goods, were referred to dirhams and dinars which their value represented by their contents. Moreover, when the basic monetary units were natural metals, i.e., gold and silver, their scarcity or plenty was out of the control of the monetary authority which was ensuring the standard value of money. And this case, the role of the government was merely to maintain this standard by supervising the purity of monetary units from deception through clipping it or manipulating its contents. But the problem arises when the nominal value and real value of things get separated and as the paper money has no more intrinsic value, but, its exchange value has come to depend totally on official commitments and legal power of its protection rather than its physical content.

Nevertheless, the intrinsic value of gold and silver does not mean that gold and silver are demanded for themselves like consumption goods, but they are mainly to function as a money for transaction purposes in exchange for other goods and services. The intrinsic values of gold and silver coins designed for monetary purposes are mostly confined to their purity or quality rather than their value in use in a non monetary purposes. Perhaps, this was perceived and conceptualized by our great theologians who have enlightened multifaceted issues of social, economic, political and religious matters. We would like to refer this discussion to their teachings seeking guidelines from their profound comprehension of the subject. It is most appropriate to cite here Al-Imam Ghazali's deep understanding about the nature of money. He held the view that the basic function of gold and silver is to facilitate the exchange system and serve as a money alone by nature. In this regard he expressed "Creation of dirhams and dinars(i.e., silver and gold coins) is one of the bounties of Allah (swt). The entire world of economic activities is based on transactions with these two kinds of money. They are two metals with no benefits in themselves. However, people need them in order to exchange them for different things⁵⁵." Further, "anyone who uses money in contrary to its objectives or functions is ungrateful to the bounty of Allah (swt). If someone hoards dirhams and dinars, he is a transgressor. Dirhams and dinars are not created for any particular persons,

⁵⁵ Al-Ghazali, *Ihya Ulum al Din*, Darul Nadawah, n.d., Beirut, vol.4, p.91

they are useless by themselves they are just like stones. They are created to circulate from hand to hand⁵⁶." Al-Ghazali emphasizes on this point again and again, that money is not desired for its own sake⁵⁷. The purpose that it is to be served by gold and silver is almost exclusively as money, i.e., dirhams and dinars, these metals are synonymous to money⁵⁸. They are symbols to know the value and grades of goods⁵⁹. Ibn Rushd also noted the basic difference between money and commodity "The first and for most objective (and purposes of using) of money is transaction not usufruct or utility on contrary to goods which have utility of their own." And Ibn Qayyim also expressed that "dinars and dirhams are the values of trade goods and hence money is the standard unit that determines the value of goods, assets and properties." Therefore, money has no intrinsic value but its purchasing power makes it instrument for exchange and transaction and gives it exchange value. And with the increase of its purchasing power its value increases, hence people demands for it not for itself but for its purchasing power. Therefore, the value of money is its exchange value only. According to this understanding the subject of matter of money is its value or purchasing power as an essential feature which determines its equality or difference. The same as the difference of quantity and number if the value or purchasing power of monetary units is different, they must fetch different quantities of goods and services. Hence the similarity and dissimilarity of monetary units are determined largely by their purchasing power. Al-Khalifi deduced the above classical views of money and values that the absolute similarities or likeness of things necessitates (i) similarity in shape and structure (quality) and (ii) similarity in monetary value or price⁶⁰. So similarity in features and similarity in value are the basic elements that determine the likeness of any two commodities or monetary units.

However, there is a difference among *Fiqh* schools on considering countable things alike, this is the view of the majority of *Fiqh* scholars they are of the opinion that money is countable and accordingly it is similar or alike. Thus, it will take the rule of alike things on the basis of its nominal value. This notion of being strict to the similarity in feature and physical likeness is perhaps the basic assumption that makes commodities and currencies of different qualities and values to be considered the same as long as they are equal in number.

⁵⁶ Ibid, vol.4, p.91-92

⁵⁷ Ibid, lhya, vol.3, p.169, 279, vol.4, p.91.

⁵⁸ Ibid, vol.4, p.91-92.

⁵⁹ Ibid, p. 73-74.

⁶⁰ M. Tahir Khalifi, Ibid., p.61-65.

This similarity had been preserved throughout Islamic history in the minds of majority of *Fiqh* scholars⁶¹. Where the similarity in features may take care of similarities in quality, this may not hold in monetary currencies which although the currency units are alike physically and numerically but they may not be equal in value. Perhaps the present Muslim scholars who held view of quantitative equality to be sufficient for the similarity of things built their assumption on the view that nominal and real value of money may not significantly diverge from each other in the Muslim societies practicing in Islamic economic system, where it is expected monetary stability in the economy. This might be practically historical fact as the Prophet (saw) had permitted when Ibn Omar asked about it. Reportedly, Bashar bin Mughir has said a man was owed to me certain dirhams but he offered me dinars, I told him that I will not take until I ask Omar, and I asked him and he said, go to the exchange dealers and ask them whether it stands for that same price, then if you like take it (accordingly) and if you like take similar to your dirhams⁶². "If the similarity in value of monetary currencies holds then the expression of Imam Abu Hanifa will take historical context when he said "the buyer should consider the value for the increase of price and its decrease may not necessarily cause invalidity of the value."⁶³

Ibn Qudama held the view that "defects decreases the monetary value⁶⁴." Ibn Taymiya went beyond that and expressed the change in the price is the reflection of the change in value and the defect in (the good) itself', and since a defect is there he held objections to the repayment of a loan on the basis of quantitative similarity and recommended its evaluation on the price prevailing at the time of the contract. Ibn Taymiya has relied in his view on the *Fiqh* principle which states that "The difference of prices prohibits the similarity." In other words where there is a price divergence there is no similarity. Ibn Taymiya explaining this point asserted that "it is necessary that the repayment of the value to be observed if the commodity (money) depreciates, that is the reduction of its value which is a kind of defect. And the defects in quality cannot be understood except through reduction of its price. Therefore, if someone lends another certain amount of *mal* (property) then depreciates in value, it is a decrease in quality which cannot be covered in numerical counting, for it will remain inferior

⁶¹ M. Tahir al-Khalifi, Ibid.

⁶² Cited by M. Tahir Khalifi, Ibid.

⁶³ From the same above source.

⁶⁴ Ibn Qudama, *al-Muqhni*, Ibid

in value, (though, it is the same number). So, it should be paid in its value and that is the justice, for the two valuable things can be alike only if their values are equal, but with deference of their exchange values, there is no similarity."⁶⁵ Moreover looking seriously into the arguments of Imam Abu Yusuf we find that he considered *fulus* to be referred to its value in dirhams and dinars, according to his view *fulus* were dependent from commodity monies, they associate with or were backed by dirhams or dinars. Therefore, the loan should be returned in terms of dirhams and dinars, even, if its quantity at the time of payment exceeds its original principal. His opinion could be understood that in case the loan is given in terms of dirhams and dinars the value of the time of collection is considered for maintaining the same amount of dirhams and dinars. But if the loan was given in terms of *fulus* their value at the time of the contract is considered. This is the view of Abu Yusuf that the *fulus* must be paid on the basis of dirhams, for instance, one who borrowed a hundred units of *fulus* which its value depreciated to half in terms dirhams or dinars he should pay two hundred units of *fulus*.⁶⁶ Despite the fact that the above eminent Islamic scholars, i.e., Ibn Taymiya and Ibn Qudama had also clearly and rationally elaborated the intimate relationship between quality and the value of the goods the significant point which the contemporary writers are still in ambiguous state resulting from their disregard about the qualitative aspects of the things.

Perhaps the basic predicament that confuses the contemporary scholars is the equal treatment of commodity and monetary currency in loan context, they see that money is different from the commodity and at the same time a same rule is applied to both. But on what ground, it is not intelligible from the presented views of contemporary Islamic economists or from the *Fiqh* scholars. Some of them are insisting that equality must hold while others ask about the logic behind this equality. Majority of the *Fiqh* scholars and large number of the Islamic economists maintain to be very strict to the literal interpretations of the classical jurists, without looking into the underlying economic rationale or logical conclusions of their views. Those who see its impracticality or its intricate dimensions they look into the problem in the context of the purchasing power or exchange value. Chishti pointed out that the change of price of wheat is due to a change in the monetary sector while its purchasing power in terms of other commodities does not change which may vary only in response to a change in the real sector. Mostly it is thought that instead of using that Shariah preserves the exchange

⁶⁵ Ibn Taymiyya, *al-Majmu' al-Fatawa*, Unspecified, see M. Tahir Khalifi, *Ibid.*

⁶⁶ Ibn Abidin, *Ibid.*, p.60. See also Taqi Osmani, *Buhuth al Fiqhiya fi Masail al-Mu'asara.*

value parity of the borrowed commodity provided the parity is not disturbed due to the changes in the real sector. Certainly, there is no dispute among *Fiqh* scholars that the loan must be returned in the same kind (*mithl*) and quantity. Otherwise, its value should be returned. In case of loan the exchange or the value is the solution of repayment when there is no similarity in kind for the borrowed object. The Holy Qur'an clearly lays down a basic principle for loan transaction: "Wrong none nor be wronged" (2:279). To the same effect there is a famous *hadith* of the Prophet (saw). "No harm and no one should be harmed." So efforts should be made to comply with the substance of Shariah principle rather than the form.

Then, the question that arises is if these are permissible principles of debt repayment why in case of goods the borrower must return the same good or its *mithl* with the same quantity irrespective of its price variation, while on the other hand in case of a loan in monetary terms, we are insisting the value must be observed? The reason as we mentioned earlier is due to the nature of the good and its intrinsic characteristics. And the problem has a simple microeconomic dimension which most of the modern jurists are missing, but noted by earlier prominent Islamic scholars Like Ghazali, Ibn Taymiya, Ibn Rushdi, and others, dirhams and dinars are created to circulate from hand to hand they are useless by themselves and they are just like stones⁶⁷. "In other words they are metals with no benefits, people do not desire for themselves, but for facilitating their exchanges of goods. If that is the situation in case of gold and silver coins what about the nature of modern paper currency? . There is no any dispute on the nature of paper money, and that it does not have in fact any value in nature or use except that it is a legal tender authorized by government to function as a medium of exchange. Thus, to the extent the concerning monetary authority make commitments to keep its exchange value, the general public may accept it as a payment for goods, services, debts, tax etc., but it can satisfy no other need⁶⁸. In case of a physical object the user derives utility directly from it, where each physical object contains certain level of utility by nature and the consumer gets satisfaction by consuming it. Therefore, monetary units are simply a warrant to acquire certain level purchasing power, which entitles to the holder a given level of utility or welfare. In other words paper currencies by themselves have no benefit except to keep the value and intermediating it through exchange of goods. Then we have to keep in mind what

⁶⁷ Ibid, vol.4, p.91-92

⁶⁸ Justice Gul M. Khan, Ibid.

is intended by taking a loan is not for just obtaining pieces of paper money but the object that is needed, not the intermediating exercise as such which is the function of any thing used as money, but the level of welfare that would be acquired from its final spending on goods or services. If we further examine the subject we find that Shariah wants that as a matter of principle the property of the people to be safeguarded and its value content should be preserved. In case the loan object is in terms of a good or commodity the quality of the goods should be preserved. This does not mean its purchasing power to be protected where the purchasing power mainly depends on its scarcity or abundance in the market. What is intended in this loan context is to preserve the quality which implies the utility or the satisfaction that commodity provides to its user at the time of the contract. The demand for the good is actually the desire of the individual for its utility which decreases with the decrease of its quality similar to the decrease of its quantity or vice versa. The change of either one ultimately reflects on the variation of its price other things remain the same. Hence, the utility of the object must be maintained as the value in use or actual content of the usefulness in the good constitute the subject matter of the transaction. This implies that the intrinsic value and essential features of the real goods are considered to be constant as long as their qualities remain the same, even though their price or exchange value in the market may fluctuate.

To illustrate the above discussions in diagrammatic form we consider the following example. Suppose there are two individuals A and B and two basket goods, physical good Q and monetary M, where in the above diagram the vertical line measures Q and M the horizontal line. We assume also two periods, i.e., present T_1 and future T_2 periods. Presently individual A has an amount OQ of good Q sufficient for two periods he is going to save half ($OQ - Oq_1 = q_1 Q$) of his goods to the future consumption Oq_2 . As he equally prefers the consumption in the two periods, his welfare will be optimum reaching at E_0 along the U_0 utility level curve, if he consumes it in equal proportions. Individual B has nothing for the time being but he is sure that he will get in the future.

Then, it would be beneficial for both individual if they make a loan contract, so that individual B not to suffer and he can make use of the saving of A and return it in the future. We assume that at the time of the contract there is one to one relationship between good Q and its monetary value, where $OQ = OM$. In this context A and B agreed upon the terms of the loan contract, on that B to return the same amount of the good with the same condition or its price. At the present time A is to consume Oq_1 amounts of good Q and other half Oq_2 goes to B. If the exchange ratio between Q and M remain the same in the future as well, A will lose nothing in receiving either of them. Suppose, general price increase or inflation has been realized and price of Q goes up in the face of M, price line rotates from E_0M to right upward to E_0Mi_2 . Now if B returns the price of the time of the contract A will end up at E_1 along the lower level curve where the original price that amounts to Mo_2 fetches now only Oqi_2 . In this case although B pays back his due in nominal terms but it is undoubtedly makes injustice to A. If A is to maintain the same level of utility B should pay Omi_2 of money in order to make A receive his original saving Oq_2 of good Q in time T_2 . It is very obvious from this analysis that the welfare level of individual A will maintain his welfare constant only if same amounts of Q is returned to him irrespective of the exchange value or the variation of the price ratio. But, this price variation of Q due to the general increase of price level should not be confused with variation of the price due to the change of quality of the good, where in both cases the price of the commodity varies, we stress in this context that the quality of the good must be the same as this is prerequisite for receiving the same level of welfare.

This diagram also depicts that while the repayment of the loan to A in real terms makes him to remain the same level of satisfaction, but in nominal monetary terms would imply a great loss to A which amounts, according to the above figure to about 40% of his original loan. So, we may conclude that what matters is the object, i.e., a commodity or the services on which the utility or welfare level of the individual is directly depending rather than the number or nominal value of paper currency which has no use in itself except to facilitate the intermediation⁶⁹. Further more as generally economists believe two natural factors usually determine the exchange value of objects firstly its intrinsic value or value in use which may serve the underlying factor of demand force, secondly its scarcity or supply force induced by underlying costs and sacrifices in its production. These two forces significantly play as the two

⁶⁹ S. Chishti, Case for an Indexed Financial Instrument, *Pakistan Journal of Applied Economics*, 1986, vol. v No. 1, p.47-61.

blades of the scissors to determine the equilibrium price level. Since all economic goods are subject to these natural laws, it is not conceivable that government can easily manipulate its quantity and price. For instance, if the government uses gold or silver money, the supply of gold and silver is less determined by the monetary authority relative to the paper money, more over gold and silver have extra usage they are used for non monetary purposes. So they have natural usefulness. These two attributes of gold and silver are major factors which relatively maintain the purchasing power of money. However paper money is devoid of these two qualities on one hand it can be produced with very negligible costs and it completely lacks an intrinsic value. Therefore, it is merely a fiduciary money its reliability is derived from the degree of government commitment to maintain its price, but if the monetary authority cannot maintain a standard stability of its value, then paper money is not fit for a loan contract or long term financial obligations. In case a loan is provided in terms of paper money, it should be assessed on the basis of another stable monetary unit for maintaining the actual value of the loan at the time of the contract.

9.5.3 Present Options and Proposed Schemes of Indexation

There is a general agreement among *Fiqh* scholars on that in case of resorting to value, due to various reasons, the loan should be assessed in monetary terms. But, which price to be referred in this evaluation and whether the borrower must pay the price of the thing when it was borrowed or the price at the time of its final repayment, it seems to be controversial. Perhaps there would be three main opinions; first, it should be according to when the change of the value was realized the second opinion recommends the price that was prevailing at the time of the contract. And the third opinion suggests that it should be the price of the time of returning the loan. However, all cases are permissible depending on the nature of the loan article and the initial terms of the contract per agreement of the two parties. Under the principle of "*La dharara wala dhirara*" The *Fiqh* scholars mention certain examples related to this above discussion. Suppose if the paper currency (fulus) is the price of a sale or loan then its price increases or decreases after the contract is concluded. Abu Yusuf held the view that he must pay the price or value of sale or loan on the time of the contract. The same is the case if it becomes obsolete⁷⁰. But Imam Muhammad opined that the value should be according

⁷⁰ Abu Yusuf, reproduced by Zarqa, *Sharhu al-Qawa'id al-Fiqhiya*, 2nd.Ed 1989, p.181

to the time when the currency became stagnant. Sh. Ahmad Zarqa is of the opinion that the present currency follows the same rule of the above principles. But, Mustafa Zarqa the son of the former Zarqa suggests that *fulus* in a loan take the rule of *Amana* analogous to *Mudaraba*.⁷¹ However, he mentioned on the basis of the principle "the harm should be removed" and referred to the above view that "if someone takes a loan in terms *fulus* then it became obsolete, he has to pay the value of the day of the contract in both sale and loan."⁷² Moreover, the evaluation must be on the basis of something (i.e., another good) or monetary currency which its value remains the same or relatively constant. Because, for the same reason it may not be acceptable if the quality or value of that good or currency is subject to variation, this good or currency cannot be the object of a loan, and it cannot be the standard for deferred payment. The object that is capable to preserve or store the value of the loan involving certain period of time is viable for loan transaction. Even though the cause of variation is due to natural factors. Hence, in this situation loan contract is not feasible at all for reasons mentioned in Chap.4 of this research.

Now, with the same analogy if the loan in the beginning takes place in the form of money. If the money is valid for performing its basic functions normally as a unit of measuring and store of value and hence reliably serves as the standard for deferred payment it can be the object of the loan. But if its purchasing power varies in relation to most or all other goods, it cannot be the object of a loan. Therefore, in this context it is imperative that any loan that involves considerable time during which the variation of the value of money is reasonably expected must be evaluated on the basis of a constant object or which its price varies in longer period. In this discussion we may assert again that; what is important in loan context is the preservation of the loan in terms of quality (value-in-use, if the loan object is a commodity) or in terms of value and purchasing power (e.g., if the loan is in monetary currency or priced on it). Islam recognizes all functions that money performs such as: being medium of exchange a store of value and standard of deferred payment. The Qur'an has repeatedly emphasized and obliged upon Muslims to establish a standard system of measurement in which there can be no reduction of either parties' property (in terms of quality and quantity). Except the unit of value measured by fiat money all units of measurements are fixed and remain constant over time. But fiat money in its value content in

⁷¹ Zarqa, *Sharhu al-Qawa'id al-Fiqhiya*, 2nd.Ed 1989, p.165-183

⁷² Zarqa, *Ibid.*,

terms of purchasing power usually changes over time, and hence a unit of value varies in relation to itself. The justice in a transaction of a commodity of the same *jins* (kind) essentially requires the same quality and quantity. This condition as we have been emphasizing all along in the previous chapters must be strictly observed.

In case of quality differential the *hadith* of Bilal (*ra*) explicitly dictates that such transaction can be made through another commodity in order to ensure exchange-value equivalence. Chishti has rightly come up with the view that exchanging today's currency unit with future inflated or deflated currency units is clearly violation of the spirit of this *hadith*⁷³. The general objectives of Shariah reinforce the view that denying a compensation for the erosion in the purchasing power of money is a violation of the basic principles of Islamic economic Justice. Furthermore, according to Islamic principles of a loan transactions establish the fact that once the loan is concluded the object is not subject to any kind of risk including theft, loss or obsolete or inflation. It is fully guaranteed in its *mithl* or value. In other words the object gets immunity against factors that possibly influences its original quality. This does not mean that the borrower should always return the same good with the same quality as this condition may sometimes become impossible. It implies that if that is not possible then the agreed value should be returned.

Thus, it would be fair enough to say now that in order *riba* to be avoided, the debt contracts must specify that loans signed on a particular date will be paid in terms of its purchasing power on that date. If during the period loan is sanctioned and repaid, the value of money in terms of goods and services has declined, the debtor will compensate the lender by paying the difference, if the purchasing power of money in terms of goods and services has increased during the currency of the loan, the debtor will pay lesser units of money, and no difference of units arise if the price level has remained stable. Nevertheless, the indexation should not be the compensation of one party for the injustice done by the inflation on the expense of the other, the protection of the lender should not be considered at the cost of the borrower. That is both borrower and the lender must be put on the same footing. M.Ghazi concluded from the Qur'anic text "Wrong none nor be wronged" (2:279) that the wrong to the lender is to deny even the payment of a complete amount of the loan principal or its

⁷³ Zarqa, *Ibid.*,

original value, while the wrong to the borrower is to ask him to pay some increase over and above the principal defined in the contract. Just as contemplated in this verse, it requires that the lender should not claim any thing over and above his specified principal under any pretext and the borrower should not be forced to pay any increase beyond the agreed principal. Hence, when the terms of the contract are clearly defined in the contract the borrower should not refuse to pay back the principal under any pretext⁷⁴. However, the loan principal should be fixed either in quantity of specific currency or good or similar value, that once this contract is concluded and agreed upon, the borrower must bear the responsibility for the return of the same value or equivalence in terms of quality and quantity irrespective of any circumstance that may take place afterwards, including the death of the borrower himself or complete loses of the loan. If someone carefully examines this proposal there is no any fear of injustice to any party where indexation does not provide any gain to the lender and it does not impose any burden on the borrower. It could be fair to both parties, but only it requires them to deal in real terms⁷⁵.

This provision of equity in terms of purchasing power will be in the interest of both the creditor and debtor and consequently in the larger context of the society. If the individual saver is not protected from the possible loss of purchasing power of his original principal, there is a greatly reduced incentive for the potential saver to assume investment risk when the ultimate enjoyment of postponed satisfaction appears doubtful. As a result of such situations, total savings will be smaller and the tendency to hoard or hold capital in idle form would be greater, except to the extent the natural impulse to save among the lower income groups and unavoidable savings by the wealthy may continue. But the general expectation of future trends in commodity prices is a dominant consideration in times of inflation and this may induce the motivated and automatic savings to shift in idle forms of metals and jewels, such passive forms of savings can damage the economic activity. The main purpose of the indexation may be expressed that is simply to make it more efficient and free it broadly, from all the constraints linked to uncertainty about the future and fully to establish the principle of justice and honesty in the execution of contracts⁷⁶.

⁷⁴ Mahmoud Ahmad Ghazi, *Ibid.*, p.115.

⁷⁵ M. Iqbal, *Ibid.*, p.26.

⁷⁶ Maurice Allais, *Ibid.*, p.32-33.

Based on the ground of this evidence, there are many reasons to believe that the real source of the trouble to be too much reliance on 'money', money has been one of the most useful inventions in the field of economics, but as Iqbal put it, even the most useful of inventions may turn out disastrous if it is misused. Perhaps, similar to the electric shock that someone may get if one is not careful in using it.⁷⁷ In view of the experience of more than a century, it can safely be said that money is suitable only for transactions that are completed shortly after they are begun.⁷⁸ This perhaps complies with the Cambridge definition of money as "a temporary abode of purchasing power."⁷⁹ Since, the monetary unit is designed to keep the value and transfer it from one commodity to another, every effort should be made the value should be measured accurately with a standard constant unit. It is very strange to experience, in this modern age where every thing on the earth is brought under universally a standard unit of measurement, the most essential factor remained undefined and value of the basic wealth, savings, and earnings of the people are subject unconsciously to evaporation or eroding wind of inflation. In an attempt of solving this problem three ways have been proposed:

- i. Eliminating fiat money and going back to gold-standard type of arrangements in which the change of its purchasing power is out of the government control ruling by the natural scarcity of gold-production.
- ii. Accepting the loss of purchasing power of money without compensation and hence to let the lenders and savers be penalized by depreciation of the purchasing power of money.
- iii. Introducing a special financial instrument or standard value index, which may be comprehensive in such a manner that it would be applicable to any financial contract related to significant period of time represents in consumer, producer, wage and loan indexes⁸⁰.

⁷⁷ M.Iqbal, Ibid.

⁷⁸ Iqbal noted that it is interesting to know that such a view was expressed by Alfred Marshall as early as 1887 when price fluctuations were not as violent as today. See Memorials of Alfred Marshall, Ed. A.C.Pigou(London:Macmillan) 1992, p.197-199.

⁷⁹ Milton Friedman, See D. G. Pierce & D. M. Shaw, (1979) 'Monetary Economics: Theories, Evidence and Policy', Butterworth & Co (Publishers), Ltd. p.38-46

⁸⁰ S. Chishti, Ibid.

As far as the first case is concerned, although gold and silver served as medium of exchange for centuries, and never completely lost their demand as precious metals, so much so that even today they are desirable throughout the world, and despite the fact that they are relatively more stable or subject to fewer frequent fluctuations compared to paper currency, but, still going back to gold standard arrangement may not rule out existence of need for more accurately a constant price index, at least in the case of long term loan contracts. This is so, because gold and silver are money, and the value of money in principle is a relative concept. It does not represent in this case its intrinsic characteristics which it may have outside the monetary sphere. Being money is to serve only as a medium of exchange and a unit of account. Gold and silver coins are designed to serve for this purpose only. Because, the demand for dinars and dirhams is in fact indirect demand as Imam Ghazali has clearly expressed dirhams and dinars are useless by themselves and they are just like stones or metals with no benefits, people do not desire for themselves, but for facilitating their exchanges of goods. Therefore, their reliability depends on, to the extent they transfer the value and prices among goods or preserve a given level of value over time period. In loan context any slight variation in either quality/ value or quantity is required to be identified and compensated.

The history tells us that a lot of fluctuations and manipulations of gold money and how people dealt with this situation. Ibn Khaldun has elaborated the nature of monetary system and value assessments in the early history of Islam, He writes "The non-Arabs used a coins and engraved special picture to them and when Islam appeared, the practice was discontinued. During the time of Abdul Malik, Hajjaj was ordered to coin dirhams, the weight of a dirham was fixed at what it had been in the days of Umer. Because the dirham and dinar differ in value and weight in different regions, cities and provinces, the religious law must have its own (dirham and dinar) with a specific legal value given to them. Later on officials of mint in various dynasties disregarded the legal value of the dinar and dirham. Their value became different in different regions. The inhabitants of every region calculated the legal tariffs in their own coinage according to the relationship that they knew existed between the actual value (of dirhams and dinars in their coinage) and the legal value."

No doubt that gold and silver coinage was, however, abused, to a great extent. Rulers in ancient and medieval times, and some governments up to the nineteenth century, frequently debased coins to realize additional income. The practice of debasing coins by clipping has

been specifically prohibited, in the time of Prophet(saw). Imam Shaukani explains that the people of Prophet Shoaib also used the same methods and were destroyed when they paid no heed to warning of Allah (swt) delivered to them through him. Allah said: "Give just weight and measure and do not defraud others of their possessions" (7:84). According to Ghazali, "It is great injustice to place counterfeited money in circulation (for in this manner) all those who have to accept such money in transactions are harmed" further, "circulation of one bad dirham is worse than stealing a thousand of dirhams, for the act of stealing is one sin and it finishes once committed, but circulating bad money is an innovation which affects many who use it in transactions⁸¹."

The second option is clearly unacceptable for the obvious reasons which we have been emphasizing throughout this research. Depreciated monetary value in fixed contractual payments is economically neither bearable nor Islamically acceptable on the basis of justice and underlying principles in the prohibition of *riba*. There is no conflict among the established principles of Shariah. In most Muslim countries, an inflation rate is very high, and in this connection it is very difficult to make people accept the deteriorated value of their debts, salaries, long term loan contracts or their meager and precious savings as it is tantamount to accepting a lower real value after periods of time, for this is very clearly injustice. On the other hand accepting this situation in the name of Shariah as Akram Khan expressed it would mean that despite all the faith of the prohibition of *riba* people to feel that they would get a raw deal at the hands of Shariah in an inflationary economy⁸². Moreover, we have elaborated in the above discussion a very established fact that if there is a difference in quality which causes difference in value as in the case of exchange of superior dates with inferior dates no quantitative equality is feasible. Any visible quality discrepancy necessitates for compensation in quantitative form. The same is the case in value difference according to principle mentioned by Ibn Taymiya in above 'where there is difference in price there is no similarity. This is so even if the exchange is at the same point of time, equality in this case implies there is *riba* involved. Based on this principle if the loan object is monetary value, it is essential the original value must be returned to the best possible of accuracy and equivalence and any deviation from this that has not been compensated may amount to *riba* according to the above principle.

⁸¹ Syed M. Ghazanfar & A. Islahi, *Economic Thought of al-Ghazali*, Scientific Publishing center, KAU, Jeddah, 1998, p. 30

⁸² Akram Khan, *Islamic Economics: The State the Art*. Ibid p.8.

The third and last option is, in fact the point of contention among contemporary Muslim economist and Shariah scholars for the last decades. The issue of indexation as we have seen in above is actually highly controversial in different perspectives. The basic challenging matter of the subject is purely conceptual which grows from the traditional comprehension of *Fiqh* scholars in *riba* doctrine and Muslim economists who see the devastating role of inflation on particularly fixed income groups and long term financial obligations. However, after this elaboration there is a room for reconciliation of the existing impasse and stalemate situation. In the final paragraphs of this paper we will try to sort out the matter even at the cost of certain repetitions. There is no doubt about the existence of a consensus among jurists on that a fungible good must be returned by its similar (*mithl*) and there is no difference among the jurists on that any increase or decrease stipulated to be paid in the contract on the amount originally lent out is *riba*. Moreover, there is an established principle in Islam that the contracts should be respected and once it is concluded must be fulfilled according to its terms.

However, as it may seem that the Islamic jurist concentrated the problem from one side only where they excessively focused on the settlement or reimbursement of the loan principal, for they are extremely sensitive about any increase that may be associated at the time of its repayment. But, the accuracy in repayment necessitates accuracy in advancement. When the terms of the contract is well defined and the characteristics of the concerning object are precisely described with complete awareness of the nature of that objects only it is expected that the monitoring of the similarity of the object to be accessible. Similarity requires the equivalence of both sides of the equation to be the same that is the loan must be identical or equivalent to the return, which necessitates both sides to be assessed on the basis of the same standard. So that the essential characteristics and the intended features of the loan object to be perfectly the same. I think it is the matter of an economic fact that the subject matter of a loan object the borrower is finally intending to achieve is basically the utility or satisfaction that will provide him by the object. And this utility in terms of goods or services depends on their quality and quantity and in terms of monetary units depends on their purchasing power and number. Then, if that is the case, these same conditions will be required at the time of returning the loan to the lender. And what *Ulama* have basically been emphasizing in all along is that the similarity must be observed in transaction of a loan.

Further more the early eminent of *Fiqh* scholars have clearly explained the conditions of similarity and they have established a very fundamental principle for the notion of similarity which states "where there is a difference in price there is no similarity." On the basis of this principle they have divided the things into fungible (*mithl*) and non fungible (*qimi*). But, apparently the application of this principle has been somehow misplaced in later on, when quantitative scales alone are considered to be sufficient for determining the fungibility (*mithliya*) condition, perhaps, certain difficulties might be faced in assessing quality aspect of goods or purchasing power of monetary units, particularly in the context of existing an economic situation of that time. It seems that this improper consideration in practical procedure of evaluating the monetary things has been preserved, since the classical *Fiqh* scholars. The present reality shows that no substantial deliberations and serious efforts have been made for its correction. Therefore, the present conceptual inconsistency emerges as a natural consequence, and the situation got more complication when the revealed injunctions of Shariah are interpreted in a way serving for safeguarding and sustaining this visible inappropriate consideration.

From these discussions, it is very clear that there are reasonable arguments and evidence in bridging the gap between economists, who call for the protection of the value of loans and contemporary *Fiqh* scholars who are strongly resisting against any compensation for value loss or monetary depreciation. Resolving the problem requires to shift the focus on the initial position of the loan contract instead of confusing its post consequences. It requires that the nature of the object and conditions of a loanable article must be clear. It requires the terms of the obligation to be unambiguously defined and the basic characteristics of the loan object in its present state at the time of agreement should be precisely described. It is not sufficient one to lend say one kg of rice, date, or one car of given size, one meter of cloth or liter of honey etc. and then to wait for receiving the same from these general vague contracts. It is not sufficient one to make fixed financial obligations over a period of time with the awareness about that the monetary value will deteriorate or its purchasing power is tending decreasing over time without making any precautions. Resolving this traditional problem calls the procedure of the future settlement should be matched with the present state of the object. And as we have said earlier the contract is to take care of any thing related to the standard quality and quantity of the object on the basis of available market grades and methods of measurement. In similar fashion in case a loan is in terms of paper money the amount and its

purchasing power at the time of contract should be evaluated according to its relative price or exchange value with probably more stable real goods or other monetary units. Suppose if the loan is in terms of rupees it may be converted in dollars, dirham, dinar, etc. or vice versa depending on their stability and the maturity of the loan. But, the parity should be determined at the time of the contract and accordingly should be returned. Both borrower and the lender should bear the variation of the price from the terms of the contract. These are general rules applicable to any loan contract in both private individuals as well as the government institutions. However, although these rules may temporarily reduce the problem, they cannot serve as the permanent remedies.

At private level, if there is no general price index available, the people are still free to contract financial obligations and they can peg the purchasing power of their monetary units to any thing they feel to remain stable in the given economic situations. However, if the loan, is concluded in terms of for instance dollars, where rupees were pegged to dollar value the borrower should pay the same amount of dollars or their value in rupees. The following example is justified even under the contemporary perception "in case there is some sort of convenience to make dollars a standard of deferred payment it can be adopted. Thus, they (borrowers) will be liable to the same amount of dollars or if they want so, they may have to pay its equivalence on the day of repayment. By way of illustration let us suppose that somebody borrowed \$10,000 on the date when a dollar was equal to Rs.10. On the day of settlement one dollar valued Rs.12. Now the borrower will either pay off \$10,000 or if he wants to return in terms of rupees he will have to pay Rs.120,000⁸³."

But, the above situation may not make substantial change in the inflationary circumstance, it may ease the intensity of the problem from some individuals who can wisely judge the direction of exchange rates and rationally hedge against it. However, as we have pointed out, the main cause inflation problem is the government's economic policies: Fiscal and monetary managements, through credit creation, highly recurrent devaluation, money printing, excessive unproductive expenditures, resource mis allocations, extreme income inequality, etc., which are mainly the basic features of *riba* based economic system. All these create uncertain economic conditions. The solution to these problems is the solution to the

⁸³ Judgement on Interest(Riba) FSC, Ibid. para.226, p.158.

most other associated problems, particularly inflation, and hence, there may not be any need for resorting to indexation.

But, if these problems are there, as the case may be in most of the Muslim states or Third World countries in general, there are many genuine reasons to call for a general price index as a point of reference for the purchasing power of local currencies. This does not only fulfill Shariah requirements but also, satisfies the requisite of a smooth economic functioning and reliability of financial performance. On the basis of this pervasive situation a number of modern Muslim economists resisting against above traditional deadlock dominated by the orthodox view of the subject have proposed various schemes of indexation. Iqbal argued that in order the money to perform its ordinary function the principle of indexation holds promise and he suggested a scheme of indexation that government to issue a new financial instrument called Fixed Value Unit (Fixvalu.)⁸⁴. Chishti also has recommended for an index instrument that he called "constant purchasing power unit" (CPU) which according to him must be reasonably accurate measure not subject to revisions, and hence manipulations at the discretion of individuals, but changes with the change of real economic forces as well as the dominant currency relations⁸⁵.

All economists know that money losses or decreases in its purchasing power, as a result of governments' malpractice and misuse of the demand management policies. Thus, as long as the power of creating money deficit financing are on the hand of ruling party, it is very difficult to find out a standard constant unit of value. The efforts towards achieving stable system of monetary dealings is momentarily growing in the world, both in international financial institutions, i.e., Islamic Dinar of Islamic Development Bank, Jeddah and SDRs of international monetary fund and regional organizations. For instance, the Euro currency of European countries is of new achievement of cutting the interference of monetary policies of particular government to play with its value/purchasing power or exchange rates. Thus, as a result of this kind of independence of monetary management from the power of the ruling parties may provide for Euro currency a long term stability. Therefore, analogous to these instruments, governments may establish a standard fixed unit of value for adjustments of debt payments and long term contracts. Whether government is to issue the indexation instrument

⁸⁴ M.Iqbal, Ibid.

⁸⁵ S.Chishti, Ibid.

or keep it as an abstract value for a reference purpose is a matter implementation which may require more empirical investigation and comparative study.

9.5.4 Qualifying Conditions

There are qualifying conditions for these schemes some of them are explicitly mentioned by the learned scholars and some others are implicitly required.

- (i) The basic requirement of these indexation schemes is that it should be a constant value over time, where if any person borrows certain amount of currency evaluated on the basis of this scheme for certain period he should return exactly the same level of Fixvalu or CPU units. It is proposed that the borrower and lender could agree to denominate in terms of this fixed value unit, if they so desire and the loan will be paid back in the same units in equal number.
- (ii) This suggests that all financial contracts should be evaluated on the basis that scheme and accordingly the real value of the loan be determined ex ant at the time of the contract that must be paid ex post in terms of local monetary currency. For if the indexation is carried out in ex post the objection would carry a lot of weight and conceptually the proposed scheme of indexation does not support to pay return or gain to the lender above the value of the principal unless a variation of the scheme itself is identified.
- (iii) There is no objection in Shariah points of view someone to extend a loan in terms of local currency, a foreign currency a commodity or bundle of commodities and contract can be concluded in terms of any commodity that the contracting parties could see it would be the most stable commodity. For the sole purpose of the scheme is to protect the purchasing power of a loan and any other contractual monetary payments or financial obligations.
- (iv) The objection is not against the idea of indexation per se, but against its application particularly to the case of *qard hassan*. The idea can be applied through some other appropriate scheme and the actual problem is of finding such schemes.

- v) The scheme is applicable only on financial instruments which are denominated in monetary terms. It is not applicable to real goods or physical assets for these have their own real values or utilities.
- vi) The scheme is applicable to unproductive monetary assets. That implies the frozen money or arrested financial properties through loan contracts and other fixed income commitments which are not subject to any growth by nature such as: wages, credits, *Meher Muajjal*, *qard hassan*, etc. or any constant financial obligations that are borne for legitimate objectives or cause.
- vii) The scheme is not applicable to all investment contracts and operating capital or assets that are engaging in business activities and even hoarded money that is kept in idle by its owner. In case of investment the incremental growth or profit takes care of the maintaining the original principal. Even if there is no profit being generated from the transformation process of goods from one state to another serves hedging against inflation. So in fact increasing the real production is instrumental to inflationary situations.

The requirement for constancy in value of monetary units can further be explained on the basis of *al-maslaha* which is a very important principle of Islamic law. According to Ghazali the essential meaning of *maslaha* is an expression for seeking something useful (*manf'a*) or removing something harmful (*madarra*) .. seeking advantage or benefit and removing harm are the purpose and objectiveš (*maqasid*) of Sharaiah which by nature are aimed at the betterment (*salah*) of the creation. Thus, introducing a scheme of constant value units or fixed value units, if it is properly implemented, would take care of the economic stability and make the government decide wisely and manage the economic policy rationally. Since, in this situation government should have to compensate all fixed income groups of the society including wages and long term loan contracts such as *qard hassan*. Hence, the government in the existence of stable accurate gauge of purchasing power, may not draw any benefit or advantage from monetary manipulations for this would turn out a proportional increase of costs, as result of the increase of general price level or inflation. Adopting certain kind of general price index is necessary for making the people aware of the real value of their wealth and hence evaluating their long term fixed financial obligations against this unit index. This

would create more trust among the society. For any precautionary measures against depreciating monetary value would actually help the effort towards eliminating *riba*. Therefore, as we have shown in above discussions safeguarding the real value of the financial loan is consistent with the fundamental Shariah principles that prohibit *riba*.

9.6 CONCLUSION

The natural distinctions between doctrine of *riba* and profit establish a number of significant economic implications. Reducing matter entirely in the context of exchange, the economic relation of exchange objects is the core of Islamic theory of value and fundamental criteria of appraising the entire economic activities. According to this division, profit ensures an efficient allocation of resources which comprises production and exchange as the two essential and important processes for transforming the goods from one state to another in order to generate more value and transferring the control of resources from one hand to another. Unlike the current predominant perceptions about the matter, we can assert with stronger confidence and theoretical justification that the profit-oriented activity leads the participating parties to higher welfare and prosperity. But, *riba*-based economy is the root of inefficiency, inequity and instability, it leads the whole economy to scarcity, want and depression, as the Prophet (saw) has declared it. Although, the economic resources may seem to be prosperous state by concentration in few hands, its double doomed result is certainly predictable, because, the consequential scarcity and want for variation would be the inevitable ultimate results of this irrational behavior.

On the other hand the prohibition of *riba* and pursue of profit is the fundamental requirement for economic development which arises from the natural fact that the desire for variation calls for diversification and the desire for quality calls for specialization, together, these two requirements establish the appropriate environment for economic development. Where through the profit pursue, the resources flow by trading and production activity from where they are in plenty to where they are scarce, from where they are relatively idle or less productive to where they are productive and usefully utilized, while, in case of *riba* the situation is the reverse.

The above treatment argues that in Islamic economy all payment commitments in the context of investment are inherently associated with the existence of profit. Thus, the nature of profit-based economy is to monitor any significant divergence between the commitment payments and actual income flow which provides the system a built-in stabilizer to the capital asset market. It is substantially elaborated that this debt commitment and return dichotomy represent the nub and kernel of stability crises in conventional economic system.

Another important implication of this discourse arises from its strong relevance with the requirements of modern monetary managements and dealing with the inflation problem. It suggests that on the face of depreciating monetary value, observing the same level of fixed contractual payments would seem to be economically neither bearable nor Islamically acceptable on the basis of justice and underlying principles of the prohibition of *riba* (principle of quality equivalence) According to the *Fiqh* principle if there is price difference there is no similarity. Thus, under an inflationary situation the elimination of *riba* necessitates that the debt and long term financial contracts must specify that the monetary amount signed on a particular date will be paid in terms of its purchasing power on a specified date. If during the period of the loan, its value in terms of goods and services has declined, the debtor will compensate the lender by paying the difference. Hence if the loan object is monetary value it is essential that original value must be returned to the best possible of accuracy and equivalence for the deviation from this without monetary reparation may amount to *riba*.

CHAPTER 10

GENERAL CONCLUSIONS

Although large progress is realized in terms of number of Islamic banks and financial institutions which are rapidly mushrooming currently in the Muslim World and in terms of intensive studies contributed to the literature still as this research reveals there are certain fundamental flaws and conceptual misgivings which deeply involve in the subject matter of profit-sharing system or its underlying elements of *riba* and profit. The presence of certain conceptual inconsistencies which may induce practical misuses of number of financial modes could cause a set back to the process of Islamization of the economy and draw away the development of this new financial system from its desired objectives. This work acknowledges the importance of the existing contemporary studies of Muslim experts. However, as this study demonstrates it is matter of fact that a number of fundamental questions are frequently recurring as the challenging points in the contemporary literature. This research work might best be characterized as a reinterpretation not so much in consistency with any school of thought or particular writings. However, its basic insights are inspired by the profound thoughts of S. Tahir, the directors' general of IIIE and principal supervisor of my dissertations that his original interpretations of the concept of *riba*. Our goal is to present a theory of excess value that is legally consistent, logically understandable and empirically plausible. Further work, in testing the aspects of the theory empirically is necessary, but the first task is to prepare the ground for it, to see how all pieces are compatible to each other or fit-together, to bring the whole picture into focus. Believing that without formulating solid foundations and engaging seriously theoretical ground preparations, any results of empirical tests could be misleading, we deliberated this oral approach. It is familiar that the standard method and favorite scientific techniques of conducting research work for economic theorists in the post-World War period has been the simultaneous equation or general equilibrium model. And mathematical economists believed that they were imbuing it with more rigor.

However our view is that, although the subject of Islamic economy is theoretically mature, much was lost in the mathematical transformation of particularly this theory of excess value (profit *riba*). The mathematical method does not aim at providing a coherent explanation that allows one to make sense or intelligible conclusion of the phenomenon under question. Rather the aim is to generate a hypothetically predictable paradigm that can be tested against

carefully measured empirical facts. The extent to which the predictions are verified provides the means of evaluating the theory. What lost through this traditional methodology, is perhaps the kind of causal explanation that is found in other social sciences. The general impression we have gained from the existing literature is that the contributions that the theory of excess value makes to our economic understanding cannot be expressed in the kind of models that dominate today in economics. We opted, therefore, the alternative, relatively much older tradition in economic theory of presenting the analysis in plain language, due to the nature of the problem which its interpretation is mainly determined by its legal dimensions. A proper understanding of its essence and implications depend on the fundamental principles and textual message of Fiqh injunctions and Shariah objectives. Unlike most of the current studies, we have started our analysis with the incorporation of the linguistic and literal interpretation of the subject.

10.1 CONCEPTUAL FOUNDATIONS

In this investigations and search for the nature and source of *riba*, we have come up with the conclusion that the integral picture of *riba* stems from its literal message. It arises from a transaction of one commodity in exchange for itself. So it is a growth of something from a single commodity or economic good's own self through sale or exchange. Thus, the similarity in kind or homogeneity of the exchange items for exchange is the necessary condition for *riba*, while excess in either scale may stand for a sufficient condition. This is the inference and direct deduction from the authentic interpretations of the verses of the Qur'an, the related *ahadith* of the Prophet (saw) and on the basis of consensus points of classical Fiqh scholars. The central theme of the study demonstrates the fundamental principles of an integrated theory of *riba* namely (i) principle of quantitative equivalence, (ii) principle of qualitative equivalence. However, while the first principle can be assured by standard unit of measurement, the second principle calls for more general principle which could take care of this qualitative equality that (iii) principle of inspection and standard specification.

In this way the picture of the theory of *riba* in Islam would be complete within the following findings. Firstly the convergence of *riba* divisions (*riba fadl* and *riba al-nasia*) into a comprehensive theory of *riba*, on the basis of its linguistic meaning and technical juristic interpretations is one of the significant contributions of this study to the existing literature.

This conceptual integration may establish a unified doctrine of *riba* in Islam. Secondly *riba* is a generic term, applicable to all goods and even services. Thirdly, since *riba* is part of devouring people's properties in vain there is no particular *ribawi* goods parallel to the action of theft and robbery which cannot be attributed to particular properties or assets. Fourthly, since an abstract time can add nothing to things, the mere time differences of the conclusion of a contract and the delivery of the object matter do not generate excess value and hence has nothing to do with the concept of *riba*. The study also asserts that the legal state of *riba* will remain the same under any degree of uncertainty. Finally decrease or increase of the loan as a part of the contract is considered *riba*, for *riba* is discrepancy of either party at the cost of the other in a given particular kind of transaction. We have demonstrated that similar rules are applicable to both sale of identical goods and loan transactions and we have come up with the fact that the two transactions are actually the same establishing a particular category of exchange theory. What peculiar in this type of exchange is its requirement for conducting it on absolutely equal balance in both quantitative and qualitative equivalence. Otherwise, the transaction may contain *riba* elements.

We may emphasize here that considering a loan contract as a kind of sale transaction is not contrary to the concept of exchange. What is inherently characterized in the nature of exchange is that two goods are given one for another and nothing more. This transference of the same good is considered as an exchange in its broad sense, both in the common usage of the term and in jurists' technical interpretations. In this sense, the loan contract represents the credit sale of this particular exchange, while the immediate transaction of identical goods may represent its spot form. Therefore, the nature of *riba* doctrine conveys the meaning of automatic expansion of a single good through this particular transaction. Thus, it bears a number of absurd economic implications, irrational, injustice and contradiction to the basic natural laws.

Establishing this integrated view of the theory of *riba* in Islam the study tries to investigate the main sources of *riba* and studied the issue in four broad areas namely; pure exchange economy, time value, risk and uncertainty and in the context of business organizations. Examining the theory of excess value in all these areas we come up with the conclusion that *riba* as it is used in Shariah and Fiqh interpretations would mean "a quantitative increase or excess value in the context of an exchange in identical goods on the

account of unbalanced quality or time discrepancy." This kind of excess value or *riba* is usually acquired on the ground of its association with either the difference of quality of the articles for an exchange or time factor, provided the contract involves certain period of time in the form of credit. In this connection, it is immaterial whether transaction takes place in the name of loan or sale. We have tried to elaborate the nature of these two elements and their economic implications. We have concluded that the quality difference that may associate with this kind of exchange should not be ignored, it must be taken into the consideration in both cases of loan and sale transactions otherwise, the contract would not be free from *riba* elements. The Fiqh argument of disregarding the qualitative discrepancy and observing one to one correspondence of exchange items of similar kind is paradoxically keep the element of *riba* in tact. However, in case of a time factor, we concluded that in its abstract sense a mere time difference cannot generate excess value. However, the enter-temporal exchange of economic means in their real values may serve as a powerful tool against business fluctuations and instability.

10.1.1 Riba Versus Profit

This reinterpretation is not necessary only for understanding the nature of *riba* but, it is prerequisite for the explanation of the gist of the concept of profit as well. This study is built on the hypothesis that both terms of *riba* and profit in Islam are increase, and excess values which are basically exchange phenomena. However, these two terms have exclusively separate roots and natural origins. In contrast to *riba* profit arises from trade in two different goods/utilities. The principle of *riba* is quite opposite to that of trade. Apparently these two activities seem to be the same and similar transactions, but one is economically rational and legally justified, while the other is absolutely prohibited in Islam, except in the above restrictive conditions. For additional income in the form of *riba* is proved to be absurd and injustice while additional income in the form of profit is scientifically justified on the basis of standard economic theories and Islamic financial principles. The Qur'an has precisely demonstrated the position of the two in Islam "And Allah has permitted sale and prohibited *riba*"(2:275).

This focus on *riba* profit studies in the context of microeconomic price theory and rigorous juristic reconsideration proposes certain departure from the main dominant view

presented in the contemporary studies, which mainly concentrate the *riba* interest relationship versus profit. This work streamlines *riba* versus profit demonstrating the underpinning logical principles of the prohibition of *riba* and the permission of the profit and their logical separations. Through this approach it would be crystal clear that the profit-oriented activity leads to an increase in welfare for the participating parties and efficiency, but, *riba*-based economy leads to scarcity, want and economic depression, as the Prophet (saw) has declared this divine truth as the ultimate consequences of *riba* practices. This fact reveals the wisdom behind the prohibition of *riba*, what the contemporary studies has substantially failed to demonstrate its practical implications in modern economic terms. We have elaborated this wisdom in simple postulation stating that the human behavior of selling something for itself in order to acquire more of it, is the basic vehicle for a *riba* element. If each individual or producer or endowment owner, sells what he possesses for more of itself and without any intermediate good or its substitution or using it for productive activity, would result an unimaginable economic catastrophe. We found that the standard law of diminishing marginal utility exposes part of these economic ramifications. Hence given this phenomenon, although the economic agents may accumulate resources of the same good through this process, but, each one of them would face the consequence of this irrational behavior.

Perhaps, the neglected aspect of the divine rule is that the prohibition of *riba* and permission of profit is the fundamental requirement for economic development which arises from the natural fact that the desire for variation calls for diversification and the desire for quality calls for specialization, together, these two requirements establish the appropriate environment for economic development. In case of profit the resources flow through trade and production activity from where they are in plenty to where they are scarce, from where they are relatively idle or less productive to where they are productive and usefully utilized, while, in case of *riba* the situation is reverse. In this way the economic resources, although, they seem to be very much when they are concentrated in few hands through *riba* practice the scarcity in general and want for variation in both haves and have nots would be the inevitable results. In this study, we have emphasized that profit and *riba* are two entirely different concepts in the context of exchange economy. Profit is based on exchange of two different goods necessitates by the human desire for variation in other words the natural diversity of human taste and difference in costs of production or resource endowments. Profit may represent, in terms of utility, consumer surplus or retained expenses and in the context of

international trade, it would represent the well-known concept of 'gain from trade'. In both cases, it is very clear that profit stands for the increase of welfare for both parties that may involve. The accepted main task of economic activities is the allocation of resources which comprises production and exchange as two essential and important processes for transforming the goods from one state to another, in order to generate more value and transferring the control from one hand to another.

Further more, while devouring each other's property in vanities and faulty way is strictly forbidden by Islam the devouring each other's property through *al-Tijara* (trade) is allowed by Allah (swt) in the verse of the Holy Qur'an, provided that such *al-Tijara* must take place "by mutual willingness." Perhaps, the rationale of this permission addresses the tolerable situation of sharing the gain from trade. When the two parties are conducting the business, it is very difficult or probably impossible to figure out the exact amount of profit/benefit that goes to either party. In this regard the mutual willingness is considered as the best indications of their equity in the distribution of trade benefits. Moreover, the trade activity may not always generate profit, it may probably get into losses whereas, either party in the contract realizes decrease of his original principal. Hence, the principle of mutual willingness negates the apprehension of assuming the loss of either party in a trade contract to be the gain that might be realized by another as long as the transaction is free from *gharar*. This has some significant implications to international trade policy, where how to share the gains from international trade is the crucial issue in international economic policy. Thus, taking all these aspects into account, Islam establishes a very important and transparent principle of permitting the benefit that may go to either party or both from a trade concluded in mutual willingness and complete consent of the concerning parties.

10.1.2 The Clarity of the Matter and Contemporary Obscurity

Although, the approach so far followed in the process of eliminating interest is facing strong theoretical and practical challenge on the basis of the above conceptual ambiguity, this approach of eliminating *riba* is theoretically rational, economically desirable and practically feasible, for this method builds its argument on simple and clear concepts of *riba* and profit in Islamic points of view. But, the predominant approach of seeking the solution from equating *riba* to a conventional term of interest in order to figure out the desired element of profit,

shows extremely difficulty and it is subject to endless controversy. Perhaps, western educated Muslim economists appreciate the complexity of *riba* and they feel they are confident in their acquaintance with interest in contrast to *riba*, so they believe that they can identify profit easily by equating *riba* to interest. But, the situation is more complicated than this shallow equivalence. Although, Western economists admit the underlying complexity and obscurity of the term interest, there may be very few Muslim economists like Uzair(1998) who acknowledges the intricacy of the matter.

The confusion is inherent to the conventional theories related to the fundamental economic concepts such as profit, rent and interest. The problem related with the identification of profit and interest is deep rooted in conventional economic theories of these subjects. Examining the modern economic literature we have found that it reveals sometimes a complete denial of the very existence of these fundamental parameters and some times intermingling their meanings. Where the interest was identified as a profit and used both terms as synonyms and interchangeable Panico (1987). Schumpeter (1954). This obscurity in the usage of economic concepts is not limited to profit and interest relationship alone, but, the same situation prevails when these two are incorporated with rent. Samuelson (1967). Maddalla and Miller (1989) have advocated 'It (an interest rate) is nothing, but the rental price of money. Boris and Thomas (1980) also have come up with the conclusion. In this jungle of conflicting views on the vital issue strong negative impressions were expressed that economists do not possess good theory of capital or interest or of their relations to equilibrium prices Hausman (1981). This confusion of conventional theories about the basic terms of interest and profit has trickled down to the contemporary writings of Islamic economists. Despite all extensive studies and research work that focused on this issue in particular yet there are conceptual misgivings and theoretical loopholes [Chapra (1985), Naqvi (1985), Chaudhary (1992)] which could damage the hallmark of Islamic financial system. For this reason we opted to the above Qur'anic methodology by addressing profit versus *riba*, instead of the debatable approach of profit versus interest, as we have elaborated in detail throughout this study.

10.2 POLICY IMPLICATIONS

This is perhaps what Islam has declared its permission provided that the trade must be completely clean from the following crucial elements; *riba*, and *gharar*. *riba* can be avoided when the transaction involves the exchange of different goods and the transaction is not characterized in features of two transactions in one sale. *gharar* may be avoided through complete information about the exchange items and the stipulation conditions of a contract. The required information must include the nature and the standard quantitative and qualitative aspect of the items as well as their original cost. The sale of what one does not own or what is beyond the reach of the seller should be also avoided. From this above discussion we concluded that there is a fundamental difference between *gharar* and *riba* in several dimensions such as: (i) in terms of their sources (ii) in terms of clarity and assessment (iii) in terms of being the object matter of the contract (iv) in terms permissibility and legal considerations. Islam considers the presence of *gharar* in transaction contracts undesirable and obligates its removal and elimination from business contracts to the possible extent. Since, risk and uncertainty are relative terms Islamic principles show flexibility in dealing with this problem. *gharar* is permitted for the sake of need, in convenience, impossibility of its separation from the object of the contract. However, the higher the uncertainty and risk the greater would be undesirability of that contract. Furthermore, this transformation processes of generating profit to take place it is required planned effort and rational exercise incorporating with the existing conditions in order, that effort to generate a lawful profit. In these kinds of activities the risk element and uncertainty are neither necessary nor sufficient condition to determine the permissibility of profit. According to these criteria *riba* will remain unlawful and profit rates genuinely legitimate return under risk-free and certainty. Nothing will change with the change of these factors, except that some level of *gharar* may be associated with the profit depend on the behavior of involving economic agents.

It is viewed by most of the Muslim scholars (M. Kahf and Tariqullah, 1992) that Islamic financing approach should be based upon the principles of a variable rate of return which can take in the form of the profit-sharing principle (PSP) or profit and loss sharing principles (PLSP). This principle is based on *Mudaraba* mode of financing. In conclusion the VRRP (*Mudaraba* and *Musharaka*) was considered a synonym for Islamic financing, therefore, it was presented as the only alternative to interest based financing. The *Mudaraba* contract in its

classical form should assign a profit for each party, the rate should be predetermined proportion or ratio of the outcome rather than a fixed amount or percentage of the principal capital, the freedom of the worker is limited to the selection of the client and the profit ratio is supposed to be decided on the basis of integrity, ability, honesty and mutual relations of the two parties. However, in contemporary operations the Islamic bank agrees with its *Mudaraba* client on the profit-ratio which is specified in the contract. The ratio may depend on the bargaining power of the client, the profit forecast of the *Mudaraba*, the personal aptitude of the client, marketability and the duration of the contract. If the *Mudaraba* does not yield any profit or gets loss, the *Mudarib* does not receive any remuneration for his labor. And in case of loss, the bank bears it provided not proved any misuse or mismanagement on the part of the *Mudarib*. But, the financial institution almost eliminates the uncertainty involved in a pure *Mudaraba* venture. The actuarial risk in the venture as utilized in Islamic banking system is quantifiable and insurable. The discussion on *Mudaraba* as practiced in Islamic banking indicates it is mostly used for a short term commercial purpose where the outcome is almost certain. The bank in minute detail prescribes how to sell the goods. The mark up is justified on the basis of a generally accepted axiom that times may be valued provided it is incorporated in a sale transaction. It is also suggested that the bank may minimize the risks in converting the *Mudaraba* finance into *Musharaka* or even the convergence of the two to Common Joint Enterprise. In this way the possibility of a moral hazard may be reduced for the entrepreneur he should be making his own investment as well. Similarly the problem of informational asymmetry would be reduced too as the bank also has a right to interfere in the management of the project in which it has invested. The bank is able to invest in largely because the clients owning large stakes in the business will not put the finance in a risk. It is possible to do *Musharaka* for long as well for short periods in different sectors of the economy. In *Musharaka* case the risk could be minimized, productivity of the enterprise may increase, a large part of *Mudaraba* funds may be invested, hence the profit may be higher.

While, the present rejection of dominant modes of financing in the contemporary business operations is not convincing and defies the authentic Shariah principles, however, this study has taken the notice of wide misuse of these concepts particularly *Murabaha* mode of finance. This perhaps is the root of contention and the source of the dominant negative impression made by the Islamic economic writers and Islamic institutions over the basic concept of *Murabaha* or *bay' al-muajjal*. As long as *Murabaha* is related to exchange of

different goods and its operations is linked with actual economic activity, it must not have any harm for it is profit-oriented business rather than *riba*-based transaction. But when the bank avoids any participation of actual goods transaction there is no other way to generate income except to indulge *riba*-based activities, however, the banks fortify the claim that they are performing *bay' mu'ajjal* or *Murabaha*, while in practice a fictitious transaction which existing only on paper are made use of, to back up credit transactions on mark ups basis. The contract is made on the name of the buy back purchase technique, the supplier and the client are the same person, i.e., the client sells his property to the bank, i.e., his car, and simultaneously buys it back at a mark up price payable at a future date either in a lump sum or installments. The most common mode of *Murabaha* financing is being used under this kind of *heela*. Practically the goods have not been sold. The client has received only loans with certain rate of interest instead of the price of his goods. Clearly, this is a pure loan contract and neither the objective of the client was to sell goods nor the intention of the bank was to purchase them. The goods are nominally entered in the agreement simply as a cover for this *riba* practice. Probably, they may repeat this process on the same contract many times. We have discussed that this practice is economically irrational behavior and we have shown that Islam has prohibited this kind of business for it contains a *riba* element. Basically buy back mechanisms is not in a position to generate profit. The acceptable form of a buy back transaction according to Shariah is basically *rahan* or securitization.

An increase in *Murabaha* is not against time, but against the goods themselves. According him, if it so, the existence of two prices, a cash price and a higher credit price would be meaningless. While, number of Fiqh scholars are of the view "The increase in price in lieu of time is lawful and valid or as they stated." "It is lawful in the Shariah that parts of the price can be given in lieu of time in financial transaction." Nevertheless, many of the Islamic economists have emerged critical to this view, arguing that in this manner. It has been conveniently ignored that accepting time value of money logically leads to the acceptance of interest, in other words accepting time value in *Murabaha* transactions and then rejecting the same in Monetary transactions appears to be inconsistent and illogical A Said (1996). We have tried to filter these arguments in order to build a consistent and acceptable area for both sides. On one hand we have shown the neutrality of the time element in economic operations, thus we rejected any value be acquired on the base of pure time value. While on the hand we

have tried to prove the increase or decrease of credit prices in exchange of different goods have nothing to do with *a riba* element irrespective of its association with time or not.

10.2.1 Stability Crises and Islamic Solution

A critical study and close examination of the theoretical explanation given by the modern conventional theorists, it revealed a number of thoughts as the main causes of stability crises of market economies. In the light of Islamic injunctions the following factors are considered to be largely relevant (i) dichotomy in debt commitment and actual productivity (ii) continual revisions of contracts and debt refinancing (iii) financial speculation and (iv) unreasonable money creation through a credit mechanism. We have referred these points to the work of Minsky(1978) and Allais (1995) Minsky has observed that 'the relation between cash receipts and payment commitments determines the course of investment and thus, employment, output and profits'. The spread between cash flow and payment commitments to be the main source of instability in investment is widely acknowledged. Nonetheless, Islamic financing arrangements make the payment commitments as a function of income flows, because the financing terms adjust according to the changing conditions such that the ratio of cash flows to cash commitments remains relatively stable. But since debt requires regular predetermined interest payment over long period where an actual situation may become different, business difficulties may be inevitable which may create a pervasive situation on the cash flow of firms, forcing reopening the contract in such a manner that puts the debtor in a dilemma to either forgo what would otherwise be some further profitable venture or sell some of its existing assets to meet liquidity requirements, or borrow further and may be at a higher interest cost. In an advanced capitalist economy with a sophisticated financial market, the volatility of investment is largely because of speculation rather than productive changes. Perhaps the financial speculation is the worse factor that generates the financial instability. The great conventional economists like Keynes have demonstrated that systematic instability and financial crises are an inherent feature of modern capitalist economy, which results securing the means of production through debt creation. In order to produce goods business must acquire physical assets. Through means of the credit mechanism, new means of payment are constantly being invented in interest-based economy which amounts to the creation of new purchasing power with no effective counter part other than promises to pay in the future, a mechanism which goes under the fallacious name of asset mobilization or monetary

transformation but which finally results only in enriching some at the expense of others. According to the Islamic financial system the elimination of *riba* and *gharar* will take care of checking completely or most of speculation behavior.

10.2.2 Inflation Problem and the Prohibition of Riba

We have discussed the implications of the concept of *riba* in the context of an inflationary situation, and concluded that the elimination of *riba* from the economy takes care of inflation. Because, of simple reason that according to Islamic principle the loan once concluded it must be protected against any risk. It is fully guaranteed in its *mithl* or value. Thus, a debt and long term financial contracts must specify that the monetary amount signed on a particular date will be paid in terms of its purchasing power on a specified date. This view makes the monetary management to be very tight and value oriented rather than volume. On the face of the present inflationary situation three options have been examined (1) eliminating fiat money and going back to gold-standard type of arrangements (2) accepting the present situation of loss of purchasing power of money without compensation (3) introducing a special financial instrument or standard value index, for financial debt evaluations. Evaluating the above proposals we have concluded that the second option is unacceptable because its recognition implies a retaining *riba* element in the economy, while the other two options are subject to more evaluations. We asserted that depreciating monetary value in fixed contractual payments is economically neither bearable nor Islamically acceptable on the basis of justice and underlying principles in the prohibition of *riba* (principle of quality equivalence in (4.2.3). According to established Fiqh principle which states that where there is price difference there is no similarity. So, different values should be considered.

Thus, call for a general price index as a point of reference for the purchasing power of local currencies does not only fulfill Shariah requirements but also, satisfies the requisite of a smooth economic function and reliability of financial performance. Introducing a scheme of constant value units, if it is properly implemented, would take care of the economic stability and makes the government decide wisely and manage the economic policy rationally under the pressure maintaining real value of all fixed income groups of the society including labor, and long term loan contracts. However, qualifying conditions are necessary for this instrument to govern its implementations, which would develop with the experience. To mention few of

them may be: (i) the basic requirement of these indexation schemes is that it should be a constant value over time (ii) this suggests that all financial contracts should be evaluated to them ex ant at the time of the contract and accordingly be paid ex post in terms of local monetary currency (v) the scheme is applicable only on financial instruments which are denominated in monetary terms. It is not applicable to real goods or physical assets for these have their own real values (vi) the scheme is applicable to unproductive loan contracts and other fixed income commitments which are not subject to any growth in nature such as: wages, credits, *Meher muajjal*, *qard hassana*, etc. (vii) the scheme is not applicable to all investment contracts and working capital or assets in operating business or idle money laying with its owner.

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