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PROFIT AND LOSS SHARING:
AN ECONOMIC ANALYSIS
OF AN ISLAMIC FINANCIAL SYSTEM

by
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INTRODUCTION

In the late nineteen-seventies, much attention in the popular press and scholarly writings in the West was devoted to a phenomenon that has variously been referred to as "Islamic resurgence," "Islamic revival," "Islamic renaissance," "Islamic fundamentalism," and "militant Islam," among other terms. The terms used suggest an attitudinal disagreement on the nature of the phenomenon. Nevertheless, there is considerable agreement among Western scholars that the decade of the nineteen seventies did witness considerable expression of an upsurge in Islamic sentiment, and that the phenomenon cannot be discounted merely as sensationalism of the mass media.¹

Several theories have been suggested as the cause of this resurgence.² The most prominent among these is that the new found wealth of the Muslim O.P.E.C. members (in particular that of Saudi Arabia and Libya) has encouraged more acceptance and perhaps promotion by Muslim states of the latent Islamic sentiment among their peoples.³ In addition, the initial Egyptian success in the 1973 war with Israel, the subsequent oil price hike, and more lately the Iranian "Islamic revolution" are said to have inspired a proud reaffirmation of Islamic identity among Muslims.⁴

The resurgence has also been interpreted as a continuation, albeit with greater intensity, of a long prevailing identity crisis being experienced by Muslims.⁵ The self-pride of Muslims that came from having been conquerors and rulers for over a millenium was battered by the shocking reality of Western military and technological superiority. Added to this was the injury and humiliation of colonialism, which turned them into a subject people. Muslim thinkers have responded to this crisis in several ways throughout time, one of which was the basis of several revival movements from the eighteenth century onwards.⁶

The ending of the Second World War was accompanied by the trend towards liberation from colonialism and also brought a heightened competition among the dominant Western ideologies for the minds of intellectuals in Muslim states--with some success. Thus, despite the new found political freedom, in the perception of the Islamically oriented scholars, the Western secularist challenge intensified this crisis.⁷

It is not surprising to find, as one of the elements of the resurgence, a growing self-consciousness among some Muslim scholars of the historical importance of their role in formulating an Islamic order which is unique in its political, social, and economic ramifications and poses a non-apologetic Islamic counter-challenge to secularist ideologies.⁸ They are concerned with preserving

their religious and hence their cultural identity. The Islamic way of life is deemed to be threatened by both socialism and capitalism, which have proved themselves to be functioning systems, despite their various drawbacks from an Islamic perspective.

This threat may well be real. On the one hand, Muslim states are threatened by the attraction felt by a portion of their populace to the "liberal" democratic socio-political process and to the technological advances and consumption patterns of Western capitalist countries. Concomitantly, the elite youth finds itself seduced by the popular culture of the West.⁹ On the other hand, the marxist ideology is more threatening due to the potential development of the poor's consciousness of their deprivation. Either of these ideologies can influence, and indeed have influenced, Muslim countries.

Notwithstanding the role of the modernised Islamic intellectuals or the 'ulamā' (traditional Islamic scholars who have played a considerable part in preserving Islamic sentiment among Muslims), the continued presence of Islam as an international phenomenon is mainly due to the adherence or loyalty to it among the Muslim people of all classes, although on average this sentiment probably varies inversely with wealth. The existence of a fervor for Islam among the Muslim masses can be gleaned indirectly from events and policies, both past and present, in Muslim countries and in particular in those countries

where the ruling regime has leaned towards some form of socialism.

The Tunisians in 1960 ignored Bourguiba's attempt to end the Muslim religious practice of fasting, even though he couched it in Islamic terms by suggesting that the consequent increase in efficiency would be a jihad (holy struggle) for development.¹⁰ In Syria, an otherwise acquiescent Muslim populace was outraged into violent protest in 1967 when a military magazine carried an article suggesting that Syrians needed to put behind them God and religion in order to make progress. The regime publicly disassociated itself from such a position, and the three years following this incident saw more mosques built in Syria than in the past thirty years.¹¹

In fact, Syria, Iraq, and Egypt all felt it necessary to draw inspiration from Islamic ideology for their social reform. Nasser is said to have considered Islam as synonymous with socialism as have other "Islamic socialists."¹² The Algerian revolutionary government under Bumedienne and his successors stressed the Islamic aspect of the Algerian identity and adopted policies to strengthen religious awareness.¹³ Once again, the most important aspect of the Libyan experiment is said to be its emphasis on Islam in its purest form, mainly as interpreted by Qaddafi.¹⁴ South Yemen, which has been said to espouse Marxism with the greatest vigor among Muslim countries,¹⁵ has shown reluctance to go

against Islamic inheritance laws.¹⁶ Despite the socialist leanings of these countries in recent history, it is significant that Islam has been and still remains the state religion.¹⁷

Examples of recent expression of Islamic sentiment are more numerous. In Syria, Egypt, and Turkey, this expression has adopted a violent form.¹⁸ In Malaysia and Indonesia, the governments have shown concern over the increasing militancy of the Islamic movement, particularly among the educated youth.¹⁹ In both Malaysia and Egypt, the intensity of Islamic feeling is perhaps indicated by the voluntary donning of Islamic dress by women on university campuses.²⁰ In Tunisia, Bourguiba's regime is being challenged by orthodox Muslims who have formed an association for the preservation of the Qur'ān.²¹ More traditional forms of armed struggle, adopting an Islamic banner, are going on in Afghanistan and the island of Mindanao in the Philippines. The expression of such an Islamic sentiment is probably partly responsible for the increasing use of Islamic symbolism if not the adoption of Islamic policies.

Sadat, himself a devout Muslim, is said to have increasingly used Islam to justify his policies. Similarly, King Hasan II of Morocco has recently made greater use of Islamic symbols. In both Bangladesh and Pakistan, regimes more sympathetic to orthodox Islam have come to power, and in Pakistan, the government has stated its

constant irritation. Many Muslim scholars, however, now seem to accept the de facto existence of Muslim states, and instead of pan-Islamism, they emphasize as a critical issue the establishment of Islam as a social political reality of the modern age, one that provides for the Muslim world a viable alternative to the dominant world ideologies. An attempt is being made on an international level, mainly with the sponsorship of Middle Eastern states, to give substance to this goal by creating institutions that serve as a unifying force for the affinities of Islamic nations.

As a response to the burning of the al-Aqsa mosque in Jerusalem in 1969, the first Islamic summit conference, organised by Saudi Arabia, was held in Rabat. This was followed in 1970 by the first annual conference of Islamic foreign ministers. The former led to the establishment of the Organisation of Islamic Conference, which by 1981 had forty three members, and a permanent Islamic secretariat in Saudi Arabia.²⁴ Since its formation, various subsidiary organisations have been established. These include the Islamic Center for Technical and Vocational Training in Dacca, the Islamic Center for Arts, Culture and Heritage in Istanbul, the Statistical Economic and Social Research Training Center for Islamic States in Ankara, the Islamic Jurisprudence Academy in Jeddah, and the Islamic Chamber of Commerce and Industry in Karachi. In addition, plans are underway for setting

up a shipping company, a maritime union, and an Islamic Center for the Development of Trade. Also affiliated with the Organisation of Islamic Conference is the Islamic Development Bank (Jeddah) and the International Association of Islamic Banks (Karachi).²⁵ The development of an academic infrastructure, backed by the same source, is also in evidence. The Islamic Council of Europe and the Islamic Foundation are engaged in publishing and disseminating works of Muslim scholars. In the particular field of this dissertation, there are institutes for research in Islamic economics currently operating in Saudi Arabia (Jeddah), Pakistan (Islamabad), and Cyprus (Lefkosa). The International Centre for Research in Islamic Economics is due to publish a periodical (Research in Islamic Economics) starting early in 1983.²⁶

So far, I have been indirectly building a case for my dissertation on a topic in Islamic economics by pointing to the significant presence of Islamic sentiment among Muslim people. The recent resurgence of this sentiment makes such a study topical. Obviously, it is not sufficient to justify a piece of research merely by arguing that it is important and topical, especially if much research--as is true in this case--has already been done in the field. In the rest of this introduction, I will first indicate where my research fits into the literature. Then, in a brief overview of the

dissertation, I will point out certain gaps in the literature.

Zarqa (1978, p. 3) has succinctly summed up the research over the past twenty five years in Islamic economics in three categories:

1. Comparison giving broad outlines of the Islamic economic system vis a vis capitalism and socialism
2. Critiques of non-Islamic economic systems and philosophies
3. Substantive expositions on a certain economic issue, e.g. riba (usury and interest) and related questions

He goes on to concur with Muhammed Al-Mubarak that "a sufficient amount has been written on 1.) and 2.) and that the time has come for going deeply into the Islamic economic system itself, understanding thoroughly its characteristics and giving it a modern formulation."

Following this line of suggestion, I have selected Islamic banking in general and profit-and-loss sharing (P.L.S.) in particular as the issues to research in my dissertation. P.L.S. is a financial mechanism linking finance capital to industry and commerce without the use of interest. It is one of the most important components of the Islamic economic system, as is evident from the intensity with which the Qur'an prohibits riba.²⁷ The concept of ribā is reviewed in depth in Chapter One. It is often interpreted to be synonymous with interest, sometimes more narrowly as interest on consumer loans only. The importance of P.L.S. is also

gleaned from attempts to abolish interest being among the first practical steps taken by countries such as Iran and Pakistan in trying to put their economic systems on an Islamic footing. In fact, Islamic banking is currently being practiced in over a dozen countries at various levels of commitment.

Islamic banking in general, or P.L.S. in particular, cannot be considered in isolation; rather, it must be analysed within the context of an Islamic political-economic system. In Chapter One, the political economy of an Islamic system, which of necessity has its basis in Islamic Law, is discussed. The approach used is that of adopting a particular analytical framework that identifies political-economic systems on the basis of the extent of their use of various "control mechanisms," i.e. persuasion, force, or the market. In the course of the discussion in this chapter, certain key issues and concepts, such as the relationship of Islamic Law and the Islamic state, ijtihād, and ribā, are discussed.

One of the unique elements in Islamic political economy, as pointed out in Chapter One, is the elimination of ribā. In Chapter Two, alternative institutional structures and settings are discussed with an emphasis on the underlying ethical underpinnings. Some of the important issues that are explored in this context include the nationalisation of banks, fractional reserve banking, speculation and capital gains, and indexation.

Also set up in Chapter Two is the institutional framework of a P.L.S. banking model that satisfies Islamic ethical constraints.

This framework is used in Chapter Three to discuss the main theoretical issues pertaining to P.L.S. banking that have received inadequate or no attention. The operational details are excluded since much has already been written about them. Some of the issues analysed are as follows. The risk-return trade-offs and their bearing on the supply of funds are considered in a financial system where P.L.S. deposits are the only income bearing financial asset. A P.L.S. banking model is presented in which banks are pure intermediaries and the sole source of funds. Other cases considered are where banks are not intermediaries and where entrepreneurs have their own source of funds in retained earnings. Some economic implications of P.L.S. banking are suggested, including those that bear on the size and composition of total investment.

In Chapter Four, the P.L.S. model is presented as having contractual relevance in the agricultural sector. First, the Islamic view on various tenure arrangements such as land-renting, share-cropping, and owner cultivation are discussed to determine whether they involve ribā. After this, P.L.S. is suggested as an alternative tenure arrangement which does not involve ribā. The mechanics of a P.L.S. contract in the agricultural sector

are analysed with a view to determining the share of operating surplus from land that accrues to the landowner, the farmer, and the state.

In the fifth and last chapter, the evidence accumulated to date on the actual implementation of Islamic banking in several Muslim countries is presented.

Since the modern application of this banking concept is very recent, the evidence is scanty. Nonetheless, data on several practicing banks in the Middle East is reviewed. Also, the experience to date of the Pakistani attempt at converting its whole banking system to an Islamic basis is documented. In all these cases, the emphasis is on examining the consistency of practice with the underlying ethical premises.

The Islamic banking movement as described in Chapter Five is in its infancy, and so it is still too early to gauge its success. However, it is the most significant concrete manifestation of an attempt by Muslims, in the wake of the Islamic resurgence, to develop an alternative economic system that is based on Islamic Law. For this reason in particular, and for other reasons mentioned earlier, it is important to examine Islamic banking with a view to both the ethics underlying it as well as its economic viability.

Notes to the Introduction

¹Daniel Pipes, "This World is Political!!The Islamic Revival of the Seventies," ORBIS (Pennsylvania), 24, No. 1 (1980), pp.9-41. Pipes argues that there was a perceptible increase in Islamic political activity in the seventies. For another example of a similar view, see J.O. Voll, "The Islamic Past and the Present Resurgence," Current History, 78, No. 456 (1980), pp. 145-148, 180-181.

²For an account of these theories, see M.E. Yapp, "Contemporary Islamic Revivalism," Asian Affairs, O.S. 67 (1980), pp. 178-195. Yapp presents his own model to explain the intensification of Islamic political activity. In a nutshell, he suggests that if the rate of rural-urban migration (where Islam is the only old identity that the rural person carries over to the new environment) is greater than the rate of assimilation into the urban culture, then political protest movements taking the form of "revivalism" will occur. Also see Islamic Resurgence in the Arab World, ed. Ali E.H. Dessouki (New York: Praeger, 1982). Part II of this intensive work on Islamic resurgence relates to theoretical perspectives. This work also contains case studies and a useful bibliography on the subject.

³Pipes, pp. 18-27. Pipes argues that Libya and Saudi Arabia are working in very different but complementary ways in posing Islam as a viable alternative "international current," the others being capitalism and communism. Also see Shaheen F. Dil, "The Myth of Islamic Resurgence in South Asia," Current History, 78, No. 456 (1980), pp. 165-168, 185-186. Dil views the resurgence merely as a process of self-identification, and he considers the role of the new found wealth in the Middle East as instrumental in allowing this process to occur.

⁴Pipes, p. 12.

⁵See, for example, Richard H. Dekmejian, "The Islamic Revival in the Middle East and North Africa," Current History, 78, No. 456 (1980), pp. 169-174, 179. See also Azad I.H. Faruqi, "The Western Image of Islam: Political Implications," Islam and the Modern Age, 9, No. 2 (1980), pp. 192-203. Dekmejian indicates that revivalism in

post-eighteenth century Islamic history reveals a cyclical pattern, and typically peaks in response to crisis situations. Faruki concentrates on the prevalence of a crisis situation in the post-colonial Muslim world.

⁶For a brief account of these movements see Bernard Lewis, "The Return of Islam," Commentary, 61, No. 1 (1976), pp. 39-49. See also Fazlur Rahman, "Islam: Challenges and Opportunities," in Islam: Past Influence and Present Challenge, ed. Alford T. Welch and Pierre Cachia (Edinburgh: Edinburgh University Press, 1979), pp. 316-323. For a description of various kinds of elite response to the Western challenge to the Muslim world, see Yapp, pp. 185-187, who reviews an adaptationist, rejectionist, and modernist response among Muslim elites.

⁷Voll, p. 180.

⁸For a sample of this literature, see Altaf Gauhar, ed., The Challenge of Islam (London: Islamic Council of Europe, 1978); S. Azzam, ed., The Muslim World and the Future Economic Order (London: Islamic Council of Europe, 1979); Khurshid Ahmad, ed., Islam: Its Meaning, its Message (London: Islamic Council of Europe, 1976); Khurshid Ahmad and Zafar A. Ansari, eds., Islam Perspectives: Studies in Honor of Sayyid A.A. Mawdudi (Leicester: The Islamic Foundation, 1979). The optimistic views among Islamic intellectuals about the growth of a renaissance Islam, embodied in Islamic states, that provide both spiritual fulfillment to its Muslim citizens and material prosperity for all, can be contrasted to Maxime Rodinson's views on Islamic resurgence in Marxism and the Muslim World (New York: Monthly Review Press, 1981), pp. 290-306. Rodinson sees the possibility of the hold of Islam among the Muslim masses to be exploited by cynical self-serving governments who seek to repressively enforce a strict moral code. He further speculates about the possibility of disenchantment with Islam itself as regimes inevitably fail to deliver what they promised in the name of Islam.

⁹For a discussion along similar lines, see Godfrey H. Jensen, Militant Islam (New York: Harper and Row, 1979), pp. 31, 126.

¹⁰Lewis, p. 47.

¹¹Lewis, p. 47.

¹²Yvonne Haddad, "The Arab-Israeli Wars, Nasserism, and the Affirmation of Islamic Identity," in Islam and Development: Religion and Sociopolitical Change, ed. John L. Esposito (Syracuse: University of Syracuse Press, 1980), pp. 117-118.

¹³Michael C. Hudson, "Islam and Political Development," in Esposito, ed., Islam and Development, pp. 16-18.

¹⁴Rodinson, pp. 229, 305-306. See also Mu'ammār Al-Qadhafī, "The Third Way," in Islam in Transition, ed. John J. Donohue and John L. Esposito (Oxford: Oxford University Press, 1982), pp. 103-106.

¹⁵John T. Cummings et. al., "Islam and Modern Economic Change," in Esposito, ed., Islam and Development, p. 25, n. 2.

¹⁶Rodney Wilson, The Economies of the Middle East (London: Macmillan, 1979), p. 133.

¹⁷This point is made by Dekmejian, p. 172, with reference to Iraq and Syria. The generalisation is based on information extracted from Wilson, Economies.

¹⁸Pipes, p. 9.

¹⁹Raphael Israel, "The New Wave of Islam," International Journal, 34, No. 3 (1979), p. 383.

²⁰Israel, New Wave, p. 383.

²¹Dilip Mukherji, "Upsurge of Islamic Zeal," Times of India, 30 May 1979, p. 6.

²²The information in this paragraph has been drawn from Pipes, pp. 10-11. For more examples of the impact of Islamic sentiment on political behavior, see Ali E. H. Dessouki, "The Islamic Resurgence: Sources, Dynamics, and Implications," in Dessouki, ed., Islamic Resurgence, pp. 10-11.

²³Mohammad Ayoob, "The Myth of the Monolith," in The Politics of Islamic Reassertion, ed. Mohammad Ayoob (New York: St. Martin's Press, 1981), pp. 3-5. The author argues that the monolithic perception of Islam is a common error of much of Western analysis of the Muslim world. The book of readings edited by the author brings together various case studies of the phenomenon of resurgence in various Muslim countries, in an attempt to destroy the myth of the Islamic monolith.

²⁴Dessouki, "The Islamic Resurgence," p. 26.

²⁵For a listing of these and other organisations, see Dessouki, "The Islamic Resurgence," p. 27.

²⁶Arabia, September 1982, p. 39.

²⁷The Holy Qur'ān, text, translation, and commentary by Yusef Ali, third ed. (Washington, D.C.: The American International Printing Company, n.d.), II: 275-276. Unless otherwise specified, the interpretation provided in this work will be utilised. In the references to this work, the first numeral stands for the chapter and the second for the verse.

CHAPTER ONE

POLITICAL ECONOMY OF AN ISLAMIC SYSTEM

Introduction.

As is the case with many dissertations, the first chapter in this one is essentially a review of literature. The literature in question is mainly contemporary work in Islamic studies that has a bearing on Islamic political economy. The reason for this endeavor is to establish the context for a detailed study, in the following four chapters, of P.L.S.

Establishing such a political-economic context by drawing on the literature would be a straight-forward process if a consensus existed in Islamic scholarship on the relevant issues. Since I could identify no such consensus on most issues, I have instead identified the currents of thought on key controversies. The framework for the study of political economy and hence for the presentation of different positions on Islamic political economy is based on Lindblom (1978).

The effectiveness of Lindblom's methodology lies in raising critical questions, answers to which categorize political-economic systems. The expression "political-economic" is understood to mean a particular mix of politics and economics that generates crucial decisions

concerning the functioning of systems, such as the allocation of resources to various uses, distribution, and the prevailing consumption pattern. Control mechanisms in turn will determine the particular mix referred to above. Lindblom identifies and discusses three control mechanisms: authority (centralised bureaucratic control), market, and preceptoral. These control mechanisms can therefore be viewed as instruments by means of which a political-economic system functions. Although no system relies entirely on one control mechanism, socialist regimes rely more on authority, while the western liberal democracies rely more on the market mechanism. The preceptoral mechanism, which has been employed by countries like China and Cuba mainly in conjunction with authority, may be of particular interest from the viewpoint of an Islamic system.

The preceptoral mechanism relies heavily on "educating" the population toward the right socio-economic conduct. Education is viewed as a catch-all term for persuasion, information, indoctrination, instruction, propaganda, counseling advice, and exhortation (p. 56). it bears a relationship to persuasion similar to that which market bears to exchange and government to authority (p.22). Since the use of the preceptoral mechanism presupposes the existence of authority, I view authority and the market to be the two key mechanisms that categorize political economic systems. Within the

authority mechanism, one may distinguish between the use of "force" and the use of "persuasion." Therefore, a reference to the preceptoral mechanism in this chapter implicitly refers to an instrument of authority rather than an alternative to it. One could, in this slightly altered framework, view market, force, and education or persuasion as the three control mechanisms.

This framework, though briefly sketched here to avoid unnecessarily reproducing Lindblom's detailed and lucid exposition, does provide the conceptual apparatus for conducting a study of Islamic political economy. Before proceeding, some qualifications on the scope of this study are in order.

Even though I have confined the scope of this work to what would amount to a Sunni (the predominant Muslim sect) view on political economy, the size of the relevant literature is enormous.¹ My coverage of it has been extensive, though by no means exhaustive. One of the striking features about the literature in this area of Islamic studies is the tremendous overlap of ideas within the various schools of thought. No attempt is made to identify the originator of the various ideas or to document all the adherents to them. In each case, a few of the scholars are documented by way of example.

In pursuing the major controversies in Islamic political economy on issues such as the relationship of Islamic Law and the state, ijtihād and ribā, some

historical and legal arguments, as used by the authors, are presented where they are relevant. Since I possess no expertise in the area of Islamic studies that would enable me to evaluate these arguments, I present them with trepidation and with apologies to the scholar in Islamic studies. Nonetheless, I would like to remind the reader that this chapter should be viewed mainly as a survey of ideas on Islamic political economy, albeit one that is conducted in a specific framework as an aid to conceptual clarity.

Some important issues are not addressed here, since they remained essentially disregarded by the bulk of the literature I reviewed. Two issues bypassed here are the social relativity of economic laws as well as their historical process of change. Both of these are broad topics for which extensive literature exists that is of direct relevance to the West. Rodinson's work (1978) does address these issues in Islam.

Finally, I would like to point out that this chapter intends mainly to focus on the broad abstract mechanisms of Islamic political economy, rather than to discuss in detail the elements of an Islamic political economy such as zakāt (welfare tax), inheritance laws, or the elimination of ribā. Each specific element merits extensive study, in the larger context of an Islamic political economy, and this dissertation, as mentioned earlier, is devoted to studying P.L.S. as an experiment in ribā-free

banking.

I. Law and the State in Islam.

A discussion of Islamic political theory needs to deal with two controversial issues. The first pertains to the relationship of Islamic Law (henceforth referred to as the Law) and the state, and the second (a related issue) to the sources of the Law. The first is critical because it affirms or negates the existence of an Islamic state and the second because it has a bearing on the basis and structure of authority within the Islamic state--if the latter is recognized as a theoretically valid entity. In the sub-sections below, scholars of Islam are categorized according to their stand on these controversial issues.²

a.) Secularists vs. Islamists. The participants in the first controversy are "secularists," who deny the existence of a special relationship between the Law and the state, and "Islamists," who assert the contrary. The secularists play no part in the second controversy, since, in effect, they deny the need for the existence of an "Islamic state." The participants in the second controversy are therefore to be found solely among the Islamists, who may roughly be categorized into the "modernists" and the "orthodox." They differ, most significantly, in their stands on the sources of the Law. In the course of further elucidation of these two controversies, the importance of these distinctions will

become evident.

The secularist point of view is, and has been, representative of only a small minority of scholars. Al-Rāziq, in Egypt during the twenties, was the first to draw widespread attention and fire for his avowed secularist views. He asserted that the Prophet Muḥammad's (henceforth referred to as the Prophet) message and purpose was essentially religious and that religion was an individual's private concern.³ This implied that it was an individual's own moral duty to recognize and live by the Law and not up to the state to impose, or be generally responsible for upholding, the Law. As a rejoinder, Rehman (1979, p. 229) indicated that Rāziq's assertion could be valid only if he had adequately established, which he had not, that the Prophet acted secularly and extra-religiously in his role as law giver or political leader. Also, the secularist assertion is often challenged by Islamists by citing injunctions from the Qur'ān making the Prophet's authority unconditionally binding and giving his actions special significance.⁴

The latter argument, however, skirts the real issue, which is whether the Qur'ān itself endorses any institutional infra-structure for persuasion or if necessary for the use of force in preserving the Law. A Qur'ānic injunction making it incumbent on Muslims to obey the Prophet does not in itself imply the former. It could suggest, as Rāziq implies, that all good Muslims for the

benefit of their own souls should follow the guidance of the Prophet.⁵ Nonetheless, most Islamic scholars do agree that even though Islam primarily provides a moral code for individual and social conduct, a role for central authority is prescribed.⁶ This position is also supported by western scholars of Islam.⁷

Khalid (1953), a more recent proponent of the secular position, phrased his objections to a religious government in the form of the more familiar "church-state" dichotomy. He made a scathing attack on "clergy" (referring to the 'ulamā) or religious scholars of Islam) for negating reason, glorifying poverty, denying fundamental liberties, and holding a monopoly on valid interpretation (p. 129). It appears that choosing to approach and phrase the problem as he does, Khalid identifies the clergy with the Islamic government. While recent Shi'a political theory does endorse the "clergy's" right to lead by virtue of their special training and knowledge, mainstream Sunni political theory regards the role of the religious scholars to be mainly that of providing spiritual leadership.⁸

Many writers refuse to accept the relevance of the concept of clergy by claiming that Islam does not accept any intermediary between man and God.⁹ Such reasoning motivated Nasr (1967. pp. 8-11) to state that the whole community of believers in Islam constitutes the "church" with each believer being a priest.

In fact, this is why most Islamic scholars object to the use of "theocracy" as being an accurate representation of the Islamic system. They suggest instead the term "normocracy," which is felt to be more representative of the primacy of the Law.¹⁰ Thus, in his preoccupation with the "clergy," Khalid fails to recognize that the central issue in Islamic political theory is the state's relationship with the Law and that the composition of the state is a separate, though related, political issue.¹¹

Khalid also suggests that the Qur'ān's emphasis on no compulsion in religion makes the notion of an Islamic state a contradiction in terms (p. 144). Fakhry (1954, p. 488), who endorses the secularist ideas, adds to the challenge by quoting a saying from the Prophet to the effect that people are better judges of their worldly affairs. He interprets this to imply that humans are capable of taking care of their temporal affairs without the intervention of God or his messengers.

In general, Islamists do base their position on the legitimacy of central authority in Islam on theoretical premises, and they also buttress this position by extensive quotations from authorities in classical Islamic scholarship.¹² A few of the major theoretical arguments against the secularist views are as follows. First, they contend that the Qur'ān makes explicit reference to institutional authority several times, such as in enjoining the collection of zakāt (a social welfare tax)

or in upholding justice.¹³ Second, they reason that after the formal founding of the Muslim umma (community) in Medina, the Prophet himself used the authority of the state to impose the revealed Law according to his true interpretation. It was incumbent on all Muslims then to obey the Prophet. As Law evolved, it later became necessary for all Muslims and hence for "those in authority" (to whom the Qur'ān refers) to follow his example. Third, they point to the sayings of the Prophet to the effect that authority is to be employed where individual conscience fails in attaining the desired objective.¹⁴

Both secularists and Islamists are ostensibly on secure grounds in drawing their support from Scripture and the Prophet's sayings. On the one hand, the secularist stand does appear consistent with the Qur'ānic ethos that each soul is responsible for, and will bear the burdens of, his own actions. This may be seen to follow from the Qur'ān's insistence on the role of the Prophet as being that of a "warner," "messenger," "witness," "instructor," and "admonisher," but not one of "managing" or "watching over" or "standing guard" over men's affairs ^{instead} of using force to overawe or compell belief.¹⁵ Also, by negating the state's right to be a general saver of souls, they would thereby prevent the state from exercising the choice God has given to individuals.

On the other hand, it is difficult to refute the Islamists' premise stated above that an Islamic state has

legitimacy. The Islamists themselves see the secular stand as one which is contrived and which has no real basis in Scripture. Though the Prophet's sayings about people being most knowledgeable about their own matters are recognized, they are regarded only as a reference to matters of detail and not those of Law. Many Qur'ānic references are cited to invalidate the sayings' more general connotations, including a verse that explicitly states that it is not up to the faithful to decide for themselves a matter which has been decided by God and his messenger.¹⁶

Differences as fundamental as these are unlikely to be easily resolved, if at all.¹⁷ There is a recognition by some authors that these differences may be exacerbated by the lack of a rigorous and common methodology for the contextual interpretation of the Qur'ān. A concern has been expressed about the readiness Muslim scholars (starting with the late nineteenth century) have exhibited in quoting from the primary sources, without the requisite historical semantic or legal knowledge or therefore of the legal theory implicit in their process of interpretation.¹⁸ Although establishing a widely accepted methodology for interpretation--itself a potentially divisive endeavor--will probably not resolve the differences, it may be a step towards beginning a purposeful dialogue about these differences. One of the most critical issues that such a dialogue would need to address would concern the

distinction between that which is purely a matter of individual conscience from that which calls for the use of authority.

Consider, for example, the Qur'ānic injunction against ribā (gains, including interest, that are ethically unjustified from an Islamic perspective). Accepting interest from a bank may at first appear to be an individual's own decision. However, those supporting action by the state to abolish it point to the Qur'ānic reference to "war" declared in unambiguous language by God and his Prophet against those who indulge in it.¹⁹ It is argued that because usury has social repercussions beyond an individual's conscience, the use of authority as a preventive is justified.²⁰ As another case, one could consider the pursuit by individuals, at their own volition, of salāt (prescribed prayer), hajj (pilgrimage), or fasting. The secularist reference to there being no compulsion in religion would most certainly apply in the pursuit of these religious practices. Perhaps on the basis of specific legislation, and contextual identification of the relevant underlying legal principles, a clear demarcation can be made between what is a matter for an individual's conscience and where the Islamic state is needed to provide a spiritual infra-structure or an enforcement agency.

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indicated in the introductory chapter), the position of the Islamists will be adopted.²¹ In short, they assert that the state is a valid and indispensable instrument for Islamisation. To analyse this position, it is necessary to explore the second controversy, which concerns the sources of the Law.

b) The "Orthodox" vs. the "Modernists." The nature of this controversy can best be comprehended in the context of the development of the Law.²² The primary source of the Law is the Qur'ān. The complement to this, and for the Muslims a perfect commentary on it, is the Sunna (model pattern of behavior) of the Prophet. The sanctity of the Sunna was derived from the theory of the infallibility of Muḥammad in particular and from the more general theological doctrine concerning the infallibility of Prophets or recipients of divine revelation. As the methodology of the Law became established, qiyās (analogical reasoning) and ijmāc (consensus of the community--though for practical purposes, that of the scholars) were recognized as independent sources which have an intimate relationship with each other.²³

The mechanism of the formation of the Law was ijtihād (systematic, original thinking), using qiyās as a method of that formation. The outcome of the process would become incorporated into Law if so determined by ijmāc. The latter was also used to ascertain,

from among the various transmitters, what the Sunna of the Prophet was and hence incorporated that into the Hadīth (recorded sayings and deeds of the Prophet). The Sunna was subsequently materially expanded to include precedents of the first four Chaliḥs and the agreements of a large number of the Prophet's prominent companions. This body of tradition is separately referred to as Āthār. It is this Sunna, compiled in these various collections, which provides the second source for the foundation of the Law.

Rehman explains the process by which Law became structured in terms of the relationship of ʿilm (knowledge) and fiqh (understanding). Fiqh was a process, and it was "up to the community under the guidance of the ʿulamāʾ (religious scholars) to decide whether the outcome of the individual thought could constitute a part of the Shariʿa" (Law). However, with the establishment of legal methodology, fiqh "passed from being a personal activity to a structured discipline and its resultant body of knowledge," and consequently, fiqh became an ʿilm (pp. 102-103).

In the course of this process, permanence was ascribed to the rulings of the four great jurists.²⁴ Subsequently, the right to absolute ijtihād was abolished, and jurists confined themselves to minor re-interpretations within the given school of Law they adhered to.

In fact, the rulings of the jurists acquired the status of a source of Law.

Several reasons have been postulated to explain this phenomenon, which has been described as the "closing of the gate" of ijtihād, dated at roughly the eleventh century.²⁵ Some writers contend that it was meant as a defense of judicial proceedings against autocratic rulers.²⁶ The idea was that what once had become a precedent could not be altered. Another explanation, more widely cited, asserts that it resulted as a defensive reaction to the threat posed by the "rationalists" (a school of thought in early Islam).²⁷ None of these, or any other justification, appears to have any contemporary relevance for modernists.

Much of the earlier controversy between modernists and the orthodoxy has been about this "closing of the gate." The modernists sought the right to ijtihād to bring the Law into conformity with the changed conditions since the rulings of the medieval jurists. The writings of earlier modernists seem to have gained wide acceptance even among the orthodox. It was probably difficult to deny the logic of prominent thinkers like Iqbal (1934, p. 140), who did not mince words in challenging the authority of the old schools, which he considered "individual interpretations" despite their comprehensiveness and which therefore could not "claim any finality." Iqbal is only one in a tradition of influential

Islamists of the Muslim world such as Mohammed Abdu, Rashid Rida, Syed Ahmed, Ameer Ali, and Syed Qutb, who are all in agreement about the necessity for ijtihād.

Only the extremely conservative thinkers would now deny the right to ijtihād for a Muslim community.²⁸ In fact, the orthodox could be sub-categorized into "traditional" and "conservative." However, since the conservative view of going back to the golden age of Islam (that prevalent during the time of the first four Chalifs) is losing ground in orthodox writings, it is bypassed in this research. Reference to the orthodox is then implicitly a reference to the traditional thinkers who do in principle accept the validity of ijtihād--whereas the conservative thinkers do not--but severely restrict its scope. Thus, the controversy is now really about the boundary between Law and independent reasoning in the spirit of that Law.

The orthodox position considers four sources to be the foundation of Islamic Law.²⁹ Qur'ān and Sunna are again the two primary sources, but apart from these, the conventions of the first four Chalifs (referred to as "the rightly guided ones") and the rulings of the great jurists are regarded as additional sources. These four together constitute the sources of Law, and only if no guidance is found in them would additional legislation be permissible in the spirit of the Law. By contrast, the modernist stand, in the extreme, would be to rely

solely on the Qur'ān and reject even the Hadīth as a source of Law.³⁰ This view may in part have found support in the questioning by Western scholars of the authenticity of the Hadīth.³¹

Considerable work has recently been undertaken that counters the orientalist claim of having established that the Hadīth literature was suspect.³² Rehman (1978, p. 67), when considering this extreme stand, suggests that "although the Hadīth in part does not represent the verbal and pure Prophetic teaching, it certainly has an intimate connection with the Prophet and especially represents the earliest development of the community's understanding of that teaching." However, any scepticism concerning the Hadīth is anathema to the orthodox, as is the general modernist stance that only the Qur'ān and the Sunna of the Prophet constitute the true sources of the Law. However, for the modernist, the Qur'ānic reference to a "Divine Law and an open road" is a justification for the need to use reason to adapt the Law to changing times.³³ These controversies between modernists and the orthodoxy do have considerable practical significance.

c.) Islamic Political Theory. The contemporary relevance of these controversies is illustrated in this sub-section by examining the debate on the constitution of Pakistan, which was ostensibly founded as an Islamic state. This case is also useful for two additional reasons. First, it elucidates a

possible structure of authority in an Islamic state; second, it illustrates modern ijtihād in the process of reviewing constitutional theory, even though the ultimate issue is ijtihād itself. A digression, this time in the form of a brief review of classic Islamic political theory, is once again deemed necessary. This will form the benchmark from which to assess the various positions on modern constitutional theory.

The early Caliphate state (632-660) is said to have been founded upon a double contract theory.³⁴ The primary contract was between the Muslim community and God, and the secondary contract was between the community and the Caliph. This leader was either selected by notables or recommended by the preceeding Caliph, but confirmation awaited the approval of the community in the form of a pledge of allegiance (bay'at).³⁵ The duty of the Caliph was to facilitate the carrying out of the obligations which had been accepted by the community under the primary contract. Sovereignty belonged to God, but it was vested in the community, which in turn entrusted it to the Caliph.

This "democratic tradition" ended with the coming of the Umayyad Dynasty (661-750). The growth of the empire, and the subsequent contact with the Byzantine and Persian traditions, transformed the Caliphate into an autocratic institution. Classical political theory reflects the changed circumstances. Sovereignty still resided with God but was now deemed to be vested in the Caliph

directly.³⁶ The Shī'a and Khārejites sects' views on succession and the legitimacy of authority differed, but the Sunnī view prevailed, and is referred to as the classical political theory.³⁷

The prescribed functions of the Caliph in this theory were to enforce the Law, to protect the faith from heresy, and to defend the community from external aggression. Much of the attention of classical political commentary revolves around the Caliphate. In particular, attention seems devoted to the theory of succession and the requisite qualities of the Caliph.³⁸

There is little mention, however, about dealing with a Caliph who does not uphold the Law. Silence on this issue, despite a tradition attributed to the Prophet stating that tyrannical power, which is contrary to the will of God, should be opposed by deed or word, has been explained in several ways.³⁹ First, as the empire expanded to unmanagable proportions, the Caliph became a symbol of Islam's religious and political unity and the protector of the Law--hence the need to legitimize his authority.⁴⁰ As power started to be usurped by regional sultans (roughly around 1258, when the Abbasid Dynasty ended)⁴¹ religious scholars attempted to reconcile the latter's temporal powers with the Caliphate and with the Law. The purpose was to ensure the continuity of the community by providing legitimacy for the changing structure of political power.⁴² Second, those ʿulamāʾ who

who were not content with political power assuming a religious mantle would find being outspoken hazardous. In fact, three of the four founding jurists are said to have suffered torture at the hands of political authorities.⁴³ Third, apologists for unchecked political authority interpreted a reference in the Qur'ān to obey "those in authority" to mean unconditional acceptance of authority. Such interpretations are still being voiced by modern writers who recommend political quietism on much the same basis.⁴⁴ Finally, some scholars have been said to have reconciled themselves to unscrupulous authority rather than risk weakening the Muslim community as a consequence of social and political disorder.⁴⁵ Whatever the reasons for political quietism, it does appear that persecution--or fear of persecution--drastically limited free inquiry into issues that would question the legitimacy of authority. This explanation has been put forward as the reason why Islamic constitutional theory did not evolve.⁴⁶

The influence of classical political theory and modern Western political institutions are both apparent in the debate over Pakistan's constitution. This could explain the striking convergence of views among modernists and the orthodox at least on political institutional structure and its interrelationships. Once again, there is agreement that sovereignty rests with God and that the entire Muslim community--rather than the Caliph--

is endowed with viceregency. To justify the switch, some writers indicate that references in the Qur'ān to vice-regency are generally in the plural.⁴⁷ There is also agreement that some form of democratic election should be the basis of forming the consultative council or the legislature. The necessity for an election is traced back to the precedence established by the ascension to power of the first Caliph.⁴⁸ A consultative assembly is deemed to be consistent with the Qur'ān's enjoining of consultation before decision making, even for the Prophet. Also, some argue that the decision of the elected consultative council would be the true ijmāC (consensus of the community) and have thereby linked an Islamic legal method to a modern democratic institution.⁴⁹ It has, however, been pointed out that ijmāC traditionally represented an ex post consolidation of opinion.⁵⁰

The main disagreement, on matters of principle, between orthodox and modernist writers largely concerns the extent to which ijtihad is to be assigned to the legislature. The most controversial issue is the modernist stand that particular social legislation was meant by the Qur'ān itself to be time specific.⁵¹ Such a position widens the scope of legislative activity beyond that acceptable to the orthodox.

There are also differences regarding the supremacy of various organs of government and how their disagreements are to be resolved. There is still considerable

pre-occupation among the orthodox with the role of a Caliph, who is intended to be the chief executive.⁵² It does appear, however, that if sovereignty is entrusted to the legislature, as is the modernist contention, then the chief executive can be no more than a chief secretary, entrusted with the overall responsibility of implementing and administering the Law.

Another issue which leads to a contradiction is the role of the judiciary. The orthodox view appears to be that the legislature must be subordinate to an independent judiciary, which in turn must decide whether any legislation is repugnant to the spirit of the Law.⁵³ This does tend to render void, according to the modernist view, the sovereignty of the legislature.⁵⁴ Thus, the problem that remains is embodying within the political institutions the concept of constrained sovereignty (the constraint being Divine Law) without turning the consultative assembly into a parody of western political institutions.

Muslim writers emphasize that their ijtihād about political institutions emanates from Islamic roots, which anticipated the emergence of western (secular) democratic institutions. Probably closer to the truth is that Islamic political writers read modern political institutions--and convincingly I think--into their primary and historical sources. Despite its drawbacks, contact with the West may have persuaded thinkers of the

merit of its political institutions due to the latter's implicit assumption pertaining to the individual. Nor would this be the first time for Islamic thinking to be affected by foreign sources. The influence on Arab political conceptions from contact with Persia and the Byzantine Empire has been acknowledged.⁵⁵ Despite the fact that the terminology utilized in the constitutional debate is western in origin, there remain several elements about the envisioned Islamic political institutions that would make them significantly different.

As mentioned above, sovereignty resides in God. The practical import of this concept is the primacy of the Law. This, in turn, implies limits on the freedom of the legislature, even though the extent of this constraint is subject to controversy. In addition, it has been suggested that the Islamic system cannot accommodate a multi-party system, where the parties may differ fundamentally on an ideological stand. All members of the consultative assembly are expected to vote their conscience, without party affiliations, subject to the guidance provided by Law.⁵⁶ More realistically, one may envision the formation of parties--at least within the Assembly--on the basis of differing interpretations. Finally, some authors reject the western electioneering process on the basis of a tradition of the Prophet condemning self-canvassing.⁵⁷ Instead, an elaborate and complex method of representation would need to be

evolved whereby the candidates are selected by communities solely on the basis of their reputation in electoral communities.

II. The Political-Economic Structure of an Islamic System.

Having accepted that an Islamic state is a theoretically legitimate entity, for the purpose of this analysis, and having examined an example of an authority structure, it is now possible to explore the political-economic structure of an Islamic system. A useful and frequently employed device is to compare an Islamic with a socialist system as theoretical entities. This is done here within the framework indicated earlier. Following the consensus among scholars, that the success of an Islamic state depends on the creation of an Islamic individual, special attention is first paid to the preceptoral mechanism.

a.) Islam and Marxist-Socialism: The Preceptoral Mechanism. Underlying the use of the preceptoral mechanism is the belief in the alterability of human nature. Neither Islam nor Marxist socialism regards human beings as having an inherent tendency to be either good or evil. Islam clearly recognizes human proclivity to greed, niggardliness, and to violence for the love of gain. On the other hand, it also recognizes the human capacity to attain the "highest of the high."⁵⁹ Transcendence in Islam is an individual and spiritual process using Scripture as a guide and so the responsibility is

largely individual. Under socialism, the individual is expected to change for the better in the framework of a larger environmental change, and hence there is more collective responsibility. This latter change initiates an individual's transformation and reinforces his altered social consciousness.

Both Islam and Marxist socialism may be said to guide the population by means of a "scripture." Whereas the Marxist "scripture" is the ideology developed by Marx and since adapted to local experience, Islam's scripture is divine revelation. The success of both systems lies in imbuing the people with the new ideologies (though one is idealist and the other materialist) since the preceptoral mechanism's strength lies in mining the immense reserves of human potential. Both systems may be thought of as "totalitarian"--Islam more so--in that proper individual and social behavior is prescribed for most facets of life.⁶⁰ Islamic scholars prefer the term "holistic" in depicting and emphasizing the unity and the interrelatedness of the Islamic ideology.

The socialist system, using the preceptoral mechanism, aims at creating a "new man," who, guided by socialist consciousness, volunteers to work for the general good.⁶¹ Apart from "education," moral incentives are designed to create social emulation, such as workers' medals or commendation by the party chairman. The Islamic system must aim at creating a morally good and just individual

whose awareness and fear, reverence, and appreciation of God induces him to do good and shun evil. Although the state has a role in educating the people, the ultimate incentive for the faithful is the attainment of salvation by his social contribution and consequent enhancement of faith.

In practice, neither of the systems can rely solely on the preceptoral mechanism. Heavily centralized state power is required to bring about the social engineering the socialist system calls for. The immensity and complexity of this task perhaps have encouraged the easier route of relying on the pre-existing infrastructure of authority, rather than on changing individual perceptions. While individual faith and subsequent moral behavior guided by a moral code are the central elements of the Islamic system, personal human weaknesses explain the Qur'ānic and the Prophet's legislation, which constitute the theoretical recognition for the need for authority. The Prophet's saying to the effect that Allah brings to an end through authority what he does not eradicate by the Qur'ān is interpreted as a confirmation of this point.⁶² However, whereas authority in the socialist system is based on a humanly devised theory, in the Islamic system, it must be based on, and limited by, the revelation.

Many Islamic political-economists, in expounding their views, perhaps inadvertently fall into the trap of

merely describing a utopian vision of an Islamic system. This somewhat impractical exercise results from their implicit or explicit assumption concerning the need for the prior existence of an Islamic individual, which leads to general statements about morally motivated behavior solving societies' problems and leading to social justice. Although the existence of religiosity in Muslim countries is not denied, relying solely on that to bring about the Islamic ideal of social justice is not theoretically justified and is probably unrealistic.

Although the Marxist experiment relies on creating a new person, it nevertheless does entail the re-shaping of institutions to ensure its own survival and to aid it in achieving its goals. Although Islamization ultimately depends on moral regeneration as an individual effort, it cannot dispense with institutional changes insofar as the stated collective goal for society is social justice.

b.) Social Justice. The most notable consensus in contemporary Islamic literature among all schools of thought is on the espousal of social justice. Since social justice is also the most ubiquitous principle in Law, the remaining discussion of political-economic mechanisms revolves around achieving this goal. However, before proceeding on that path, it would be useful to question whether the Islamic concept of social justice is in any way unique.

The concept of social justice, as it is propounded

in contemporary Islamic literature, is set forth here. Primary among the elements of justice which figure most prominently is equality of all before the Law. Objectivity of the Law itself makes this a more meaningful concept. Other important elements of this many-faceted concept are as follows: insuring equality of opportunity by making education the state's responsibility; imposing a welfare tax and providing basic needs for the handicapped and the right to work for all, as instruments for reducing economic inequality; eradicating, without exception, all vestiges of social inequality; and suppressing all opportunities for return without socially legitimate effort, but safeguarding that which is acquired within the Law.⁶³ It would be difficult to argue, judging from the above, that the Islamic concept of social justice is much different from the justice that, at least in expression, is a near universal pre-occupation.⁶⁴ Perhaps what is unique to the Islamic world view is the extent of emphases on social justice and, to some extent, the means to be used in its realisation. It is worth elaborating on these issues, since attaining social justice can safely be viewed as the primary goal of the Islamic system to which all other goals must be subordinate.

To show that this is indeed the case, one would have to go back to the primary sources to understand the prominence given to justice in Islamic writings. The

Qur'ān is said to refer to justice, which is the third most frequently used word after "God" and "knowledge," over a thousand times.⁶⁵ Justice may be viewed as the wider concept in which social justice acquires a prominent role. In fact, writers assert that the whole Islamic legal infra-structure was grounded on social justice.⁶⁶ That this is indeed the case may be gleaned from the legal methodology, implicit or explicit, in the rulings of the founding jurists.⁶⁷ Islamic political philosophers, who carried forward the legacy of Greek thought, continued to regard justice to be of paramount importance in the Islamic context. However, they were unanimous in replacing nomos--the man-made law--by the Sharī'a--which was of divine origin--to attain justice.⁶⁸ This leads to the second issue in connection with the means prescribed in attaining social justice.

The Islamic system may be considered unique insofar as it possesses a set of ethical constraints on the political-economic mechanisms it is to utilize. However, what could be of more importance is the degree of flexibility it is willing to embrace in pursuing its goal. These apparently contradictory statements will be explained here, starting with the latter. Many Islamic writers point out that since the Qur'ānic revelation is of eternal applicability, it cannot possibly endorse any given economic system, since the latter is, by necessity, subject to change and evolution.⁶⁹ This, in principle,

is said to leave the Islamic state ample flexibility in securing its goal. Other systems also perceive social justice to be a critical goal, though there continues to be heated ideological debate on the question of the means of achieving it. Perhaps the irony is that in emphasizing method, the end may be forfeited. In other words, the political economic mechanisms that are to be brought into play to accomplish a certain end often become sacred in and of themselves. One consequence of this ideological entrenchment is that it leaves a system with little maneuverability. The question of whether the constraints on an Islamic system hinder its flexibility, however, remains unanswered.

c.) Elements of an Islamic Economy. The political concepts in the Qur'ān and their contemporary implications have already been reviewed above.

Specific Qur'ānic legislation that is prominent in its bearing on economic issues includes injunctions that relate to zakāt, inheritance laws, and ribā. Aspects of the first two will be summarized briefly, since voluminous literature is available on them. More space is devoted to ribā since it is directly related to P.L.S.

Zakāt is a welfare tax to be collected and disbursed by the state. It is special insofar as it is meant to be a spiritual exercise. By relinquishing something of value to oneself, the individual is expected to grow spiritually and to simultaneously help society and gain

merit with God. Zakāt is specifically designed to aid certain needy categories, such as the old, the handicapped, and the orphans.⁷⁰

Inheritance laws are also particularised in the Qur'ān. Much effort has been exerted by jurists over the centuries in interpreting and adapting the Laws to specific cases. Allowing a bequeather say in settling only one-third of his estate, and a just specification of shares for family members, are thought to be the socially productive features of the Laws. What is expected to follow from them is a more diverse distribution of wealth as a healthy antidote to concentration.⁷¹ Inheritance, in itself, could be questioned on grounds that it allows individuals the acquisition of wealth through no effort. It has, however, been argued that offspring often do provide a strong motivation towards individual productivity, perhaps on the basis of sheer instinct. In some cases, they do contribute directly to a family enterprise by their labor, whereas in other cases, they fulfill their religious obligation in caring for their elders.⁷²

Ribā, Haque (1978, p. 33) asserts, is considered by the Qur'ān to be the most heinous sin among the major sins. It is not surprising, then, that the concept has been subjected to much analysis, discussion, and of course, controversy. I will first explain the meaning of the concept as it has been adopted for this

dissertation and then pursue some of the major controversies.⁷³

Ribā has been defined by Haque (1980, p. 16) as "an excess (fadl) which, in an exchange or sale, accrues to the lender without giving in return any equivalent countervalue, substitute, or recompense (iwad) to the other party."⁷⁴ This excess that comes from not providing an equivalent countervalue is said to lead to injustice. Clearly some elaboration is needed on the kinds of transactions that are said to lead to such an excess.

A review of the literature indicates that there are at least three major categories of transactions that lead to such an excess. First, the category of transactions where a return is guaranteed to individuals solely on the basis of ownership is forbidden.⁷⁵ Interest and rent would fit into this category in that a return is guaranteed to capital and landowners without any exertion of effort.⁷⁶ It may be argued that some assets which bring the owners a return may well have been procured by effort. The Islamist would argue that the possession of the asset is evidence that the owner was rewarded for his effort and that morally speaking, there is no entitlement to a further reward for that effort.

A second category of contracts that have been forbidden are those between two parties such that one could specify a fixed, pre-determined remuneration to

himself irrespective of the outcome of the venture that is the subject of the contract. Two implications follow from this. First, any party to a contract can claim a share to profit only if the venture actually leads to a profit. Second, no contract can be valid if one party to the contract exercises unfair economic power. Examples of such contracts not only include interest (due to the pre-determined return), but also monopoly, black-marketing, hoarding, or the cornering of a market.⁷⁷

Finally, the third category of contracts that are viewed to be forbidden is a sub-category of those that entail uncertainty in the way they are framed.⁷⁸ Uncertainty itself is not the issue, but it can lead to the appropriation of value without the contribution of legitimate countervalue. Examples of such contracts include those on the stock exchange or the forward market.⁷⁹

The commonality in these contracts is the prohibition on drawing income without providing anything socially productive in exchange. This broad definition of ribā does have the advantage of providing a unifying ethical basis for the prohibition of what might otherwise appear to be unrelated activities. Not everyone, however, agrees with this broad definition.

The origin of one part of the controversy dates back to early Islam, and it revolves around the issues of what kind of ribā the Qur'ān really forbade. The two

types are ribā-al-nasi'a, which involves lending and borrowing, and ribā-al-faḍl, which involves buying and selling.⁸⁰ A time dimension is involved in the first and could also be involved in the second. Schacht (1939, p. 1148) asserts that in the early period of Islam the Qur'ānic prohibition was understood to apply to loans (money and food), and anything beyond that is accepted to be a later development. Rehman (1964, pp. 4-7) suggests that ribā-al-faḍl has its origin in the Hadīth and concludes after a lengthy analysis that no attempt to really define ribā on the basis of the Hadīth has been successful (p. 30). Haque (1980, p. 27) points out that ribā in both sales and loans existed before Islam, and the Qur'ān clearly implies that. Furthermore, he attempts to show that the Hadīth, and the juristic formulations thereof, are elaborations and extensions of the basic Qur'ānic concept. He also argues that ribā-al-faḍl is merely a corollary of ribā-al-nasi'a, since money can always be transformed into commodities (p. 26).

The controversy in its contemporary form involves the sub-categorization of interest itself. The modernists equate ribā merely with interest on consumption loans, on the grounds that the Qur'ān intended to prevent the exploitation of the economically weak and discourage excessive consumption.⁸¹ Furthermore, it is argued that seventh century Arabia knew mostly loans for consumption

or distress purposes and not for productive ventures.⁸² Orthodox writers, however, go to some length to prove this contention a fallacy.⁸³ Finally, it is asserted that only interest of an excessive kind amounts to usury and that the Qur'ānic references to "doubling and re-doubling" of the principle applied to them.⁸⁴ According to the orthodox view, this notion can lead to arbitrariness, and in any case, they argue that all forms of interest are banned. The most widely used argument to support this stand is the verse of the Qur'ān that is interpreted to explicitly suggest the recovery of only the principle.⁸⁵

There is a consensus of opinion on the view that the attainment of social justice is what is common to these three elements of an Islamic economic system.⁸⁶ If this is so, as it appears to be, then instead of infringing on the flexibility of an Islamic political-economic system in attaining its goal, they could be contributing towards attaining it. Abolishing interest does imply a radical alteration in how financial transactions are to be conducted, but no inflexibility is implied regarding the choice of institutions to bring this about. The concluding sub-section of this chapter examines the political-economic mechanisms in Islam, taking into account the discussion so far.⁸⁷

d.) Political-Economic Mechanisms of an Islamic State. Little has thus far been said about the use of the

market in an Islamic system. Smogyi (1967, p. 61) maintains the following: "Laissez-faire, which in Europe did not become an economic theory and practice until the eighteenth century, had been Islamic theory and practice as early as the seventh century." The research of other writers, both Muslim and western, does indicate an emphasis on the establishment and use of an unhindered market. It has been pointed out that a tradition derived from the Prophet prohibited price-fixing and that jurists condemned practices that might disturb the free play of supply and demand.⁸⁸ Another saying shows the Prophet to have been against any form of tax on buying or selling.⁸⁹ It appears evident, therefore, that the use of the market has been endorsed by Law.

It was also recognized that considerable supervision of the market would be required to avoid the occurrence of ribā. Thus, in order to temper the use of the market with the demands of social justice, various practices, such as monopoly, hoarding, black-marketeering, and contracts conducive to uncertainty like forward transactions, were banned. All these transaction were and are considered to lead to ribā since they enable sellers to earn something for which no concomitant lawful contribution to society is forthcoming. Thus, market prices could only be reflective of fair exchanges of value in

the context of a socially just order that had eliminated concentration of economic and hence political power based on ribā. The widely quoted Qur'ānic verse to the effect that wealth is not to be permitted to make a circuit only among the rich is interpreted in this light.⁹⁰

To insure proper use of the market mechanism and to implement other social legislation would appear to require a considerable use of authority. Yet, most contemporary writers do tend to explicitly espouse a heavy reliance on the preceptoral mechanism. One justification for this stand rests on the notion that accountability to God is an individual, and not a collective, matter.⁹¹ Thus, each soul, in the process of bettering himself and acting righteously, will better society. Although this sounds strikingly close to the secular position, the Islamists differ in the suggested prescription. While the secularists advocate the separation of the "church" from the authority mechanism, the Islamists consider the state primarily responsible for providing the appropriate spiritual and educational infra-structure to inculcate Islamic perceptions.⁹² As earlier indicated, the need for authority is recognized as something to fall back on as the last resort.

What is then to be the criterion according to which the delicate balance is to be drawn between the use of authority, market, and persuasion? The answer to this

question can be drawn from a legal principle, on the validity of which there is considerable agreement, of subordinating the individual to the community interest. A specific case may be examined to consider this point. It is not unusual in poor countries for wealth to be confined to a small elite. This concentration is reinforced when all banking and insurance become their exclusive domain. From an Islamic perspective, this leads to ribā and therefore to social injustice. But dispossessing the propertied appears to violate the lawful right to private ownership. To resolve the conflict between these principles, recourse can be taken to the legal principle mentioned above.

As in the case of sovereignty, property is recognized to be only a trust and not an unqualified right. On the other hand, social justice has been established as the primary goal in an Islamic system. Therefore, it is argued that in accordance with this principle the rights of private property would have to be subordinated to the demands of social justice.⁹³ It is on the same principle of public interest that the claim that all natural resources and public utilities are required to be state-owned is often made.⁹⁴

The formula suggested above has the virtue of being simple. Unfortunately, simplicity is not a sufficient condition for workability. If the state represents the interest of the elite, as it usually does, can it be

relied upon to oppose them for the sake of social justice? If experience answers this question in the negative, the poor have only their own resources to fall back on, to bring about an Islamic system and to be its guardian. Thus, the ultimate protection for the masses is their own righteous indignation towards a violation of the Law in whose justice they have absolute faith.

Such activism is now viewed by many to be totally justified. It is suggested that the only justification of authority is to preserve the Law. As explained earlier, the foundation of the Law is social justice, so that the *raison d'être* of authority is the preservation of justice. Authority loses its legitimacy and can be justifiably by-passed if this principle goal is not preserved.⁹⁵ This fact was recognized even in the past, by eminent authorities such as Ibn Sina (Avicenna, 980), who held tyrannicide (where tyranny is defined as the violation of the Law by the authorities) as the most pleasing to God, next to only the belief in his Prophet.⁹⁶ A similar message has been inferred from the inaugural address of the first Caliph (Abū Bakr), who asserted that his authority should be considered binding only so long as he upholds and lives by the Law.⁹⁷

Conclusion.

In this chapter, I attempted to identify the political economy of an Islamic system. In so doing, I put to use Lindblom's framework of analysis which views political

economic systems in terms of their use of various control mechanisms such as authority and market. The central issues of this chapter are which mechanisms--and in what proportions--an Islamic political system should utilize and whether it would be in any way unique.

In order to discuss authority within an Islamic system in any meaningful sense, it is necessary to first determine what the legitimacy for that authority is and also what its likely structure may be. Because my research methodology entailed following the "consensus of scholars" in the area of Islamic studies, my analysis did of necessity reflect the controversy on issues where there is no consensus. The first two controversies pertain to the legitimacy and structure of authority in the Islamic system.

The debate between "secularists" and "Islamists" really pertains to the legitimacy of authority. The secularists emphasize that religion is an individual's own concern and challenge the Islamists' position that the state is needed to uphold the Law in an Islamic system. As shown in the text, both base their arguments in Scripture, and the debate is essentially unresolved. Since there is much current interest in Islamisation, I accepted, for the purpose of analysis, the Islamist stand that there is a legitimate basis for an "Islamic state" and proceeded to the next controversy, which sheds light

on the likely structure of the Islamic state.

The controversy this time rages within the Islamist camp between the "orthodox" and "modernists." It takes the form of a disagreement over the sources of law and, following from this, disagreement over the right to ijtihād (independent reasoning). When Islamic constitutional theory is analysed to provide an example of the contemporary significance of this controversy, an insight is produced into the structure of authority in an Islamic system. Modernists would want to embody the right to ijtihād in a popularly elected legislative assembly, whereas the orthodox would restrict the assembly's right to ijtihād by binding it to their view on the sources of the Law. In concrete terms, they advocate a higher organ, like a judiciary, that could declare void the outcome of legislative activity.

Once again, the debate remains unresolved. However, there is a consensus about the ultimate basis of sovereignty and that the structure of authority is to be representative. Islamists are also agreed on the need for a democratic political system and on some detail, concerning elections and the party structure, which would make the Islamic political organs unique.

It bears mentioning that I reviewed only one likely structure of authority in Sunni Islam. The reason why it is mentioned is simply because it is the only one that has been coherently presented and discussed in the

literature. The notions embodied in the constitutional debate are influenced by western political institutions, even though the Islamic basis and content are indicated. The application of this or any other form of ijtihād, bearing on the structure of authority, would realistically and theoretically have to be a function of the community's acceptance of it.

Having analysed the legitimacy and structure of authority, I then went on to discuss the political economy of an Islamic system. The discussion is oriented around the concept of social justice because of the overwhelming consensus in contemporary Islamic literature pinpointing it as the major goal for the Islamic system. As indicated in the text, it is certainly possible to firmly ground this emphasis on social justice in the primary sources, and trace this concern to Islamic legal and philosophical scholarship. However, the contemporary concern with it seems to have been brought about by the challenge posed to Islamic nations by socialism, and in particular by the justice it promises to poor Muslim masses.

Following the consensus of scholars, I accepted social justice as the primary goal of an Islamic system and examined what control mechanisms would be needed to bring this about. Islamist writings indicate the endorsement of all mechanisms. Force is expected to be brought into play when education is not sufficient to

attain the desired objectives or the market violates them. Since attaining social justice is stated to be the primary objective, I asserted that it could be used as the criterion for determining the choice of control mechanisms in particular situations. For this reason, flexibility must be retained in the use of these mechanisms as opposed to adopting entrenched positions a priori. It follows from the above that force should override individual choice only when exercising that choice produces an externality that violates social justice.

In the process of examining the use of various control mechanisms, the uniqueness of an Islamic system was discussed both by examining elements particular to it and by contrasting it to the socialist system. There do indeed seem to be several features of an Islamic system that render it unique, perhaps the primary among them being the ethical and economic ramifications of institutional change that would be necessitated by the abolition of ribā. The following three chapters are devoted to an examination of these issues.

Notes to Chapter One

¹The Shī'as constitute the other major Muslim sect. The origin of the difference between the two dates back to the death of the Prophet Muḥammad. Differences arose within the newly formed Muslim community when it was deciding upon the legitimate successor to the Prophet, both as a spiritual guide and secular chief of the community. For an account of the differences between the sects, see Hamid Enayat, Modern Islamic Political Thought (Austin: University of Texas Press, 1982), pp. 18-68. Also see H.A.R. Gibb, "Constitutional Organisation," in Law in the Middle East, ed. Majid Khadduri and Herbert J. Liebesny (Washington: The Middle East Institute, 1955), pp. 3-10.

²The approach adopted here is not historical. For a historical treatment of the controversies, the changing trends in Muslim thinking, and the interaction between various schools of thought, see Fazlur Rehman, "Islam: Challenges and Opportunities," in Islam: Past Influence and Present Challenge, ed. Alfred T. Welch and Pierre Cachia (Edinburgh: Edinburgh University Press, 1979), pp. 316-323, and also by the same author, "Islam: Legacy and Contemporary Challenge," Islamic Studies, 19, No. 4 (1980), pp. 235-246.

³Alī A. al-Rāziq, "The Caliphate and the Basis of Power," in Islam in Transition, ed. John J. Donohue and John L. Esposito (New York: Oxford University Press, 1982), pp. 29-37. Similar ideas to those of al-Rāziq were voiced in Tunisia in 1933. See Louis Gardet, Mohammedanism, trans. William Burridge (New York: Hawthorne, 1961), p. 141.

⁴See for example Hamid Behzadi, "The Principles of Legitimacy and its Influence on Muslim Political Theory," Islamic Studies, 4, No. 10 (1970), p. 280, and see S.H.H. Nadvi, "Quran and the Challenge of Modernism," Voice of Islam, 16, No. 4 (1968), p. 289; XXVI: 100, 126, 144, 163.

⁵Enayat, pp. 52-55, devotes considerable attention to a review of al-Rāziq's views. He suggests that Rāziq admitted that the Qur'ān did in fact envisage the existence of central authority to administer the affairs of Muslims but that he emphasized that the essence of the Qur'ānic

message on the role of the Prophet had him primarily being a warner and a guide. In the source I have cited above for Rāziq's views, I found categorical statements denying the role of any government or central political authority in Islam. See in particular pp. 31-33.

⁶Manzooruddin Ahmed, "The Classical Muslim State," Islamic Studies, 1, No. 3 (1962), p. 96; Sayyid Qutb, Social Justice in Islam, trans. John D. Hardee (New York: American Council of Learned Societies, 1970), p. 99.

⁷Henry Siegman, "The State and the Individual in Sunni Islam," Muslim World, 54, No. 1 (1964), p. 14; Helmer Ringgren, "On the Islamic Theory of the State," in The Myth of the State, ed. H. Biezais (Stockholm: Almqvist and Wiksell, 1972), p. 103.

⁸Rūh Allāh Khumaynī, Islam and Revolution, trans. Hamid Alger (Berkeley: Mizan Press, 1981), pp. 55-125.

⁹Mahmud A. Faksh, "Basic Characteristics of an Islamic State," Journal of South Asia and Middle East Studies, 5, No. 2 (1981), p. 6; Manzooruddin Ahmed, p. 88.

¹⁰Majid Khadduri, "Nature of the Islamic State," Islamic Culture, 21, No. 4 (1947), p. 330.

¹¹A distinction can be found in the literature between the "church-state" and "religion-politics" dichotomies. The majority view is that the first distinction is not relevant in Islam and that the relationship between the elements in the second dichotomy are all-encompassing. See A.A.K. Soze, "Islam and the Unity of Church and State," Islam and the Modern Age, 8, No.3 (1976), pp. 24-32.

¹²See Manonchehr Paydar, "Aspects of the Islamic State," diss. University of Utah, 1972, p. 118. In emphasizing the role of the state in preserving the Law, Paydar quotes from the prominent scholar al-Ghazālī, who wrote "know ye that the Shari'a (Law) is the foundation and the government is the sentinel." Also see Mohammad Umar, "The Nature of the State in Islam," The Voice of Islam, 14, No. 10 (1966), pp. 522-526, for extensive quotations from the same vantage point.

¹³Afzal Rehman, "Islamic Attitude to Economics: Two Aspects," Criterion, 4, No. 1 (1969), p. 48; Fazal Rehman, "Some Reflections on the Reconstruction of Muslim Society in Pakistan," Islamic Studies, 5, No. 4 (1967), p. 107.

¹⁴Sayyid A.A. Maududi, First Principles of an Islamic State, 2nd. ed. (Lahore: Islamic Publications, 1974), p. 42; Mouloud K. Nait-Belkacem, "The Concept of Social Justice in Islam," in The Challenge of Islam, ed. Altaf Gauhar (London: Islamic Council of Europe, 1978), p. 137.

¹⁵The Qur'ān. References to the Prophet's role, II: 119, III: 20, XXVII: 92, XXXVIII: 4, 65, XLIV: 9, XLVIII: 8, L: 2, LI: 50-51, LIII: 56, LXII: 2, LXXIX: 45; references to the Prophet not being appointed to arrange men's affairs, IV: 80, VI: 66, 107, X: 107-109, XI: 8-12, XLII: 48, LXXXVIII: 21-25; references for God being sufficient in authority and against the use of compulsion in religion, XLIII: 88-89, XLVIII: 17, L: 45, LIV: 6, LVIII: 21.

¹⁶Mohammad al-Ghazzali, Our Beginning in Wisdom (Washington: American Council of Learned Scholars, 1953), p. 42; Maududi, p. 24; XXXIII: 36.

¹⁷For an exposure to the Islamist-secularist controversy in the Syrian context, see the text of an article by Shaykh Mustafā al-Sibā'ī (then head of the Syrian Muslim Brotherhood), trans. by R.B.Wender, "Islam as State Religion," Muslim World, 44, No. 3 and 4 (1954), pp. 215-226. For a rejoinder, see George N. Sfeir, "Islam as State Religion," Muslim World, 45, No. 3 (1955), pp. 242-249. The theoretical issues get somewhat submerged behind political posturing for the Islamist view and rhetoric for the contrary view.

¹⁸Nadvi, p. 288, asserts that a thorough contextual and philological knowledge is required for interpretation. He seems to suggest that as a consequence interpretation should be confined to the learned religious scholars. Fazlur Rehman in Legacy (1980), pp. 242-243 makes a similar appeal, although he is not exclusive in his approach. He suggests the need for scholars to assume more responsibility, and he states that the context or historical background for revelations is preserved in Qur'ānic commentaries and is available and accessible to all those willing to make the effort. He also points out how ignorance of legal theory could lead to errors in interpretation. For a more demanding methodology for interpretation, see Asaf A.A. Fayzee, "The Reinterpretation of Islam," in Donohue, ed. Islam in Transition, pp. 190-193. All this is despite the Qur'ānic reminder of how it has been made easy "to understand and remember." See Qur'an, LIV: 17, 22, 32, 40. The burden of establishing that these verses do not say what they seem to, or that their application is qualified

or limited due to contextual reasons, rests with scholars suggesting the various methodologies for interpretation.

¹⁹ Muhammad A. Arabi, "The Islamic Economy and Contemporary Economy," The Third Conference of the Academy of Islamic Research, 1966 (Cairo: 1966), p. 221; S.H.. Zaman, "Islam vis-a-vis Interest Rates," Islamic Culture, 40, No. 1 (1966), p. 8; 11: 279.

²⁰ Syed A. Ali, Economic Foundations of Islam (Bombay: Orient Longmans, 1964), pp. 173-174; Ali Ausaf, "Political Economy of the Islamic State," Diss. U.S.C., 1970, p. 122.

²¹ Adopting this position immediately brings to prominence the status of dhimmīs (non-Muslims) in an Islamic state. For a consideration of this issue, see A.D. Muztar, "Dhimmis in an Islamic State," Islamic Studies, 18, No.1 (1979), pp. 65-67.

²² This summary is based on Fazlur Rehman, Islam, 2nd. ed. (Chicago: University of Chicago Press, 1979), pp. 68-84.

²³ Ijmāc is a complex concept with many facets. The most critical question raised about it (among many others) by G.F. Hourani, "The Basis of Authority of Consensus in Sunnite Islam," Studia Islamica, No. 21 (1964), pp. 13-60. is whether ijmāc of one generation is binding on coming generations. Further, Hourani finds ijmāc has no real basis in either the Qur'ān or the Hadīth literature. Muslim scholars do not question the validity of ijmāc as a source of Law, though modernists writers do question its being binding across generations. See Mohammad Hamidullah, Introduction to Islam (Paris: Centre Culturel Islamique, 1969), p. 113.

²⁴ The four major Sunni schools were founded by Abū Ḥanīfa (d. 767), Mālik ibn Anas (d. 795), Muḥammad ibn Idrīs al-Shāfi'ī (d. 819), and Ahmed ibn Ḥanbal (d. 855). For an analysis of the differences in their methodologies see Umar Abd'Allāh, "Mālik's Concept of 'Amal," Diss. University of Chicago, 1978, pp. 121-129, 146-195.

²⁵ Maxime Rodinson, Marxism and the Muslim World (New York: Monthly Review Press, 1981), p. 66.

²⁶ W.M. Watt, Islamic Political Thought (Edinburgh: Edinburgh University Press, 1968), pp. 73-75.

²⁷ For a detailed explanation, see Muhammed Iqbal, Reconstruction of Religious Thought in Islam (London: Oxford University Press, 1934), pp. 142-144.

²⁸Syed R. Ahmed, Maulana Maududi and the Islamic State (Lahore: People's Publishing House, 1976), p. 109.

²⁹Maududi, pp. 3-5; Nadvi, pp. 283-286.

³⁰Chirāg 'Alī, "Islam and Change," in Donohue, ed., Islam in Transition, pp. 44-47; G.A. Parwez, "The Quranic Economics," The Islamic Review, 48, No. 1 (1960), pp. 19-22.

³¹Alfred Guillaume, An Introduction to Hadith Literature (Oxford: Oxford University Press, 1924), pp. 9-36; Maxime Rodinson, Islam and Capitalism (Austin: University of Texas Press, 1974), pp. 12-13.

³²M.M. Azami in Studies in Hadith Methodologies and Literature (Indianapolis: American Trust Publications, 1977), p. 24 points out that each link in the recitation chain (isnād) of the hadīth has often been counted as a separate hadīth, thus expanding the total quantity. One reason for scholars to have suspected fabrication is the sheer volume of the sayings attributed to the Prophet. A similar point has also been made by Nabia Abbot, who also points out that the hadīth as a rule were scrupulously scrutinized at each step of the transmission. See Studies in Arabic Literary Papyri (Chicago: University of Chicago Press, 1967), II, 2.

³³Muhammed Asad, Principles of State and Government in Islam (Berkeley: University of California Press, 1961), p. 14; V: 51.

³⁴Majid Khadduri, "The Juridical Theory of the Islamic State," Muslim World, 3, No. 41 (1951), p. 185.

³⁵M.H. Hussain and A.K. Kamali, The Nature of the Islamic State (Karachi: National Book Foundation, 1977), p. 9.

³⁶S.D.F. Goitein, Studies in Islamic History and Institutions (Leiden: E.J. Brill, 1968), p. 203; Ann K.S. Lambton, Government and State in Medieval Islam (Oxford: Oxford University Press, 1981), pp. 43-68, p. 309. Lambton points out that the practice of assuming authority of the Caliph came directly from God rather than the community started with the 'Abbasid Dynasty (750-1258) due to Persian influence.

³⁷For details on the differences in views of these sects see N.J. Coulson, "The State and the Individual in Islamic Law," The International and Comparative Law Quarterly, 6, Part I (1957), pp. 49-50; Gibb, 1955,

pp. 6-10; Muhammad N. Kaka-Khel, "Legitimacy of Authority in Islam," Islamic Studies, 19, No. 3 (1980), pp. 171-173; also see Joseph Schacht, "Pre-Islamic Background and Early Development of Jurisprudence," in Khadduri, ed., Law, p. 34. Schacht holds that the doctrines of Law adopted by the minority sectarian movements did not vary greatly from the main orthodox schools of Law.

³⁸E.I.J. Rosenthal, Islam in the Modern Nation State (Cambridge: Cambridge University Press, 1965), p. 14; Lambton, p. 17.

³⁹Muhammad S. El-Awa, On the Political System of an Islamic State, trans. Ahmad N. al-Imam (Indianapolis: American Trust Publications, 1980), p. 90; Lambton, p. 19, points out that this remained a theoretical point since no institutional mechanism was ever decided upon by means of which an unjust leader could be judged.

⁴⁰Rosenthal, p. 13.

⁴¹Nasr, p. 10.

⁴²Hamilton A.R. Gibb, "Constitutional Organisation," in Khadduri, ed., Law, p. 10; Nasr, p. 10; Lambton, pp. 308-309.

⁴³Paydar, pp. 97-98.

⁴⁴Abdul H. Khalifa, Islamic Ideology (Lahore: Publishers United, 1952), p. 193; IV: 59.

⁴⁵Hussain and Kamali, p. 202; Khadduri, pp. 184-185; Asghar E. Engineer, "Islam and Socialism: An Interpretive Approach," Islam and the Modern Age, 9 and 10, No. 1 (1978-1979). p. 58.

⁴⁶F.M. Najjar, "Democracy in Islamic Political Philosophy," Studia Islamica, 51 (1980), p. 111; N.J. Coulson, A History of Islamic Law (Edinburgh: Edinburgh University Press, 1964), pp. 122-133.

⁴⁷Kemal A. Faruki, Islam Today and Tomorrow (Karachi: Pakistan Publishing House, 1973), p. 370; M.Z. Khan, "Islam and the West," Proc. of the Harvard Summer School Conference on the Middle East, 25-27 July, 1955 (Gravenhage: Mouton and Co., 1957), p. 203.

⁴⁸Hamoodur Rahman, "The Islamic Concept of State," Hamdard Islamicus, 2, No. 1 (1979), pp. 51-64; Kamali, pp. 9-13; Goitein, p. 10, disputes the validity of such an inference.

⁴⁹Islamic writers have insisted that both Islamic Law and early political tradition suggest that principles of democracy are embodied in Islam. For example, see Asad, pp. 44-66; Awa, pp. 87-96. This view has not gone undisputed. Bernard Lewis in "Communism and Islam," International Affairs, 30, No. 1 (1954), pp. 1-12 asserts that identification of Islam with democracy is based on a misunderstanding of either one or both concepts. Also, Najjar, pp. 108-120, points out that democracy is currently fashionable; however, medieval Muslim political philosophers did not have the same view of democracy as modern Muslim thinkers. Also H.A.R. Gibb in "Religion and Politics in Christianity and Islam," Islam and International Religions, ed. Jessie Harris (New York: Praeger, 1965), p. 10, argues that neither history nor prescription suggests popular participation by the community in Islam.

⁵⁰J.N.D. Anderson, "Decision by Majority in Islamic Law," Multitudo Legum-ius Unum, Fest. W. Wangler (Berlin: 1973), p. 64; Siegman, p. 24.

⁵¹This view is suggested by Rehman (1979), p. 39 and Fayzee, pp. 189-190.

⁵²For an account of the emotional attachment of Muslims to the office of the Caliphate and the crisis its abolition (by the efforts of Mustafa Kemal (Attaturk)) brought about, see Enayat, pp. 52-68.

⁵³Asad, p. 66.

⁵⁴Fazlur Rehman, "Implementation of the Islamic Concept of State in the Pakistan Milieu," Islamic Studies, 6, No. 3 (1967), pp. 209-218. Rehman emphasizes the primacy of the legislature and in fact denies any constraint on its sovereignty. However, he mentions the need for an independent judiciary without clarifying its relationship to other state organs (p. 218). For a contrary opinion that emphasizes limited sovereignty, see Mazheruddin Siddiqui, "The Concept of Sovereignty in Islam," Proc. of the Third All-Pakistan Political Science Conference, 1962 (Karachi: University of Karachi, 1962), pp. 87-92. For a good summary of the differences in orthodox and modernist views, see Manzooruddin Ahmed, "Islamic Modernism," Islamic Studies, 12, No. 3 (1973), pp. 179-192.

⁵⁵Bashir-ud-Din, "The Political Theory of Islam," Islamic Culture, 8, No. 4 (1934), p. 587.

⁵⁶Erich W. Bethmann, Steps Towards Understanding Islam (Washington, D.C.: American Friends of the Middle East, 1966), p. 36; Asad, p. 60.

⁵⁷Farooq Hussain, The Concept of State and Law in Islam (Washington, D.C.: University Press of America, 1981), p. 57. For a contrary opinion that Islam need not forbid conventional self-canvassing in the election process, see Rehman (1967), p. 214.

⁵⁸For an example of this kind of exercise, see Faruki, p. 373. For an endorsement of a selective voting process, see Mohammad A. Ahmed, The Nature of Islamic Political Theory (Karachi: Ma'aref, 1975), p. 141.

⁵⁹Aly alKhafeef, "Individual Property and its Limits in Islam," Proc. of the First Conference of the Academy of Islamic Research, March 1964 (Cairo: Al-Azhar, Academy of Islamic Research, 1964), p. 91; Sulayman S. Nyang, "The Islamic State and Economic Development," Islamic Culture, 50, No. 1 (1976), p. 10; Muhammed Muslehuddin, Economics and Islam (Lahore: Islamic Publications, 1974), p. 38; IV: 127, XVII: 102; XCV: 4-5, C:8.

⁶⁰Rodinson, 1981, p. 96.

⁶¹John C. Gurley, "Capitalist and Maoist Economic Development," Bulletin of Concerned Asian Scholars, 2, No. 3 (1970), p. 39.

⁶²Muhammad Qutb, Islam: The Misunderstood Religion (Lahore: Islamic Publications, 1972), p. 152; Engineer, p. 60.

⁶³For accounts of social justice in Islam, see Hasan Ashari, Society and State in Islam: An Introduction (New Delhi: Islam and the Modern Society, 1978), pp. 77-169; Yahya Noori, "The Islamic Concept of State," Hamdard Islamicus, 3, No. 3 (1980), pp. 71-92; H. Mintjes in "The Shari'a and Social Justice," Al-Mushir, 19 (1977), p. 99 argues that this concern with justice is clearly a modern pre-occupation. This is a similar point to that made earlier about the influence of contemporary western thought and political institutions on Muslim thinking. In fact, in the literature on social justice and Islamic economic development, "blueprints" of an ideal Islamic state turn out to be morally regenerated welfare states. See, for example, Muhammad U. Chapra, The Economic System of Islam (London: Islamic Cultural Center, 1970), and also by the same author, Objectives of the Islamic Economic Order (Leicester: The Islamic Foundation, 1979); Khurshid Ahmad, Economic Development in an Islamic

Framework (Leicester: The Islamic Foundation, 1979); Syed A. Ali. Economic Foundations of Islam (Bombey: Orient Longmans, 1964).

⁶⁴Of particular interest in this regard is Pope John Paul II's policy statements about social justice. See "The Pope Gets to Work," Newsweek, September 28, 1982, p. 59.

⁶⁵This has been pointed out by Syed N.H. Naqvi in Ethics and Economics: An Islamic Synthesis (Leicester: The Islamic Foundation, 1981), p. 86.

⁶⁶Nait-Belkacem, p. 135; S.W.A. Husaini, "Principles of Environmental Engineering Systems Planning in Islamic Culture," in Programs in Engineering Economic Planning (Stanford: Stanford University Report E.E.P.-47, 1971), p. 181.

⁶⁷For example, Abd-Allāh, pp. 121-129, points out that three of the key principles that were adopted by Malik in his rulings were istihsān (equity), sadd adh-dharā'i^c (blocking of means leading to unjust ends), or al-muṣālīḥ al-mursala (public interest). These do reflect this preoccupation with social justice. Also see Khalifa, pp. 227-228.

⁶⁸E.I.J. Rosenthal, "Political Philosophy in Islam and Judaism," Judaism, 17 (1968), p. 431.

⁶⁹A.K. Brohi, "Islamic Way of Life," in Islam in the Modern World, 2nd. ed., ed. Khurshid Ahmad (Lahore: Publisher United, 1975), p. 109; M.M. Siddiqui, What is Islam?, 2nd. ed. (Pathankot: Maktaba-e-Jama'at-e-Islami, 1945), p. 65.

⁷⁰Mabid A.M. Al-Jahri, "Zakāt and Fiscal Policy," in Studies in Islamic Economics, ed. Khurshid Ahmad (Leicester: The Islamic Foundation, 1980), pp. 119-130; Abdul Q. Shaikh, "Zakah and Taxation," in Outlines of Islamic Economics, Proc. of the First Symposium on the Economics of Islam in North America, March 1977 (Indianapolis: Association of Muslim Social Scientists, 1977), pp. 5-12; M.A. Izadi, "The Role of az-Zakat (An Institutionalised Charity) in the Islamic System of Economics in Curing the Poverty Dilemma," in Proc. of the Third National Seminar of the Association of Muslim Social Scientists, May 1974 (Indianapolis: Association of Muslim Social Scientists, 1974), pp. 9-18.

⁷¹Mian M. Nazeer, The Islamic Economic System: A Few Highlights (Islamabad: Pakistan Institute of Development Economics, 1981), p. 23.

⁷²Muhammad A. al-Sa'ud, "Islamic View of Ribaa," The Islamic Review, 45, No. 2 (1957), p. 13.

⁷³Ribā has been defined narrowly as meaning only interest on consumption loans or broadly to include many other transactions. Important proponents of the latter view, which has been adopted for this dissertation, are: Zia ul Haque, "Riba, Interest, and Profit," Pakistan Economist, May 24, 1980, pp. 14-35 and May 31, 1980, pp. 13-30; Abd-al-Hamid Abu-Sulayman, "The Economics of Tawheed and Brotherhood," in Contemporary Aspects of Economic Thinking in Islam (n.p.: American Trust Publications, 1976), pp. 9-54.

⁷⁴It has been similarly defined by Joseph Schact, "Riba," Encyclopedia Islam, 1939 ed.

⁷⁵Haque, p. 33; Al-Sa'ud, p. 13.

⁷⁶Although perhaps not in this specific sense, many Islamic writers are in agreement that Islam forbids a return without an effort being expended for it: Abdul H. Ghanameh, "The Interestless Economy," in Contemporary Aspects, p. 86; Abulhasan Bani Sadr, Work and the Worker in Islam, trans. Hasan Mashhadi (Tehran: The Hamdani Foundation, n.d.), p. 9.

⁷⁷Afzal-ur-Rehman, Economic Doctrines of Islam (Lahore: Islamic Publications, 1974), I, 42; S.M. Yusuf, Economic Justice in Islam (Lahore: Ashraf, 1971), p. 50.

⁷⁸Joseph Schact, An Introduction to Islamic Law (Oxford: Clarendon Press, 1964), p. 147; N.J. Coulson, 1964, p. 38.

⁷⁹M.A. Khan, p. 29; Afzal-ur-Rehman, p. 50.

⁸⁰Haque, p. 26.

⁸¹Sabri F. Ulgener, "Monetary Conditions of Economic Growth and the Islamic Concept of Interest," Islamic Review, 55, No. 2 (1967), p. 12; Homayoun Katouzin, "Riba and Interest in an Islamic Political Economy," Peuples Meditteraneens, No. 14 (1981), p. 102; Ausaf, p. 122.

⁸²Syed Y. Shah, "Islam and Productive Credit," Islamic Review, 47, No. 3 (1959), p. 37.

⁸³Ziauddin Ahmed, "The Theory of Riba," Islamic Studies, 17, No. 4 (1978), p. 179, and also Sayyid A.A. Maudoodi, "Prohibition of Interest," Muslim News International, 3, No. 9 (1965), p. 25.

⁸⁴Fazlur Rehman, "Riba and Interest," Islamic Studies, 3. No. 1 (1964), p. 6.

⁸⁵S.H. Husan-uz-Zaman, "Islam vis-a-vis Interest Rate," Islamic Culture, 40, No. 1 (1966), p. 8; 11: 279; F. Gannauri, "A Study of Commercial Interest in Islam," Islamic Thought, 5, No. 4 and 5 (1958), p. 29.

⁸⁶M. Hamidullah, "Islam's Solution to Basic Economic Problems--the Position of Labour," Islamic Culture, 10, No. 2 (1936), pp. 213-233; Ziauddin Ahmed, "Socio-Economic Values of Islam and their Significance and Relevance to the Present Day World," Islamic Studies, 10, No. 4 (1971), pp. 350-353.

⁸⁷It has been suggested that the economic history of Islamic territories provides evidence of replete use of various legal fictions (hiyal) to circumvent riba regulations: Rodinson, 1978, pp. 28-58. The contrary view that riba regulations were taken seriously has also been presented. See A.L. Udovitch, "Reflections on the Institutions of Credits and Banking in the Medieval Islamic Near East," Studia Islamica, No. 41 (1975), p. 19; and also by the same author, "Bankers without Banks," in The Dawn of Modern Banking, ed. CMRS, U.C.L.A. (New Haven: Yale University Press, 1979), p. 257. The concern in this study is not with the historical experience of the practice of a doctrine but rather with the theoretical concepts and their applicability in current conditions. The former does have a bearing on the latter, but can not rid it of all relevance.

⁸⁸Rodinson, 1978, p. 34; S.M. Yusuf, p. 40.

⁸⁹M.J. Kister, "The Market of the Prophet," Journal of Economic and Social History of the Orient, 8, No. 3 (1965), p. 273.

⁹⁰M.A. Al-Arabi, p. 256; LIX: 7.

⁹¹Brohi, p. 45.

⁹²Khurshid Ahmad, pp. 178-181.

⁹³Subhi Mahmassani, "Transactions in the Sharī'a," in Law in the Middle East, p. 181; Mirza M. Hussain, Islam vs. Socialism (Lahore: Ashraf, 1947), p. 58.

⁹⁴Husni Ahmad, "Social Justice in Islam," Islamic Studies, 10, No. 3 (1971), p. 213; Fazlur Rahman, "Economic Principles of Islam," Islamic Studies, 8, No. 1 (1969), p. 5.

⁹⁵ Ahmad A.W. al-Ghandour, "Islam and Social Justice," The Islamic Review, 46, No. 3 (1958), p. 9. Ashari, p. 173.

⁹⁶ E.I.J. Rosenthal, Political Thought in Medieval Islam (Cambridge: Cambridge University Press, 1962), p. 153.

⁹⁷ Yusuf H. Khan, "Islamic Polity," Studies in Islam, No. 7 (1970), p. 71; Ahmad M. Al-Azmal, "Islam and Democracy," The Islamic Review, 43, No. 11 (1960), p. 10.

CHAPTER TWO

ALTERNATIVE INSTITUTIONAL STRUCTURES FOR PROFIT AND LOSS SHARING AND THE UNDERLYING ETHICAL ISSUES.

Introduction.

Islam makes stringent demands on its adherents in matters of financial practice. A Muslim is expected to refrain from accepting interest, but he must also avoid hoarding and conspicuous consumption.¹ To make conformity with these requirements of Islamic Law possible, writers have sought to revive medieval Muslim financial practice in what is becoming known as "Islamic banking." This banking is essentially based on principles of profit-and-loss sharing (P.L.S.), which allow for conformity to Islamic ethical principles.

Since P.L.S. is the specific topic of this dissertation, this would have been an opportune place for a review of the literature on the whole subject. However, since there already exists a recent and extended survey of literature on Islamic economics, including P.L.S., I will limit myself to a narrower scope.² Since little attention has been devoted to the various possible institutional structures of Islamic banking with their underlying ethical premises, this is the subject of study in this Chapter. "Ethical" is understood to mean

"legal with reference to Islamic Law." In Islam, the two terms can be used interchangeably, whereas this may not be more generally the case.

I start section one of this chapter with an historical account of two financial practices which are the basis of current Islamic banking. The ethical basis of the contemporary adaptation of P.L.S. into Islamic banking is explained in section two. In section three, I critically examine various institutional structures and settings in which P.L.S. banking can be embodied, with an emphasis on identifying the ethical underpinnings.

Section four is of primary importance in this chapter, and it serves two purposes. First, it is used to examine in some detail the key ethical issues raised in the discussion of interest-free banking in section three. These include the legality of fractional reserve banking and nationalisation of banks, speculation and capital gains, indexation for inflation, and rent-sharing in a leasing arrangement. Second, it is used to set up the institutional framework of a P.L.S. banking model which satisfies Islamic ethical constraints. This framework is used in chapter Three as the basis of an analysis of the main theoretical issues pertaining to P.L.S. banking.

Finally, in section five, to better illustrate P.L.S. banking, I compare it with the sophisticated and complex capital market, with its varied financial investments and insitutions, which it is intended to replace.

I: Medieval Islamic Commercial Institutions.

Two of the most important commercial institutions during the inception of Islam were mufāwada (partnership) and muḍāraba (profit-sharing). Their wide acceptance in early Islamic history followed from the Prophet's implicit acceptance of them. He is recorded as having been a party to the muḍāraba contract, and mufāwada was practiced without his disapproval during his time.³ While muḍāraba appears to have originated among the Arabs, the use of some form of partnership dates back to the time of the Babylonians.⁴

Both of these commercial associations are now being adapted to form the basis of financial transactions in some banks in several Muslim countries.⁵ What follows is a brief description, based on Udovitch (1970), of the medieval financial practice.

a.) Mufāwada: Only the Hanafi and Mālāki schools of Law accepted the validity of this commercial association. In Hanafi Law, the emphasis was on equality of the partners in personal and financial status, and hence in the contribution to the partnership. Other than that, the mufāwada was like the modern conception of partnership. Liability was unlimited, and the partnership was based on the principle of mutual agency (each partner being an agent of his colleague) and mutual surity (each partner being a guarantor of his colleague's actions). Thus, each partner was fully liable for the actions and

and commitments of the other in financial matters. Dissolution of the partnership could result from several things, including the death of either person or unilateral abrogation.

A more restricted form of this partnership was referred to as 'inān'. In this, the equality of the partners was not mandatory, and the mutual agency extended only to those commodities and areas of trade agreed upon. Mutual surety was not part of this contract. Liability was strictly limited to each partner's contribution to investment and distributed according to the proportion of their investment. Profit-shares could also vary with the contribution to total investment. Most of the partnerships were of short duration and limited to specific undertakings. It was not incumbent upon the partners, as was true for mufāwada, to invest their whole property.

The Mālāki mufāwada was closer to the Hanafi 'inān' in that there were no requirements of strict equality of the partners, and not all eligible capital had to be included in the partnership. Mālākis were also more flexible about investment form. In what may be referred to as the Mālāki version of 'inān', there were severe restrictions regarding what the partners could do with the joint capital. In general, the partners were expected to act together except in an emergency.

b.) Muḍāraba: Legal treatment of muḍāraba in three of the four major schools of Law (Hanafi, Mālāki,

and Shāfi'ī) was fairly uniform. The quote below from Udovitch (p. 170) serves well to summarize its principle features:

The commenda (mudāraba) is an arrangement in which an investor or group of investors entrusts capital or merchandise to an agent manager, who is to trade with it and then return to the investors the principle and a previously agreed upon share of the profits. Any loss resulting from the exigencies of travel or from an unsuccessful business venture is borne exclusively by the investors; the agent is in no way liable for a loss of this nature, losing only his expended time and effort.

It is important to point out that the agent was to be considered liable for a loss that was proved to have resulted from his negligence. Also notable is that there was no pre-determined amount of profit specified for either party. Instead, the parties concerned were to share profits in accordance with an agreed upon formula. Profits were only recognized as existing once the original capital was returned to the investors. However, the contract was legally terminated when the investor received his principal after profits were shared.

II: Profit-Sharing--The Ethical Basis for Contemporary Adaptation.

The method employed in adapting medieval financial practice to modern banking is to modify modern banking institutions so that they embody the principles implicit in the former. Four of these principles of particular

importance are listed here. First, risk taking, when related to a commercial venture, is a socially productive activity and consequently entitled to a reward. Second, a related point is that all loans must be to finance socially productive activity. Third, financial risk rests solely with the lenders and not with the managers/agents. Fourth, interest is forbidden because it is a predetermined fixed sum due to the owner of loanable funds irrespective of the outcome of the business venture--which makes it tantamount to a contract involving ribā.

The sources from which a description of contemporary Islamic banking can be had fit roughly into three categories. There are numerous articles and books on the issue, which started appearing as early as the nineteen forties. These studies began to be taken seriously in the Middle East--after the sharp rise in oil prices--where several Islamic investment companies and banks were formed. The organisational reports of these institutions (procured directly from the institutions concerned) provide a second source for my description of Islamic banking. Finally, based on these reports, there is a recent spate of published and non-published literature written mainly for academic seminars. These reports, apart from describing banking operations, also raise some related theoretical issues. In this section, I will mainly concentrate on two of the P.L.S. contracts as they are described in the sources listed above, and on examining their

consistency with the above-mentioned principles.

Mufāwada, the partnership contract referred to in section one, is now termed mushāraka. Under the latter, the bank and the borrower or agent undertake to contribute jointly to the capital and management of the business venture. The share in the profit and the duration of the joint venture are agreed upon in advance. In some cases, a "self-liquidating" form of partnership can be agreed upon, in which the bank would gradually relinquish its claim to ownership in accordance with the agent's ability to pay back the principle. Loss is shared in proportion to the contribution of each party to the capital, unless the agent is proven to be the cause of loss due to negligence or some willful action resulting in adverse consequences for the joint venture. The contract may specify that the agent is wholly responsible for the management and must keep the bank informed with regular progress reports.

The second form of the P.L.S. contract is still widely termed muḍāraba. Here, all funds are contributed by the bank, and the agent is solely responsible for entrepreneurship. Profits are once again shared on some agreed upon formula whereas the losses are entirely borne by the lenders, except for the qualification mentioned above. The agent, in case of business failure, loses his time and effort.

The difference in the two contracts seems really one

of degree rather than of ethical principles. What distinguishes them from each other is whether or not the agent supplies any capital on his own. Because of their similarity in most other operational aspects, both are broadly referred to as P.L.S. contracts. Muḍāraba is often referred to as profit-sharing. However, since the agent does stand to lose his time and effort, I have adopted the broader term (profit-and-loss sharing) even for it.

In addition to these two financial arrangements, Islamic banks currently in existence are also engaging in, or actively considering, several other financial practices that are commonly viewed to be acceptable under Islamic Law. The most notable of these is murābaha.⁶ The bank agrees to a purchase for a client who will then reimburse the bank in a stated time period at an agreed upon profit margin. The bank's profit premium is stated to be justified in that it bears a risk by allowing the client to unilaterally refuse to accept a commodity procured on its behalf by a bank. This financial arrangement has been used to finance internal and external trade. The bank cannot specify a security deposit or collateral in the contract, and therefore the contract is only engaged upon after a thorough consideration of the marketability of the product which a bank may find itself having to dispose of. Not all existing Islamic banks allow the client this right, and the return to those who don't is

questionable, since they are not bearing any risk.

The same transaction may be engaged upon on an installment basis with the qualification that the price will not be altered and a reprieve granted in case the client has difficulty meeting payment obligations. In this case, however, banks do specify security in some form to ensure repayment. Other financial arrangements (also on an installment basis) used to finance the purchase of craft goods such as leathers, saws, sewing machines, or even vans and taxis, really amount to hire-purchase or leasing. The above proviso to provide a reprieve in case the client undergoes unusual financial difficulties does still apply, but the view has been expressed that the fixed premium (rent) required by the bank resembles ribā.⁷

So far, one important unanswered question concerns the source of funds supply to the bank. To answer this query, one must review the type of accounts an Islamic institution offers, and by doing so introduce depositors as the third party to P.L.S. contracts. Islamic banks invite deposits in checking, saving, and investment accounts. The first two are similar (though not identical) to conventional banking accounts of the same names. One difference in some cases is that banks have to obtain permission of the depositors to use funds deposited in these accounts for investment.⁸ The deposits are guaranteed, but there is in principle no return of any form to

be earned on them. In practice, some banks do offer special privileges, like interest-free loans for the purchase of consumer durables on installments, or even profit-shares on savings accounts. Without these saving inducements, there would be no way of distinguishing between saving and checking accounts. Since saving accounts are guaranteed, no risk is borne by the saver. Given this absence of risk, it follows that a return on savings accounts in the form of profit-shares, or special privileges granted by the banks, amounts to ribā.

Investment deposits are presented as an account unique to Islamic banking. These deposits--which are not guaranteed--have to be above a minimum amount and for at least a minimum specified time duration. Withdrawal from the account before the specified time would result in a penalty in the form of foregoing part or all of the profit. Deposits are either "authorized," i.e. used for particular projects that the bank intends to be a party to or they are "unauthorized," i.e. used for the general investment fund. In the former case, depositors would share in the profit or loss of a specific project, whereas in the latter case, they would be a party to the generalised outcome of the bank's loaning and investment activities.⁹

Both forms of P.L.S. avoid ribā in that no predetermined share for the lender is prespecified irrespective of the outcome of the business venture. Also, as required by Islamic Law, risk is borne by the lenders

rather than the agents. However, there are certain cases in which the return to lenders is ethically questionable because their capital is subjected to negligible risk. This appears to be the case in unauthorized investment accounts, because in modern banking, risk can be reduced to a negligible amount by diversification. Although bank failures are not unheard of, especially when economic conditions are depressed, there is no way of establishing whether the profit earned on unauthorized accounts is commensurate with the risk undertaken. In fact, some writers have even suggested the establishment of a reserve fund, by retaining some percentage of the profits in each fiscal year, to guarantee depositors a return.¹⁰ While this banking innovation--which most banks currently in existence are practicing--may encourage investment deposits, it severs the direct link between a productive endeavor and the subsequent profit or loss to the financial contributor. Authorized accounts avoid these pitfalls by tying the fortunes of the lender to that of the particular project they finance.

III: Alternative Institutional Structures for P.L.S. Banking.

The mechanics of P.L.S. in the various institutional categories mentioned below are in all cases similar to those described in the last section. In this section, the particulars of the various institutional forms described in the literature are analyzed, with an emphasis on the

ethical ramifications involved. These descriptions are either based on an inference from the theoretical literature or represent a generalized description of real working models of Islamic banking. Four different structures of banking are considered below.

a.) The Joint Stock Bank. Most of the Islamic banks currently operating in the Middle East are based on the joint stock principle. So far, I have assumed that depositors are the only source of the supply of loanable funds. Obviously, in joint stock banking, the shareholders provide the banks with an independent source of funds. These funds essentially go into a pool of unauthorized investment accounts, and so the same ethical objections would hold true on the profit earned by shareholders, as would be the case for returns on unauthorized investment accounts.

Some Middle East Islamic banks have been set up with a host of special privileges.¹¹ Despite that, being an island in the sea of conventional banking, their ability to compete is affected by having to deal with disadvantages unique to them. First, in an environment where risk-free returns on savings are still possible, Islamic banks have to offset the risk they impose on depositors with a much higher return. Banks may be tempted to deal with this problem by looking for safe short term investments.¹² Second, whereas interest is generally deductible as an item of cost in business, profits forwarded to a bank

have not been made deductible in at least one country.¹³ However, this tax dis-incentive in dealing with Islamic banks, where it exists, may well be offset by the reduced risks incurred in the business.

These Islamic banks may also be confronted with several operational problems. Unlike conventional banking, there is a lack of any penalty in the form of interest on outstanding loans to bind agents to their commitments. Also, since the interest of the banks is so closely tied to the ventures they finance, even more energy than is normally expended must go into appraising them. Finally, agents may understate profits, especially when they recognize that relative to less efficient firms in the same industry, they must pay a higher absolute amount of profit.

Some procedures suggested to safeguard banks' investments include a detailed investigation of borrowers' financial position and dealings.¹⁴ Islamic Law also allows some form of security to be taken as collateral in case of breach of contract. The banks also insure their operations with an Islamic insurance company, although losses not resulting from a breach of contract are borne by the lenders, in proportion to their contribution in the case of authorized partnership investment. It has been suggested that contracts should be written to allow banks the legal right to continuous supervision (in the form of progress reports submitted) and to intervene

managerially if necessary.¹⁵ Finally, proposals involving a penalty in the form of a reduction in profit-share to enforce the liquidation of a project, as specified in the contract, and the blacklisting of borrowers have also been suggested.¹⁶

Joint stock banks currently operating in the Middle East also have certain other features. There is in all cases a Shari'ah supervisory board to advise and supervise the bank's operations and to ensure adherence to Islamic Law. There is a zakāt fund which derives its funds on fixed percentages (in compliance with Islamic Law) from the bank's capital and accrued profits, from investment accounts of depositors--who have requested such withholding--and from donations and grants. This fund is used for social welfare projects including interest-free loans to needy students and other individuals.

Finally, in some cases banks or investment houses issue certificates for participation in particular muqārabas (participation certificates). These are transferable, and the hope has been expressed that their circulation will encourage the growth of an Islamic financial market.¹⁷ The value of these certificates--which will vary with the progress of the project they are financing--is to be announced at regular intervals. This information is expected to form the basis of their "circulation." This procedure certainly allows the need for immediate liquidity to be met, but it also raises the related issues

of speculation (forbidden by Islamic Law) and capital gains. These ethical issues, along with some others, are discussed in section four.

b.) The Joint Stock Banking System. The whole banking system could be Islamized such that it consisted of joint stock commercial banks run on P.L.S. principles. This, in fact, is the pattern of banking that has received the widest attention and acceptance in the literature. If the whole banking system is run on P.L.S., then the problems specific to Islamic banks in a conventional banking environment would probably become less urgent insofar as they would affect the whole system. However, the whole system would face the operational problems listed above in addition to a few others.

Perhaps the most pressing problem would be that of generating an adequate amount of saving to meet the community's development needs. The problem is likely to arise from the elimination, in P.L.S. banking, of all risk-free assets such as bonds, interest bearing government securities, or interest on savings accounts. This issue will be analytically addressed in Chapter Three.

Another criticism of P.L.S. banking concerns its inability to handle short-term loans.¹⁸ Now, it is asked, can a bank assess a profit on a six month loan designed to aid a firm's import requirements? This would not necessarily be a problem where banks have unauthorized investment accounts. Banks could enter into a partnership

contract with an agent for the fraction of the year that the latter needed a loan. The same fraction could then be applied to determine the bank's share in the agent's annual profits. However, if unauthorized accounts are considered ethically unacceptable, then the banks may certainly have a problem attracting authorized funds for short term ventures.

There is of course the very tricky problem of deciding what a fair share of profit is. This issue is generally glossed over by using expressions such as "mutually agreed upon." An analytical discussion of this issue is postponed to Chapter Three. In the case of a mushāraka, where the agent brings his own physical capital into the partnership contract, evaluating the capital to determine profit shares could be the source of an operational headache.¹⁹

Monetary policy would lose considerable flexibility since some of its conventional tools would become unavailable. Manipulating the discount rate would no longer be available as an option for monetary policy in interest free banking. The absence of government bonds would nullify the open market operation as another instrument. Authorized muḍāraba shares should normally be non-transferable to avoid capital gains from speculation. Making muḍāraba shares transferable would be likely to make the market value of the shares different from the issue value. Changing reserve requirements may remain as the sole

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instrument of varying the money supply. Some writers have suggested changing profit-shares as a discretionary tool for monetary policy.²⁰ Since profit-shares should really be reflecting the realities of production, I argue in Chapter Three that altering them to suit the needs of monetary policy would be inefficient.

M.P.
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In fact, some writers also object to reserve banking. From an Islamic perspective, one could object to the ability of banks and their depositors to benefit from the "creation of credit." This is because a hidden form of ribā may be involved in the bank's use of funds that they have not legitimately earned in any way.²¹

Another ethical problem could result from the existence of inflation. Even in conventional banking, saving account holders are often losers when the rate of inflation exceeds the interest rate. In Islamic banking, where no interest is promised, the depositors would have still another reason to avoid saving accounts. On the other hand, borrowers would be implicitly engaging in ribā since the purchasing power of the principal they returned would be less than when they borrowed it. This arrangement is inequitable since it entails the subsidization of borrowers by lenders.

P.L.S. may have an advantage in being introduced into an Islamic environment. Since engaging in P.L.S. would satisfy the ethical requirements of using funds productively, and not engaging in ribā, it may draw funds

currently held "under the mattress" by devout Muslims dissatisfied with conventional banking. One study estimated on the basis of a survey that hoarding in Saudi Arabia alone amounted to twelve billion, and in the Middle East, to forty billion dollars.²² Since hoarding is unequivocally condemned in Islam, for some at least, P.L.S. could be a release from the choice between the devil and the devil.

Also, some disadvantages facing joint stock banks may be mitigated or made benign if the whole system were Islamized. Agents who may get away with defaulting on timely payments or understating profits in dealing with individual banks will find themselves with a very poor credit rating when dealing with the whole system. Thus, just as a firm needs to show a reasonable profit in order to sell its stock, an agent would have to have a good profit record to negotiate future P.L.S. contracts. Once again, although an individual bank may feel the strain of having to conduct detailed project appraisals, a system with the interest of the depositors, agents, and banks tied together can have its advantages.²³ Thus, even if the agent is legally allowed full freedom of action, he may benefit from the technical assistance of the bank.

c.) Nationalized Banking. Many of the same issues crop up with nationalized banking, which is an alternative to the joint stock banking system. I have concentrated

in this subsection on the differences. Those who favor this option do so by adducing the principles of "public interest." The argument is that nationalization is justified because banking involves the interest of the entire community. Another justification for nationalization could be pre-empting the possible occurrence of ribā that arises from the concentration of economic and hence political power that private sector banking is often accompanied by.²⁴

Pakistan may provide the first working model for nationalized Islamic banking. In fact, the five major commercial banks were nationalized prior to the recent Islamization drive in the country. A phased process (detailed in Chapter Five) has been initiated whereby the first phase, which is now underway, will offer an optional P.L.S. account. Profit rates are announced for all the banks, which have retained their old names and branches and compete for deposits on a service criterion. The final phase is to have all banking transactions conducted on an interest-free basis.²⁵

Both the joint stock and nationalized banking systems are to run on essentially the same operational principles. The one significant difference here would be having the banks play the role of pure intermediaries. This follows from the banks having no ownership interest in the lending and hence in the profit or loss. Fees would be levied for the financial intermediation and technical

assistance. In practical terms, this may not be too different from joint stock banking, where there is a separation of ownership and management.

Nationalized banking may have some advantages. Insofar as it displaces a highly concentrated commercial banking industry, it may be expected to determine and police P.L.S. formulas more commensurate with the contribution of the parties involved in the contract. In exercising an investment allocative function, it would probably be more sensitive to vital development needs than private sector banking. Obviously, its ability to have an impact on this area would be constrained by the need to attract deposits. But, between two equally productive projects, it could be expected to opt consistently for the most socially productive. Clearly patronage and other forms of corruption can prevent this potential from being realized.

The effectiveness of monetary policy could be increased, particularly if the 100% reserve requirement rule is adopted. In the joint stock commercial banking system, the ability of the autonomous commercial banks to thwart monetary policy by retaining excess reserves can be considerable.

d.) P.L.S. as an Experiment in Development. Most of the writings of P.L.S. banking implicitly have urban based operations and sophisticated capital markets in mind. Ironically, the first reported

experiment with P.L.S. on a significant scale was rural based. This was started in the early nineteen sixties in rural Egypt with one room and a staff of twenty five. The emphasis was mainly on educating and aiding village communities in the use of their own resources.²⁶

The initial success of the experiment resulted in savings banks on the same pattern being established in several neighboring communities using local resources and talent. The banks operated on fiscally conservative principles, and with the technical expertise they offered, they were able to aid the development of local small industries on a P.L.S. basis. More will be said about the operational details and the achievements and the limitations of this operation in Chapter Five, which reviews the experience to date of Islamic banking.

This Egyptian experiment does provide a refreshing example of appropriate technology applied to banking even before the term itself was coined. The major barrier to this project, as is probably true of most appropriate technology endeavors, was political. I have argued this as a general point in more detail elsewhere, but it should suffice to say that in most developing countries, such an experiment would conflict with established feudal, bureaucratic, and financial interests.²⁷

Perhaps using the Egyptian experiment as an example, nationalized Islamic banking may consider establishing decentralized rural saving units as one of its key

objectives. The state apparatus has a better chance of succeeding than noble but isolated experiments, assuming that the state is motivated to attain social justice.

IV: Ethical Issues Underlying a Ribā-Free Banking Model.

The various institutional structures discussed above are concerned mainly with the elimination of interest. Interest is only one aspect of the phenomenon of ribā as it was defined in Chapter One. In fact, the assertion here is that it is not possible to run an interest-free banking system that is truly ribā-free simply by substituting P.L.S. for interest. What follows is an attempt to arrive at the minimum conditions for a completely ribā-free Islamic banking system. In this exercise, I draw on the discussion of the last section and speak to some of the problems raised there.

There are at least two reasons that argue for the nationalization of banks and their conversion into pure intermediaries. The first is based on the empirical observation that controllers of capital inevitably attain an unwarranted amount of influence and power. This would lead to ribā insofar as this enables powerful banks to dictate terms to both depositors and borrowers who are autonomous and economically weaker.²⁸ Beyond this, where fractional reserve banking is permitted, banks are said to have the ability to draw profit on funds that they have in no way expended productive effort in earning.

One alternative to fractional reserve banking is having 100% reserves. This was advocated in the U.S. by several prominent economists, particularly after the Great Depression. Fractional reserve banking was regarded as partly responsible both for the origin of the depression and its magnitude once it began.²⁹ In general, it is blamed for contributing to the accentuation of both the upswings and downswings of the business cycle. Eliminating fractional reserve banking has also been suggested in order to acquire greater efficacy for monetary control.³⁰ This would come about by removing the commercial banks' ability to influence or subvert monetary policy where it does not coincide with their interests. This ability is believed to come about by the maintenance of excess reserves in a fractional reserve banking system.³¹

From an Islamic point of view, the ethical rather than the economic considerations are primary. In fact, it has been asserted that the prohibition in Islamic Law of the use of deposits for investment inhibited the development and growth of banking in the Islamic world, despite its early start with the use of a wide range of sophisticated credit instruments.³² However, not all Islamic economists view 100% reserve banking as an ethical necessity,³³ just as not all of them accept the legality of nationalization.³⁴

One may justify the existence of fractional reserve private banking -- regulated to avoid concentration --

on grounds that it is a flexible means of providing credit to productive entrepreneurs. Looking at the issue in another way, one would have to recognise the loss of flexibility that results from eliminating fractional reserve banking as the price to be paid for ethical purity.

Even though risk pooling does seem to be a departure from the one to one relationship of risk and return implicit in mudāraba and mushārīka, it may be the more practical proposition. As long as banks are appraising projects, it would appear arbitrary to link specific deposits with projects backed by the bank even if it were on a first-come first-serve basis. This procedure would also give banks an unwarranted amount of power of patronage. As banks have been structured in practice, lenders have been given the option to link their deposits to specific projects or to allow them to be part of a generalized investment fund which entails the pooling of risk. No jurist has so far raised the objection that minimizing the risk on a loan makes the financial contracts in question more similar to those of conventional banking.

There do remain some important distinctions. First, since there is a variability on the return on investments in deposits--tied to the variability in the level of economic activity--an element of risk remains in pooled or unauthorized investment deposits. Second,

there is a guarantee that the loans are to be forwarded towards some productive activity.

Investors in a ribā-free Islamic banking system could have open to them the option of buying stock, which would be similar to an authorized investment deposit. This option once again raises some ethical questions. Although buying stock is permissible from an Islamic viewpoint, making the contract transferable can be problematic if it leads to capital gains from speculative activity or even an attempted take-over, since such returns would amount to ribā.

A distinction has been made by one writer between stabilising and destabilising speculation.³⁵ Here, the concern is more with the intent rather than the effect of an activity. According to the definition adopted in Chapter One, in this context ribā is engaged in where an attempt is made to acquire a return by manipulation on a market rather than contribution to real production. Examples of such activities are hoarding by a retail store or speculative activity on the stock market.

The latter restriction would seem to imply the elimination (and this has been advocated) of the stock market, with the consequent impact that may have on the mobilization and allocation of funds. This is an important issue particularly because several Middle Eastern banks have declared their participation certificates (on muḍāraba or mushārīka basis) transferable and to be freely

exchangable on the financial market. The idea of doing this was to enable individuals' immediate need for liquidity to be met. It is anticipated that such flexibility will encourage saving. But this practice does leave open the possibility of speculative behavior insofar as the market value of the certificates is allowed to differ from their face value.

A way around this seems to have been attempted by the Islamic Investment Company of the Gulf (Sharjah).³⁶ This is to state the value of the certificate at regular intervals based on the actual progress of the project. The value of the certificate at a given time reflects the principle plus or minus the profit or loss incurred, which is added as a dividend or is subtracted as a penalty depending on how the project being financed is faring. Exchange is transacted on the basis of this value, which fluctuates because the profit-share is added to it or or the loss subtracted from it until the loan matures. This procedure prevents the face value of a participation certificate from differing from its market value, but it does cater to individual liquidity needs.³⁷

The existence of capital gains, however, goes beyond the obvious cases of stock market speculation and hoarding. Their wide prevalence necessitates a finer distinction between them to identify and separate those that may be acceptable from those that are unethical. Capital gains can result as a byproduct of regular

productive and trading activity. For example, the value of capital equipment or inventories can appreciate. Trading, in fact, is premised on being able to sell goods at a premium, and the appreciation of stocks could be considered part of business acumen. Finally, consumers may invest in real estate, jewelry, land, or other goods, as a hedge against inflation.

Thus it appears that in many cases the line between legitimate and unethical capital gains may be extremely fine. The authorities should probably concern themselves with restricting capital gains resulting from non-productive activity which simultaneously distorts market signals. An example of this is profiteering manipulations such as in the case of hoarding. Identifying and preventing such abuse of market institutions is never easy, particularly where the economically strong practice them. Nevertheless, fines, heavy capital gains taxes and regulations may be utilised to moderate their extent.

Another difficult issue involves the distinction between real and nominal returns on bank savings accounts. It was earlier explained how inflation may be unfair in its effects on the depositor, where there is no interest allowed. Indexation has been put forward as a solution to this problem.³⁸ Indexation has also been advocated in the West as a means to minimise the inequities of inflation and to reduce it by changing expectations.

Minimising the uncertainty attached to inflation reassures creditors, and the functioning of long term capital markets is improved.⁴⁰

Indexation, however, has not found ready acceptance among Islamic scholars. Their stand against it is mainly premised on the lack of approval by Islamic jurists of indexation.⁴¹ This opposition may be due to the negative view of hoarding in Islam, which funds forwarded to saving accounts (rather than for investment) closely resembles.

The technical problems of devising an indexation formula that is fair to lenders of all income brackets--in avoiding over- or under-compensation--and also to borrowers from different economic sectors has also been recognized by Islamic scholars.⁴² Despite these problems, it should be pointed out that some success in instituting indexation schemes on the credit market has been noted in the West.⁴³

Finally, the practice of renting in interest-free banking is another issue involving ethical considerations. This is present in the way some hire-purchase and leasing contracts are framed. As in the case of capital gains, certain distinctions may once again be made between different kinds of renting. The important categories include the renting of a natural resource, of something that provides an unambiguous service, and of something that can be used in a venture that can incur a profit or

a loss (i.e. a craft tool).

Renting of a natural resource is a complex issue, the discussion of which is appropriately deferred to Chapter Four, where alternative tenure arrangements are examined. Islam is said to legitimise the drawing of income from the renting of a house.⁴⁴ It may appear that, by analogy, the hire-purchase and leasing contracts that operate on the basis of drawing a fixed rent for the provision of a machine should be acceptable also. There is, however, an important distinction to consider here. Rent from a house is paid in exchange for a service actually rendered to and realised by the renter. This differs from the service rendered to an individual in financing a craft tool. The value of this service depends on whether the renter realizes a profit or a loss. Thus, taking a fixed rent irrespective of the financial outcome of the use of the tool is similar to a fixed interest drawn on a loan to finance a productive venture irrespective of its outcome. The same ethical considerations which prohibit interest as ribā and suggest P.L.S. as an alternative may apply to financing the purchase of craft tools and machinery for a fixed pre-determined rent. However, it is true in this case that banks are directly engaged in a productive endeavor.

On the basis of this discussion of the various ethical issues, I propose a model for a ribā-free Islamic banking system as follows.

The deposit side is to be as is currently available--accounts with or without authorization for specific projects. Productive loans are to be made on a P.L.S. basis. Also, P.L.S. certificates may be issued and made transferable in a form that avoids speculative activity. Banks are to be nationalised and to function as pure intermediaries--i.e. with 100% reserves. The latter issue is less critical where banks are nationalised. However, with nationalisation, the incentive structure needed for management to operate efficiently becomes a more important consideration. The threat of being fired for incompetent management could always be there. Given this "stick," the "carrot" of basing a portion of management's remuneration on the average profit rate declared by them could be used. This basic model along with some extensions will be more formally considered in Chapter Three.

Before moving to that it is useful to examine in some detail the similarities and differences of P.L.S. banking with the complex capital market it intends to replace in some Muslim countries.

V: P.L.S. as Compared to Conventional Capital Markets. Capital markets in the advanced industrial economies are highly sophisticated and complex. They function to provide lenders and borrowers with choices depending on their liquidity preference and risk-return

trade-offs. In addition, there are institutions to oversee the market and intermediate between lenders and borrowers. Here, only the broad features of this market will be contrasted with P.L.S. For this purpose, I will first consider how P.L.S. is to replace debt and equity financing as commonly practiced, and second, how P.L.S. institutions will be expected to replace various intermediary institutions of a conventional capital market.

a.) Debt and Equity Capital.⁴⁵ In a conventional capital market, business can rely on debt or equity financing to make up for their shortage of long term funds. Debt financing may take the form of term loans. Since these are negotiated directly between borrowers and lenders, they minimise formal procedures in comparison to bond or stock financing. They also allow for the possibility of a change in contract, if the need arises, due to changed economic circumstances. Like bonds and stocks, P.L.S. contracts have several member as parties to the contract, and therefore are unlikely to maintain the flexibility of term loans.

Issuing bonds may in some circumstances be an easy and cheap source of credit. As is true of loans, bonds entail repaying the principal on maturity and a fixed interest. Bonds can be of numerous types, the most common of which are the following: mortgage bonds, debentures, subordinated debentures, convertible bonds, income bonds, index bonds,

and redeemable bonds. These different categories allow the various needs of the borrower and lender to be accommodated and therefore widen the market. However, bond financing differs from term loans and P.L.S. in that the contracts themselves are transferable. This allows for the possibility of capital gains or losses and hence can encourage speculation, which, being ribā, is not permissible from an Islamic perspective. Also, the return on bonds is considered unacceptable from an Islamic viewpoint since it is pre-specified and fixed in amount. In both debt financing and P.L.S. there is a principal due back to the lender when the loan matures as specified in the contract.

Equity financing differs in this regard from debt financing and P.L.S. since there is no principal to be paid back. In equity financing, the lenders forward capital to firms in buying shares of stock. However, unlike debt financing, the size of their stock holdings determines the extent of their ownership of a corporation and hence their right to vote. Ownership can therefore be used as an instrument of control by casting votes to elect the directors, who in turn select the management. The existing stockholders also have the right to the first purchase of new shares. This can limit the dilution of ownership. It could enable an outside group of stockholders (those not controlling management) to pre-empt

management from warding off a bid for control (by means of a proxy fight) by issuing new stock. Although proxy fights are rare, the threat can serve to focus management's attentions on the stockholders' interests.

Under debt capital or P.L.S., the same countervailing pressure cannot be applied since forwarding funds is not tied to ownership. In these cases, the firm's possible need for future capital may keep it in line. Equity capital is also advantageous because dividends can only be paid out of profits, which prevents having to liquidate as in the case of a default on loans. In this aspect, P.L.S. does resemble equity financing, since it actually eliminates the borrower's risk of default. Whereas in equity financing, the borrower has discretion in determining dividend policy, under P.L.S. the borrower must part with the lender's share of the profit once that is determined. Stocks, like bonds, are transferable. In this case, ideally, the performance of the firm is reflected in the market value of the stock. However, the market value can depart from the real value and lead to speculative activity.

As indicated earlier, P.L.S. participation certificates can be made transferable under certain restrictions which prevent the market value, and the value quoted at different intervals by the investment company, from differing. In practical terms, the difference between these certificates and equities is that the profit is

added to the face value of the certificate and reflected in its increased value but not appropriated as dividends. Similarly, losses are actually subtracted from the face value, rather than registered in a fall or absence of dividends, and in the drop in the market value of a security. These gains or losses are actually realized when the certificate matures. In the meantime, someone in need of liquidity can pass on a commitment of funds (to a project) by selling the certificate for its stated worth at a certain time.

Even in this case, speculation can be attempted. One may choose to sell a certificate and realise the profits if one expects the project being financed to perform less well. However, if others expect the same, then this will not be reflected in a fall in the value of the certificate but in the individual's inability to sell it. Thus, adherence to the face value of the certificate may make it less liquid. In effect, this comes about from refusing to allow any capitalisation to take place, which happens implicitly in the determination of the market value of securities. For stock, the performance of a company, along with several factors concerning the economic environment which affect the company's performance, would be implicitly capitalised into its market value. Due to expectations, it is possible in this case for the market value not to reflect the realities of a company's past productive performance. These expectations

may also be the cause of bringing about capital gains or losses, which may or may not accurately reflect the performance of a company.

In the case of P.L.S. participation certificates, capital gains are ruled out since the value at any time reflects the history of the economic performance of a company from the time the contract was engaged in, and this is the only value at which purchase is possible. The sellers of a certificate can claim a share only up to the time they were participants in a company. In being constrained to sell at the stated value, they are prevented from arriving at the value of the certificate by capitalising on the basis of expectations of the future performance of the company. By purchasing the certificate at its stated value, the new owners grant to the old the profit or loss that is their due for the risk they have borne and are simultaneously contracting to be participants in the future profits or loss of the company.

Avoiding the use of a stock exchange entirely is a very extreme measure which would lead to severe rigidities in the financial system of the kind indicated above. In a sense, attempting to get rid of the stock market because it is open to abuses is like getting rid of the whole market system because it is open to abuses, i.e., monopoly and hoarding. In both cases, the answer probably is to impose regulations rather than throwing out the baby with the bath water.

In the case of a stock market, the normal malpractice regulations could be accompanied by a capital gains tax, tailored to vary inversely with the length of holding of securities.

Unlike debt financing, both P.L.S. and equity financing are suited to projects that have a great deal of fluctuation in their returns.⁴⁶ However, equity financing differs from P.L.S. in that the costs of flotation are often substantial and may run up to 25% of the issue price for small issue. Also, unlike P.L.S. the character of stocks can be altered to provide for the needs of both the lender and the borrower. Thus, for example, stocks can be categorized into either class A or class B, where the latter would be company stock, with sole voting rights, but these would not pay any dividends until the company has established its earning power. Provisions for convertibility, such as converting class A into class B, when B pays more than the amount specified for A, enhance the flexibility of stocks as a financial asset. Preferred stock and cumulative preferred stock, which afford no ownership privileges, make available the risk/return option.

b.) Financial institutions. P.L.S. can be embodied in various kinds of financial structures, as explained in section three. Ordinary commercial banks function differently from the Islamic institutions in several obvious ways. Certain other financial institutions exist in advanced industrial countries' capital markets, whose

function differs in less obvious ways from, for example, an Islamic joint stock bank or the model of an Islamic bank described in section four.

Investment banks are one such financial institution.⁴⁷ New corporations which cannot use stock exchanges and find it difficult or inconvenient to dispose of their own stock may rely on investment banks. Of course, these banks will sell stock only of corporations they consider promising. Profits of the bank result from selling stock at prices greater than those quoted to them. Although investment banks are subject to the risk of unmarketable stocks, in practice, they minimize this risk by forming an underwriter's syndicate in conjunction with other banks.

An Islamic joint stock bank receives an agreed upon share of the profits depending on its share (derived from the sale of stock) of the total funds loaned. When banks are not pure intermediaries, their fortunes are linked to the business ventures being financed even if their own contribution of funds is negligible. This linking occurs because the bank's share of profits is determined by P.L.S. contracts. In fact, the banks engage in a double P.L.S. contract. As usual, the borrowers contract with the banks, but the banks are now actively represented as lenders. The second contract is between the banks and their depositors, with the banks being represented as borrowers. Ultimately, the banks' profit depends on the

differential in profit-shares they can negotiate to pay the borrowers and its depositors. Being a party to the risk and hence to profits of a business undertaking, the bank undertakes more than merely arranging the financing. Its co-operation with business could range from a shared project appraisal to managerial advice or direction, depending on the nature of the contract it is engaged in. Whereas ultimately both institutions are intermediaries between lenders and borrowers, investment banks cater more to the needs of the borrowers. Islamic banks are structured such that serving their own needs they simultaneously serve those of the lender (depositor) and borrower. Nevertheless, this harmonious engagement in a productive endeavor should not be exaggerated, as it often is. Prior to the establishment of a contract, a potential for conflict exists in the determination of profit-shares.

Nationalized Islamic banks that function as pure intermediaries would be operationally the same. However, in this case, the bank would have no direct stake in the profit or loss resulting from the contract it facilitates. Such a unit, and particularly one that handles authorized accounts, could be viewed as performing the function of an investment bank. However, as a pure intermediary, it would not be performing the underwriter's function and would exist on a management fee rather than

the profits from the distribution of new issue.

In advanced capital markets, various financial intermediaries also work on behalf of the lender. These include personal trust companies, consumer credit institutions, and various forms of saving institutions, such as mutual saving banks and the saving and loan associations. Insofar as these function on the basis of fixed interest rates, which are made possible by the use of their deposits for financial investment, they are less relevant to the discussion of Islamic banking.

Investment companies and mutual funds work by drawing savers' funds in selling them shares and in return paying both dividends and capital gains.⁴⁸ Once again, they are able to do this because they use their reserves to invest in a whole range of financial assets that furnish both a regular source of income from dividends and interest. Capital gains can be realized from the buying and selling of securities, and these in turn are also distributed as capital gains to shareholders.

Investment companies are referred to as "closed-ended" insofar as they issue a limited number of securities, which are then traded on the securities market. Innovations with this formula have been taking place.

Mutual funds are "open-ended" in that they continuously sell their shares to investors, who can redeem them after a specified time period at net asset value. Various kinds of funds emphasize providing income, security, or capital

appreciation. Mutual funds are essentially a form of indirect security ownership. Investors have the advantage of relying on the skilled management of the fund. As is true of all institutional investments, due to their size economies, the mutual funds possess other advantages: more is expended on research; diversification is more effective; there is more access to inside corporate information; large sums of money can be committed for longer periods of time. Thus, the lender may conveniently draw income from a relatively safe and liquid investment. The same claim may be made for Islamic P.L.S. banking as described in section four.

Although some similarities exist, the differences will be focussed on here. The major difference is the form the financial investment takes. First, an Islamic bank must commit its pool of unauthorized funds to productive investment and may not use it for speculative securities trading to maximize capital gains distribution for its stockholders. Thus, a one-to-one relationship must exist between the bank's loaning of funds and the financing of productive activity. This relationship is not necessary in mutual funds. Second, a mutual fund management will have considerable discretion in declaring returns to its shareholders, whereas a P.L.S. contract commits the parties to pre-specified shares of profit. Third, P.L.S. contracts commit funds for a defined investment period and hence are less liquid.

Further, since the share is not freely transferable, no capital gains and losses are involved, as is possible when a mutual fund share is redeemed or sold. The capital value of the principal committed in the P.L.S. contract may change depending on the performance of the project. Fourth, the high loan value generally incurred due to advertisement expenses of the distribution company, dealer, and salesmen's commission is not a consideration in the P.L.S. contract. Finally, whereas the mutual funds generally have to declare bankruptcy when they cannot redeem shares, P.L.S. banks are structured such that they would not be in that predicament.

Conclusion:

This chapter has examined several institutional structures that could embody the P.L.S. contract and has emphasized the underlying ethical issues. Although operational procedures are identical, the differences between these structures arise from issues of ownership, scale, and policy objectives.

The most widely accepted mode of Islamic banking is the privately owned joint stock bank. Although this does avoid interest, it may be ridding banking of its legitimate Islamic ethical content to the extent that it attempts to do away with risk. Some risk will inevitably remain, due to the variability in profit-shares. Also, the requirements that loans be tied to productive

investment are satisfied even where risk is pooled.

However, even if the banking is based on authorized accounts, there are covert forms of ribā stemming from the practice of fractional reserve banking and from inflation. Apart from these ethical objections, there are also various operational problems. The most serious of these concerns the ability of banks to generate adequate savings without riskless returns--i.e. interest. An attempt has been made in section four of this chapter to discuss these issues and thereby suggest a mode of banking as a framework, within which several theoretical issues are analyzed in Chapter Three.

In section five, P.L.S. banking is contrasted with various investment media available in conventional financial markets. It becomes apparent that P.L.S. banking bears considerable resemblance to several existing mechanisms of financial intermediation and investment. A few points, however, are worthy of note. The most striking is the complexity of the conventional financial markets, where numerous instruments and institutions compete for the savers' funds by providing a mix of risk, return, and liquidity--which P.L.S. seeks to replace. The most distinctive features of P.L.S. are its insistence that loans be tied to productive, non-speculative investment and the lack of discretion institutions have in determining dividends when profit shares have been decided. Also, even though the lenders are paid what

could be interpreted as a variable dividend and bear complete financial risk, no ownership of a productive establishment is implied by being a party to a P.L.S. contract. Thus, ownership rights cannot be traded, nor can any capital gains or losses be realized from speculative trading. The latter restriction contributes to the inflexibility of P.L.S.

The study of P.L.S. is made particularly compelling by the desire of Islamists to make its form of equity financing the sole basis of financial transactions in an economy. The implications of this for the working of the financial market are analyzed in the next chapter.

Notes to Chapter Two

- ¹ Qur'ān, II: 188 and III: 180.
- ² M.N. Siddiqui, "Muslim Economic Thinking: A Survey of Contemporary Literature," in Studies in Islamic Economics, ed. Khurshid Ahmed (Leicester: The Islamic Foundation, 1980), pp. 191-316.
- ³ M.Abu-Saud, "Money, Interest, and Qirad," in Ahmed, ed., Studies, pp. 10-11.
- ⁴ A.L. Udovitch, Partnership and Profit in Medieval Islam (Princeton: Princeton University Press, 1970), p. 8.
- ⁵ See Arabia, September 1982, No. 13, pp. 33-56 for an extensive report on Islamic banking.
- ⁶ The description used in the text is drawn from Abdel-Rahim Hamdi, The Operations of Faisal Islamic Bank (Sudan). Paper delivered in the International Conference on Islamic Banking and Insurance (Sudan: National Printing and Publishing House, June 1981), pp. 15-17.
- ⁷ See Munawar Iqbal and Muhammad F. Khan, A Survey of Issues and a Program for Research in Monetary and Fiscal Economics of Islam (Islamabad: Institute for Policy Studies, Aug. 1981), p. 38. This source also contains a discussion of other financial arrangements proposed for in Islamic banks as an alternative to interest-based transactions, pp. 34-40.
- ⁸ Abdel-Rahim Hamdi, p. 22.
- ⁹ For a description of the various accounts and services offered by Islamic banks see Banking Services Offered by the Dubai Islamic Bank (Dubai: Dubai Islamic Bank Press, n.d.), pp. 1-11.
- ¹⁰ See for example Afzalur Rahman, Islamic Banking and Insurance (London: The Muslim School Trust, 1979), IV, p. 371.
- ¹¹ Law of Establishment and Statutes, Faisal Islamic Bank of Egypt (Cairo: Shorouk Press, n.d.), pp. 6-7.

¹²This observation was made by Muhammad F. Khan in "A Report on the Islamic Banking as Practiced Now in the World," unpublished paper presented in the follow-up seminar on Fiscal and Monetary Economics of Islam (Islamabad: Govt. of Pakistan, Planning and Development Division, Sept. 1980), p. 30.

¹³Hamdi, p. 10.

¹⁴These operational safeguards are suggested in Hamdi, p. 10.

¹⁵Such interference by the bank in the case of mud-
arabah contracts is deemed unlawful. See Muhammad Mus-
lehuddin, Banking and Islamic Law (Karachi: Islamic Re-
search Academy, 1974), p. 66.

¹⁶Blacklisting is suggested in Interest Free Banking: Introduction and Operations in Pakistan (Karachi: Inter-
national Association of Islamic Banks, n.d.), p. 23.

¹⁷Report Made Available by the Islamic Investment
Company of the Gulf: Sharjah (n.p., n.p., n. page).
The Jordan and Bahrain Islamic Banks have also authorized
the use of such certificates.

¹⁸Muhammad Uzair, Interest Free Banking (Karachi:
Royal Book Company, 1978), p.8.

¹⁹This and other potential operational problems are
noted by Muhammad A. Khan in "Interest Free Banking:
Some Further Questions," in Islamic Education, 5, No. 2,
(1972), p. 41.

²⁰See for example M.N. Siddiqui, Banking Without
Interest (Lahore: Islamic Publications, 1976), p. 186.

²¹For a discussion of this issue see Monzer Kahf,
The Islamic Economy (Indiana: Muslim Students' Associa-
tion, 1978), pp. 72-75. See also Nasser A. Sheikh, Some
Aspects of the Constitution and Economics of Islam
(Woking: The Woking Muslim Mission and Trust, 1961), pp.
77-79.

²²Simon Proctor, "When Usurers 'Shall Be Given to the
Fire,'" The Guardian, 3rd Dec., 1979, p. 14. In another
source where the same numbers are cited, the author ad-
mits that a wide margin of error was possible in the
statistics quoted. Since hoarding is forbidden in Islam,
the bias may be towards systematic understatement of the
real magnitude.

²³ Muhammad N. Siddiqui, Rationale of Islamic Banking (Jeddah: International Center for Research In Islamic Economics, n.d.), p. 17. This is perhaps the most recent contribution of the most prolific writer on Islamic banking.

²⁴ Kahf, p. 73; M.A. Mannan, Islamic Economics (Lahore: Ashraf Publications, 1970), pp. 230-250.

²⁵ There is a fairly detailed examination in Chapter Five of this dissertation of the Pakistani experiment. For more information on the phased process of introducing interest-free banking into Pakistan see Interest Free Banking, pp. 24-26.

²⁶ R.K. Ready, "The Egyptian Municipal Saving Bank Project," International Development Review, 9, No. 2 (1967), pp. 2-5.

²⁷ Shahrukh R. Khan, "Appropriate Technology: The Missing Dimension," Approtech, 2, No. 4 (1980), p. 24.

²⁸ Anwar I. Qureshi, Islam and the Theory of Interest, 2nd. ed. (Lahore: Ashraf Publications, 1974), p. 191.

²⁹ Irving Fisher, 100% Money, 3rd ed. (New Haven: The City Printing Company, 1945), p. 55, p. 154.

³⁰ A.G. Hart, "The Chicago Plan for Banking Reform," Review of Economic Studies, No. 2 (1935), p. 105.

³¹ Charles H. Walker, "The Chicago Plan for Banking Reform," Review of Economic Studies, 2, No. 2 (1935), p. 118.

³² A.L. Udovitch, "Reflections on the Institutions of Credits and Banking in the Medieval Islamic Near East," Studia Islamica, 41 (1975), p. 19.

³³ Many Islamic economists feel no compunction in assuming fractional reserve banking would continue as in conventional banking. See Siddiqui, 1976, pp. 106-114.

³⁴ For a strong case made in favor of nationalisation, see Qureshi, pp. 187-194. For an emphatic refutation of this point, see Muslehuddin, p. 73.

³⁵ M.S. Noorzoy, "Islamic Laws on Riba (Interest) and their Economic Implications," International Journal of Middle East Studies, 14, No. 1 (1982), p. 11. For an outright rejection of speculation, see Sheikh, p. 133; Muhammad A. Khan, "Stock Exchanges: Functions and Need for Reform," Criterion, 7, No. 1 (1972), p. 29.

³⁶Their discussion of the value and circulation of shares is cryptic. I have therefore filled it in, keeping in consistency with Islamic ethical principles.

³⁷For a further discussion of this certificate see section five of this chapter.

³⁸Syed N.H. Naqvi, Ethics and Economics: An Islamic Synthesis (Leicester: The Islamic Foundation, 1981), p. 121.

³⁹Milton Friedman, "Using Escalators to Help Fight Inflation," Fortune, July 1974, pp. 94-97, 174-176.

⁴⁰Gustav D. Jud, Inflation and the Use of Indexing in Developing Countries (New York: Praeger, 1978), p. 140.

⁴¹Panel of Economists and Bankers, Report on the Elimination of Interest from the Economy (Islamabad: Govt. of Pakistan, Planning Division, 1980), p. 6.

⁴²Abdul J. Khan, "Commercial Banking Operations in the Interest Free Framework," mimeo (Karachi: Habib Bank, n.d.), pp. 4-6.

⁴³Indexation of Financial Assets (Paris: O.E.C.D., 1975), p. 24.

⁴⁴Noorzoy, p. 10.

⁴⁵This section is in large part based on Eugene F. Brigham, Fundamentals of Financial Management (Illinois: Dryden, 1978), pp. 310-360.

⁴⁶This point is made in the context of a comparison of debt and equity financing by Ernest W. Walker in Essentials of Financial Management (Englewood Cliffs: Prentice-Hall, 1965), p. 101.

⁴⁷For an overview of investment banking see Irving Friend et. al., Investment Banking and the New Issues Market (Cleveland: World Publishing Company, 1967), pp. 1-79.

⁴⁸This description of mutual funds is based on Stuart B. Mead, Mutual Funds (Massachusetts: D.H. Mark, 1971), pp. 1-36, 88-99.

and the conversion of banks into pure intermediaries. It is important to bear in mind that P.L.S. is one element in a package, albeit the pivotal one, which is geared towards establishing a ribā-free economy. In this chapter, I attempt to analyze the impact of instituting P.L.S. on the the financial sector of the economy.

This chapter has several sections, the first of which attempts to establish the context for the remaining sections by explaining what I understand by profit. In section two, the basic P.L.S. model is outlined in symbols, and the profit rate is defined. In section three, P.L.S. is compared with conventional banking to compare returns to lenders and borrowers under these alternative arrangements. First, this is done without taking the risk-return trade-offs into consideration. Then a simple portfolio model is presented in which the "Islamic case" of allowing only P.L.S. is contrasted to a "capitalist case" that allows both fixed interest and P.L.S. The results of this comparison with respect to the supply of loanable funds is utilized in the following sections.

The next three sections are concerned with the mechanics of the P.L.S. model itself--the primary focus of the chapter. The supply and demand for loanable funds are described, following which the working of the loanable fund market under P.L.S. is analyzed. Section seven then considers some extensions of the basic P.L.S. model, including the case where banks are not pure

intermediaries. In section eight, some options for changing the money supply for discretionary monetary policy, in a ribā-free banking system, are suggested. Finally, in section nine, some tentative comments on the economic implications of P.L.S. are offered, including some on the impact of P.L.S. on the level and composition of investment.

This is also a good point to mention issues related to P.L.S. which I have chosen not to research. Much of the literature on P.L.S. banking is concerned with its operational details. These include a discussion of the establishing and managing of P.L.S. banks; the operational aspects of the relationship between central and other banks; making interest-free consumer loans; the creation of reserve funds and other schemes to insulate depositors from losses on paper; the criteria for making loans; issues dealing with short-term loans and discounting bills of exchange; ways of dealing with bad debts; mechanisms for providing security for banks; outlets for pleas for those whose applications for loans were turned down; and the basis of international financial transactions in a P.L.S. banking system.¹

For the most part, my research bypasses the operational issues, and is concerned with producer loans in a closed economy. As the chapter section outline above indicates, most of the issues to be dealt with here are analytical. These I feel are issues that have been

ignored or have not received adequate attention in the literature so far.²

I. Profits

From an Islamic perspective, the concept of P.L.S. can make sense only if the origin of that profit itself is not based on ribā but rather on some form of productive activity. A discussion is in order, therefore, of the theory of profit on which I am basing my analysis. To justify the use of any particular theory, some mention of competing theories is necessary.

Clearly, a review of the various theories of profit is outside the scope of this dissertation, especially since several reviews already exist.³ I will discuss the main sources of profit that are relevant in the context of the returns to the two parties of the P.L.S. contract. The broad view of profit, as any surplus originating from production that is not due to the contribution of labor, is being utilized here.

One source of profit is monopoly "power," and this is one which would clearly lead to ribā and is therefore unacceptable. This is not to suggest that this source of profit will not exist in an Islamic economy. The idea is that if it does, then the authority mechanism would have to eliminate it by anti-trust action.

The neo-classical theory of positive profits is based on the interaction of time preference and productivity of capital.⁴ This explains why a lender is assured a

positive risk-free return insofar as he is willing to "abstain." The return could really be interpreted as a rent based on ownership. In fact, by viewing interest in this fashion, the Islamists regard it as ribā and hence an ethically unacceptable form of income. Apart from theories based on monopoly and abstinence, another category of theories relates profit to a contribution originating from some kind of productive activity.

One of these is due to Schumpeter (1912), who shows profit arising from entrepreneurial innovation. Unlike classical economists, he distinguishes between profits and interest, where the latter has its source in the former. Schumpeter anchors his theory of value on labor and land, the two primary factors. In the static state circular flow of the perfectly competitive economy, profits do not exist because ultimately all surplus must be imputed to the value of the primary factors. Profits, and in fact economic development, result from "new combinations" which are the outcome of entrepreneurial action. In fact, an entrepreneur earns his name only insofar as he can innovate and realise the profit potential from introducing a new product, mode of organisation, technique of production, or from tapping a new market for outputs or inputs (1935, p. 66).⁵

Profits arise from innovation because of a lag in imputation. Entrepreneurs pay for resources at the prices set by previous uses. Innovation enables a more

productive combination of those resources and hence leads to a surplus. In the absence of monopolies, the iron law of costs and competition (in the form of a "herdline" movement to imitate the innovation) do eventually erode these profits. At this point, the entrepreneur--strictly speaking no longer describable by that label--fits into the circular flow and into a predictable pattern of production and exchange. The process continues with others who claim and bear the torch of "enterprise." So, to sum up, the profits originate from the will and action--for practical purposes a new agent of production--that went into the reorganisation of existing resources.

At least two issues need further consideration. Given the assumption of perfect foresight normally made in the analysis of a perfectly competitive economy, there would be no lag in imputation, which is needed to explain profits. Furthermore, while Schumpeter's theory justifies a return to the entrepreneur (borrower), it does not justify, from the ethical perspective earlier referred to, the return to the lender. Interest in his larger theory (pp. 155-211) is merely a tax on profits. It persists, while profit disappears, because mobile capital can continually feed on the profits from fresh innovations.

These issues can be dealt with by examining Knight's (1921) theory of profit. This is really presented as an alternate theory, although I feel it is an extension of

and a complement to Schumpeter's theory. Knight relaxes the assumption of perfect foresight and defines uncertainty as a condition under which objective probabilities cannot be assigned to a distribution of outcomes of an economic action. He goes on to argue that where uncertainty is absent, the imputation of product values to product services will always be perfect and exhaustive, and profit will be absent except stochastically (p. 98). Profit is once again unimputable income, but it arises because, due to chance, there is a divergence of actual conditions from those that were anticipated. Factor incomes are determined by the competitive process on the basis of anticipated rather than actual conditions, and the residual value from sale of output, if positive, is profit (1964, p. 98). Profits, on average, will be positive due to innovations.

On the basis of this reasoning, Knight asserts that it is uncertainty which leads to profit. Knight does admit that the precondition of uncertainty is "change," which is defined to be much like the conditions that caused a departure from the static state in Schumpeter's theory (pp. 141-173). It is for this reason that I feel the two theories really complement each other, where change is the source of the profit and uncertainty is the basis of its realization.

Knight's breakdown of the entrepreneurial function into its various elements serves to resolve the second of

the two issues I mentioned above. The two functions of the entrepreneur are control and guarantee (p.284), both of which arise from the existence of uncertainty. Control, in a hierarchical organisation, resides with the ultimate "orderer of orderers" (the highest ranks of the control hierarchy) on the basis of trust in one's "knowledge of others' knowledge" (p. 297). The critical role in the mechanics of control is always pushed further up the hierarchy due to problems confronted in the face of uncertainty. Once again, control is very closely tied to the innovative function of the Schumpeterian entrepreneur, since without that, a routine and purely managerial function for the entrepreneur would be adequate.

The guarantee function refers to the bearing of uncertainty. Since most productive resources require an a priori commitment to remuneration for their services (contract income), the guarantor shoulders the uncertainty in providing this contract income and settling for a return from the residual income if that is positive. Generally, the guarantors (those who have a direct stake in the outcome of the venture) would also be expected to be in a position of control. Knight does recognize the theoretical possibility of separating those functions (p. 289). This is in fact how P.L.S. may be expected to operate, with the borrowers assuming the entrepreneurial role of innovation and control, and the lenders that of

providing the guarantee. Since bearing uncertainty (tied to socially productive enterprise) is considered productive activity in Islam, the profit-share of the lender in his role of the guarantor would be legally justified. I proceed now, viewing this discussion as the context within which the analysis of this chapter is to be conducted.

Schumpeter's entrepreneur--in his case starting from the static state--is totally dependent on credit to be able to carry out his plans. Banks create the purchasing power or claims to resources by means of which entrepreneurs can bid away resources from their existing uses (p. 73). A temporary increase in the price level is inevitable (length depending on gestation periods), but ultimately deflation would result from the new influx of goods and services onto the market. Banks thus play a very crucial role in the development process, and it is precisely this role which makes their characterization as intermediaries inaccurate.

This is the point where my analysis has to differ, for operational reasons, from Schumpeter's. I argued in Chapter Two that reform of the banking sector along Islamic lines not only requires abolishing interest but also requires the conversion of banks into pure intermediaries. Not only does this deny the banks (as a whole) the ability to create purchasing power, but in every other way denies them any stake in profit. A question

immediately follows: Can an orderly functioning financial market continue to exist after these fundamental changes? This, and other related questions, will be the subject of the rest of this chapter after the P.L.S. system is outlined in the following section.

II. Profit and Loss Sharing.

This system has already been discussed in detail in Chapter Two. Here, the symbols that are representative of the shares of the different parties to a P.L.S. contract as well as the starting assumptions for this model are introduced.

The two active agents to such a contract are the lenders of funds (also referred to as depositors) and the borrowers of funds (also referred to as entrepreneurs). Banks will be in general assumed to play the purely intermediary role of bringing the two parties to the contract together. This assumption will be dropped in section six, where banks will be considered an active party to the contract.

As a pure intermediary, the bank provides a service for both parties, and it covers its administrative expenses by charging both partners a fee. If in a conventional banking system, the difference between lending and borrowing rates of interest includes a profit margin, then this differential exceeds the total administrative fee by the extent of that margin.

This leaves the shares of the active parties to the

contract to be determined. To begin with, the muḍarāba contract, where all funds are provided by the lenders, will be considered. In section six, the mushārika contract, where the entrepreneurs also provide part of the funds for the project, say from retained earnings, will be analysed.

Let π be the average operating surplus (residual income, after all costs contracted on a fixed income basis have been subtracted from total revenue) that results from entrepreneurial activity. Let p be the share of this surplus forwarded to depositors in P.L.S. accounts in the bank. I will illustrate in section five how p is determined in the market for loanable funds.

Given the above symbols, one can state the following:

$p\pi$ = share of the operating surplus forwarded to depositors in P.L.S. accounts;

$(1-p)\pi$ = share of the operating surplus retained by the entrepreneurs.

If k represents the total funds forwarded by depositors, and the operating surplus accruing on these deposits is $p\pi$, then one can define a profit rate r , where

$$r = \frac{p\pi}{k}$$

The most noticeable difference of P.L.S., as defined above, from the conventional debt financing for a fixed interest rate is that lenders are being constrained not

only to shoulder the "risk" of project failures (which is always there) but also to settle for a variable return. The implications of this constraint are analyzed in the next section.

III. P.L.S. vs. Conventional Banking.

Many critics fear that interest-free banking leaves too little incentive to lenders to supply funds. An attempt has been made below to derive the conditions under which the lender could expect to get a higher return under P.L.S. than via interest from a savings account.

For the conventional banking system, we can define

i_L =lending rate of interest;
 i_B =borrowing rate of interest;
 $\frac{\pi}{k}$ =profit rate.

It is normally reasonable to expect that $\frac{\pi}{k} > i_B > i_L$.

If $\frac{\pi}{k} < i_B$ the entrepreneur would not borrow, and it is by having $i_L < i_B$ that banks earn their revenue. Thus, one can specify

$i_B = a i_L$ -----1 and
 $\frac{\pi}{k} = b i_B$ -----2, where

a represents the bank's premium. It reflects the difference between what they charge borrowers and what they give to depositors. b represents the margin that entrepreneurs on average operate with. To feel secure, they would want a certain difference between what their fixed interest commitments to banks are and the profit-rate

they have been experiencing. The profit rate for the lender under P.L.S. was defined as $\frac{P\pi}{K}$.

In terms of the above symbols, I am looking for the condition under which

$$\frac{P\pi}{K} > i_L \text{-----3.}$$

Substituting 1 and 2 into 3, this reduces to

$$P > \frac{1}{a}b \text{-----4.}$$

The values of a and b would differ depending on the economy in question. For a developing economy with dualistic and segmented capital markets, these would not be uniform across the different markets and sectors. However, statistics quoted for the industrial sector for Pakistan show a to be approximately 2.⁶ One suggestion concerning b is that it must be at least 3 or 4 to encourage the industrialists to produce in order to cover for risk.⁷ With these numbers, the depositor is better off under P.L.S. than conventional banking, even if P is roughly about 13% to 17%.

Some qualifications and explanations are in order here. These numbers are intended to be for illustrative purposes only. Also, it bears mentioning, even though the point is minor, that the share of borrowers and lenders is overstated by the extent of the administrative fees to be forwarded to the financial intermediaries. As

long as this fee is less than the differential represented by α , there is a surplus to be redistributed to borrowers and lenders that would make them both potentially better off than in conventional banking.

This surplus would arise, strictly speaking, as a consequence of nationalisation, which turns banks into pure intermediaries. P.L.S. is, however, only one of the options on the basis of which nationalised banking may function. Finally, there is the implicit assumption here that nationalised banks can operate at least as efficiently as private enterprise banking.

The other parameter that affects the size of p is b . A high b indicates that producers are very averse to bearing uncertainty, and in a financial contract where they do not have to shoulder it, they will be made better off in proportion to the degree of their aversion. Borrowers would therefore seem to be made better off on two counts. First, they may be able to share in the surplus that previously accrued to banks after their conversion into pure intermediaries. Second, they can contract to have some other party bear some of the uncertainty of a productive endeavor--but they still do have their opportunity cost and the psychic costs of failure on the line.

Lenders may be made better off on one count but worse off on another. The low estimate of p above at which depositors would be satisfied under P.L.S. solely

takes into account the potential redistribution of surplus normally accruing to banks. This estimate does not take into consideration the crucial point that lenders are constrained to undertake uncertainty in order to draw a positive return on their funds. Thus, any increased return that may be forthcoming on average must be weighed against the increased uncertainty inherent in the P.L.S. contracts.

Using the neo-classical portfolio balance framework to adjust for risk aversion (the best that can be done, given that uncertainty is not measurable), one can show that, irrespective of the value of ρ , the elimination of risk-free assets with a positive return (in a pure P.L.S. system) is a constraint on the financial system that will inevitably make lenders less well off. To show this, the portfolio model as presented in Branson (1979, pp. 251-258) is modified slightly to incorporate P.L.S. Under P.L.S., without risk-free assets, the lender has to bear the risk that is inherent in the productive activity itself. Thus, the two assets in this model are P.L.S. claims and money, instead of bonds and money. Suppose risk under P.L.S. is estimated from the probability distribution of expected returns on P.L.S. deposits and represented by σ . Then, if the total liquid wealth available for lending in P.L.S. accounts is W , the total risk, σ_L , incurred on account of that lending must be σW , assuming all funds in P.L.S. accounts are forwarded

for use by entrepreneurs.

$$\sigma_T = \sigma W \text{ -----5.}$$

Similarly, if π_{-1} is the profit rate that prevailed in the last period, then the current expected return is

$$R = r_{-1} W \text{ -----6 (assuming that the lender's profit expectations are based on last period's profit rate).}$$

Substituting $W = \frac{\sigma_T}{\sigma}$ from 5 into 6 results in

$$R = r_{-1} \frac{\sigma_T}{\sigma} \text{ -----7.}$$

In Figure 1 below, the upper right quadrant shows the budget line representing the trade-off between risk and return. Its slope can be arrived at by differentiating equation 7 with respect to σ_T :

$$\frac{\partial R}{\partial \sigma_T} = \frac{r_{-1}}{\sigma} \text{ -----8.}$$

The geometrical device in the lower right quadrant enables one to read the level of risk undertaken corresponding to the extent of liquid wealth a lender has in P.L.S. accounts. That this is indeed the case can be seen by differentiating equation 5 with respect to σ_T :

$$\frac{\partial W}{\partial \sigma_T} = \frac{1}{\sigma} \text{ -----9.}$$

W max on the vertical axis of the lower quadrant represents the point where all funds are deposited into P.L.S.

accounts. Using equation 9, one can read off from the lower quadrant σ_T max as the maximum total level of risk this corresponds to ($W \text{ max} \times \frac{1}{\sigma} = \sigma_T \text{ max}$). Using equation 8, one can read off from the upper quadrant $R \text{ max}$ as the maximum expected return which $\sigma_T \text{ max}$ corresponds to ($\sigma_T \text{ max} \times \frac{r_f}{\sigma} = R \text{ max}$).

So the information summarised in equations 8 and 9, when graphed, results in the two lines with the slope of $\frac{r_f}{\sigma}$ and $\frac{1}{\sigma}$. We can superimpose a preference ordering for a risk averse individual on the budget line represented by equation 8. The tangency of the budget line with the indifference curve represents the optimal portfolio balance between holding money and depositing it into P.L.S. accounts as shown below.

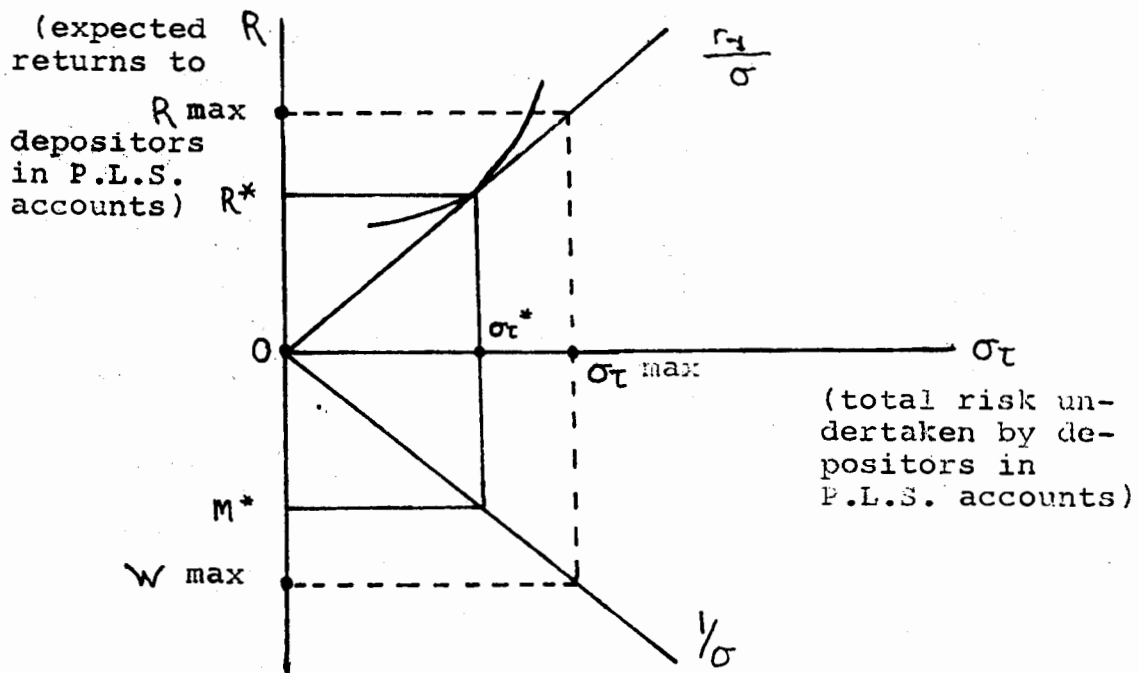


Fig. 1 --Portfolio Selection Between P.L.S. and Money.

The starred items above represent the optimal risk-return configuration for the lender. Corresponding to that is the optimal distribution of total wealth between P.L.S. accounts (OM^*) and money (M^*W/\max). Corresponding to OM^* in P.L.S. accounts is OR^* , the expected return to the lender.

One result that follows from this analysis is that the supply of funds for profit-sharing accounts would vary positively with ρ given π_{-1} (where $r_{-1} = \rho \pi_{-1} / K_{-1}$). This result would come about because a higher ρ would lead to a higher budget line and hence show more wealth diverted into the P.L.S. accounts and away from checking accounts representing the demand for money to hold.

I now proceed to illustrate the result I set out to show: the addition of minimum risk assets within the P.L.S. banking system would make the lenders better off within the context of a portfolio balance model. Let a guaranteed interest, i , on savings accounts be the additional asset. The third asset would now change the budget line into the budget-set $OiW\lambda$ as shown in Figure 2 below. O represents a point of all money and zero risk. iW represents the maximum return (with zero risk) on saving accounts with a positive rate of interest. Finally, λ represents the maximum return (with maximum risk) derived from putting all of one's funds into P.L.S. accounts. The budget-set represents a linear combination of these three points. Since $iW\lambda$ dominates a linear

combination of money and P.L.S., the lender is unambiguously made better off, as one might expect, from the introduction of a guaranteed interest saving account.

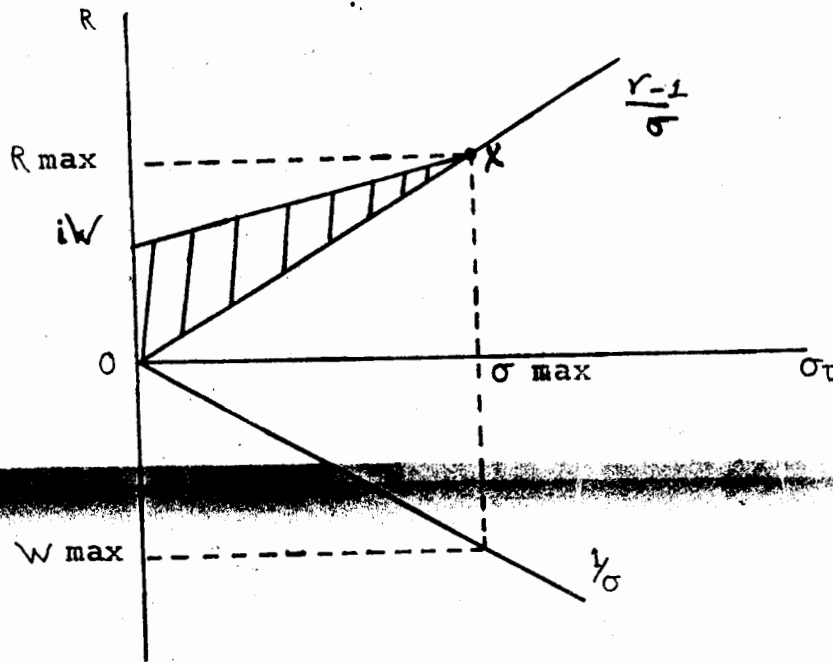


Fig. 2--Portfolio Selection Between P.L.S., Money and Interest Bearing Saving Accounts

Perhaps a more meaningful comparison would be that between P.L.S. and a conventional financial system without P.L.S. that offers the lender a whole range of options (not including P.L.S.) to balance their risk and return depending on their preference function. The comparison is complicated due to an additional and qualitatively different element of risk that is introduced due to the possibility of realising capital gains or losses on financial assets. Under P.L.S., risk is related only to the variability of profit as arising from production and fluctuations in economic activity. Secondly, there is

no way to relate a priori i with r either. Thus, since the critical elements in the model are different, the comparison becomes difficult. To add to this complexity is the likelihood that the aggregate preference function itself may change in a Muslim country due to the introduction of a ribā-free system.

Thus, I conclude this section by asserting that it is not possible to show that the replacement of a conventional financial system by P.L.S. would unambiguously leave the lenders better or worse off. However, the welfare of a lender would be higher under P.L.S. if a "risk-free" financial asset with a positive return were also available.

IV. Supply of Loanable Funds.

Little can be theoretically established about the position of the supply curve that would result from the substitution of P.L.S. for a conventional banking system due to the reasons stated in section three, although it is likely that the supply of loanable funds would decline if the interest option were no longer available and lenders were constrained to take a risk to get a return, as in P.L.S.

Based on what was stated and demonstrated in the last section, the supply function can be written as

$$S = f(p, r_{-1}), \text{ (where } r_{-1} \text{ is the last period's profit rate)}$$

and graphed with a positive slope with respect to p .

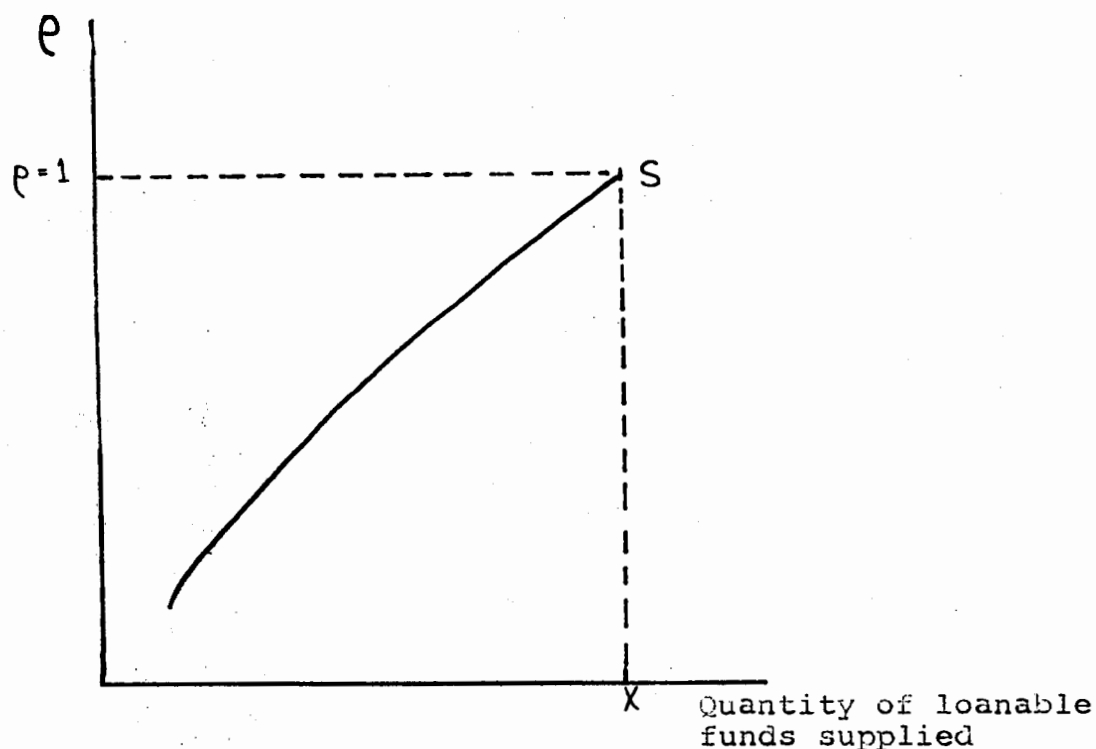


Fig. 3--Supply of Loanable Funds

X corresponds to the maximum available funds. Most of them would be made available for P.L.S. as p tends to 1 .

Some further discussion of the supply curve is possible both from an empirical and institutional perspective. Islamic economists have long argued that the interest based financial system diverts the funds of true Muslims into hoarding due to their alienation from interest based banks. Hence, they reason that an Islamic system would draw out those funds, thus adding to the stock of loanable funds available.⁸ Of course, this would be true only if these funds had actually been kept out of circulation--i.e. under the mattress. Some

recent evidence from reports of Islamic banking in the Middle East does suggest that considerable sums are hoarded, although it is not clear in what manner.⁹

Pakistani banks which offer a P.L.S. option do report a fairly enthusiastic participation by lenders in this experiment.¹⁰ A detailed discussion of the available empirical evidence is deferred until Chapter Five.

The institutional comments hinge upon a point earlier made, stating that abolishing interest must be examined in conjunction with the larger attempt to abolish ribā. Therefore, although one cannot say with certainty that under P.L.S. the same quantity of loanable funds will be available for investment, it is instructive to examine what options are available for the utilization of those funds in an Islamic context.

Speculation in the form of transactions on the stock market or on the commodity market is not an available option in an Islamic economic system since that constitutes ribā. Although financing by stocks is not forbidden, the stocks themselves cannot be transferrable in such a way as to lead to capital gains or losses, as explained in Chapter Two. Here, the return to risk is not justifiable since it is not associated with a productive activity. (See Chapter Two, pp. 103-105, for qualifications on the transferrability of P.L.S. shares.)

This still leaves open the possibility of investment in either land, durable goods, or jewelry in the hope of

capital gains or to keep up with inflation. Hoarding, conspicuous consumption, and capital flowing out of the country are also channels for loanable funds being diverted into non-productive uses. Specific Qur'ānic injunctions condemning conspicuous consumption (II: 188) and hoarding (III: 180). Also, various categories of capital outflows and commodity dealings which are destabilising or speculative may be considered prohibited. Partly off-setting all this may be the fact that zakāt is levied on savings but not on funds forwarded for productive activity.

Apart from capital outflows and hoarding, it is not clear that the funds that exchange hands in the rest of the transactions mentioned above are diverted away from the funds available for productive investment in P.L.S. accounts. This is so because someone ends up with the funds expended in these transactions. However, given that only part of these funds may be forwarded into P.L.S. accounts (and part again expended on the above mentioned transactions), the flow of funds into P.L.S. accounts at a point in time will be reduced.

What happens to the supply of loanable funds is essentially an empirical issue. One could conclude that some funds will be drawn from hoarding into P.L.S. accounts that claim to be ribā-free. On the other hand, some people will avoid committing their funds to such accounts due to the absence of "risk-free" returns on deposits; instead they may seek non-monetary forms of investment such as real estate or jewelry.

V. Demand for Loanable Funds.

The demand curve for loanable funds can be represented by function $D = f(p, \pi_e)$, where π_e is the operating surplus expected by the entrepreneur. This is based on current and anticipated choice of technology available, mix of government incentives and regulations, resource availability, product market demand considerations, and political climate.

An individual entrepreneur could be conceived as building these expectations into his calculations on the basis of the formula for the internal rate of return.

$$0 = -C_t + R_t + \frac{R_{t+1}}{1+m} + \frac{R_{t+2}}{(1+m)^2} + \dots + \frac{R_{t+n}}{(1+m)^n}$$

where

C_t = set-up costs at time t ;
 R_t = net revenue at time t ;
 m = internal rate of return that will discount the present value of a project's flow of net revenue to zero.

Different entrepreneurs are conceived of as attempting projects yielding different internal rates of returns. This is based on differences in factors like knowledge, experience, information, contracts, location, and taste for bearing uncertainty. Successful entrepreneurs may, however, be expected to diversify towards projects that yield a higher return. Given an adequate availability of entrepreneurs, one could envisage an investment schedule varying inversely with m , implying that the projects

with the higher yield will be attempted first, as shown in Figure 4 below.

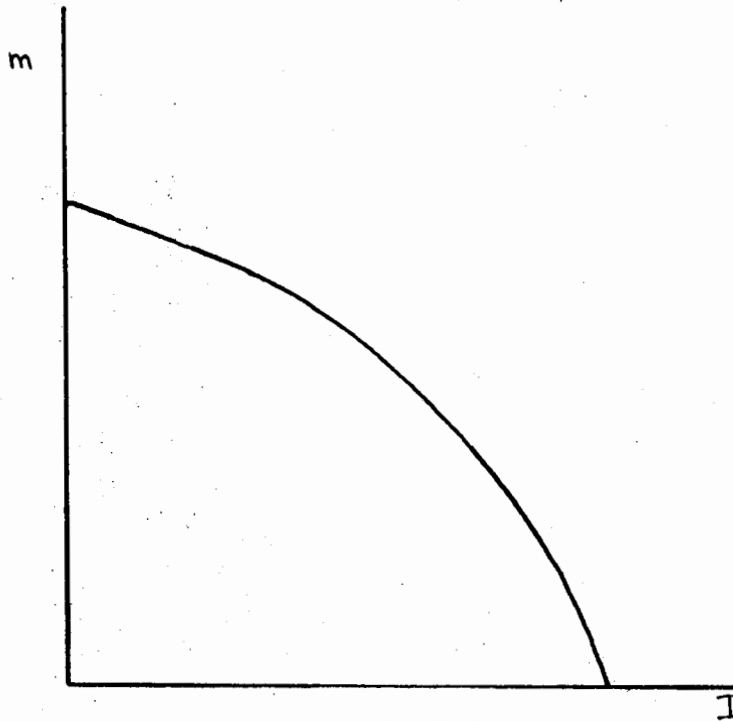


Fig. 4--Investment Schedule

Thus, an expansion of the scale of the investment coincides with less profitable projects being attempted.

This notion about the existence of a pool of entrepreneurs who differ as explained can be used to explain the slope of the demand curve for loanable funds in Figure 5 below. The entrepreneurs are likely to compare the expected profits retained with the opportunity cost of their time, and their aversion to bearing the uncertainty of a project failure. The lower p gets, the higher will be the expected profits retained on the average and the greater the number of borrowers in the market for loanable funds. Conversely, the higher p gets,

the lower the number of borrowers that will remain in the market. In the limit, if p equals 1, the demand for loanable funds can be expected to be zero. Graphing this information shows a demand curve looking as follows:

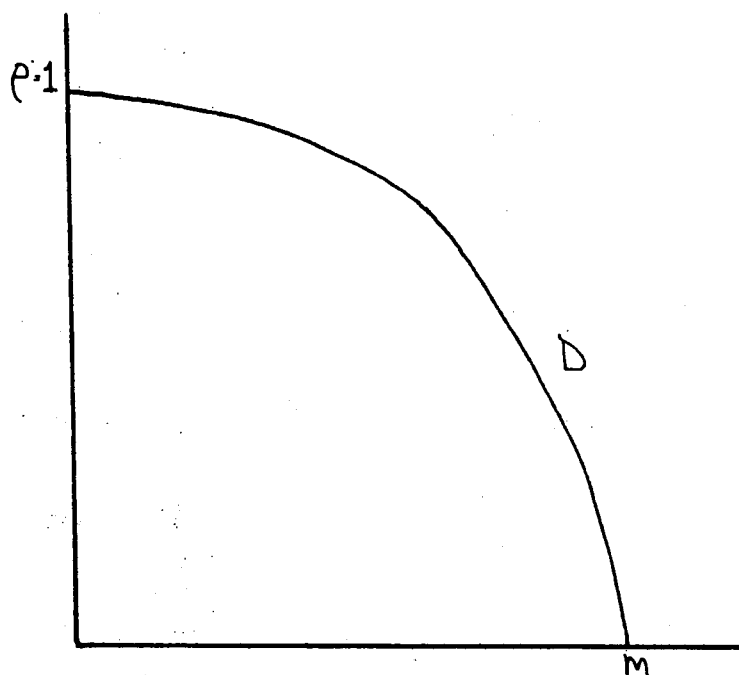


Fig. 5--Demand for Loanable Funds

M in the figure corresponds to the maximum level of investment.

VI. The Market for Loanable Funds.

Using the demand and supply curve for loanable funds, the equilibrium profit share of lenders and the level of investment financed by P.L.S. can be arrived at as shown in Figure 6 below.

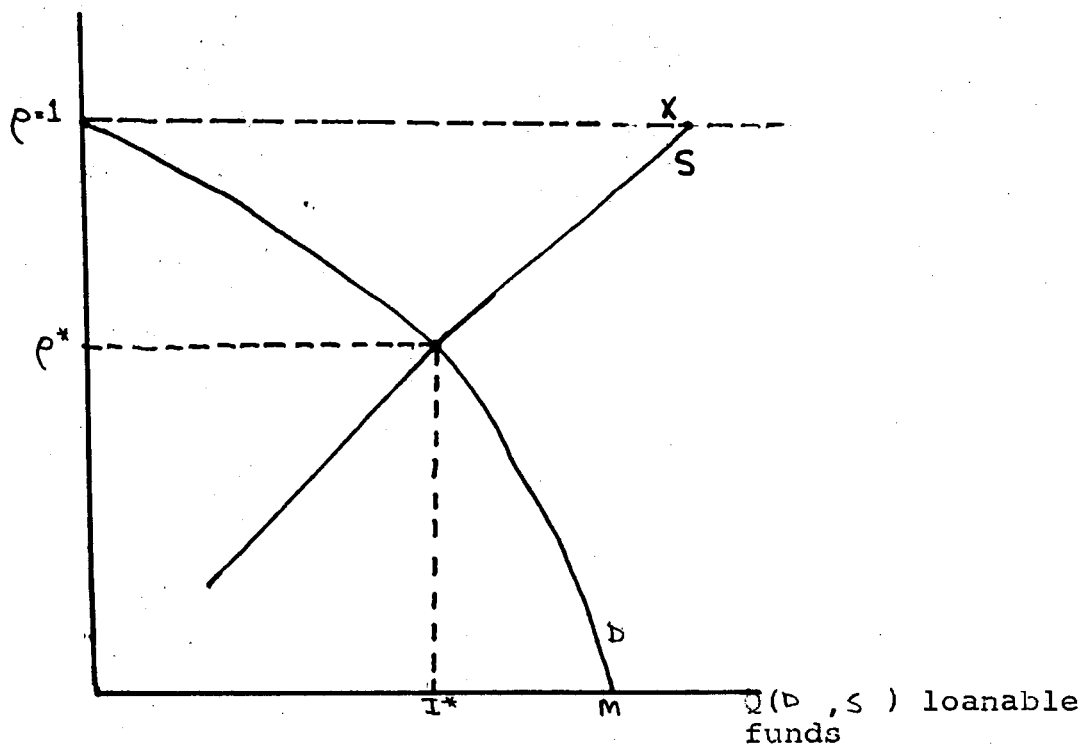


Fig. 6--Determination of Profit-Shares and the Level of Investment.

A few simple comparative static exercises are presented here to illustrate the functioning of this loanable fund market. Figure 7 below illustrates a shift in the supply curve to the right (from S_1 to S_2) due to an injection of foreign remittances. I am of course assuming that part of this inflow finds its way into P.L.S. accounts. As might be expected, an initial increase in funds in the market will reduce the returns forwarded to the P.L.S. accounts on new contracts. This short-run change in p (from p_0 to p_1) will encourage investment as reflected by the movement along the demand curve below.

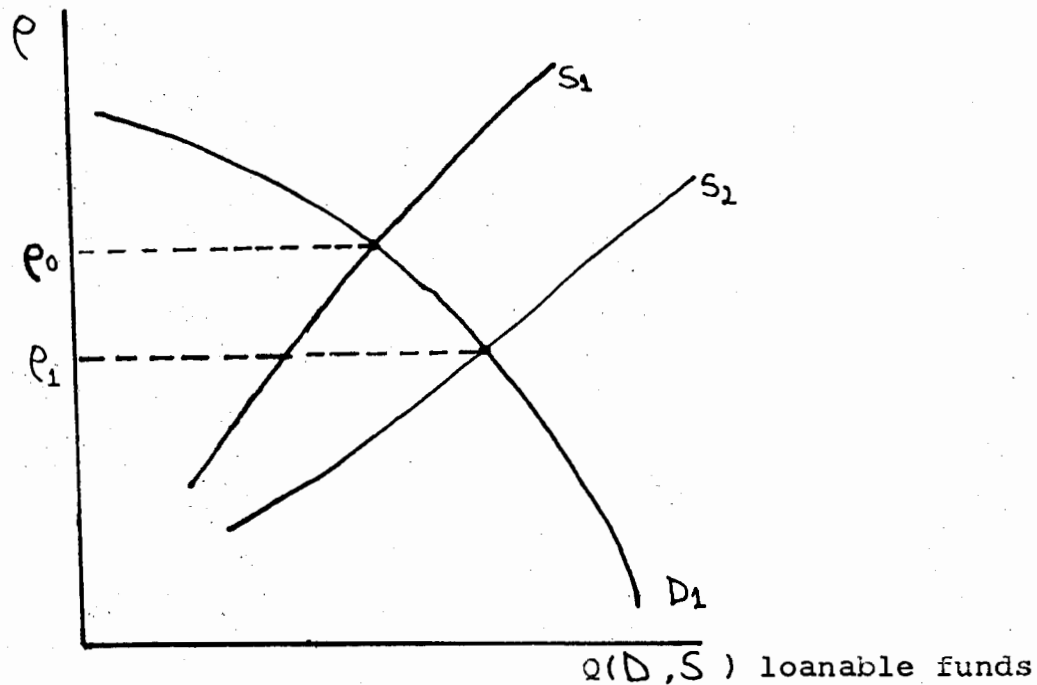


Fig. 7--Comparative Statics: Capital Inflow.

This is essentially a short-run model, though it is possible to ascertain some of the long-run forces that would be activated due to this initial change. The increase in investment would be associated with a decline in average profitability of investment even though the total **operating** surplus will rise. In the long run, to the extent that expected profits are based on past recorded profits, the demand for loanable funds may decline. This would be even truer if the rise in investment is associated with an increase in the cost of capital goods, since that would further reduce recorded profits. Conversely, the whole investment schedule itself may shift out if the increase in income accompanying the increased investment sets into motion the accelerator--

assuming that the structure of the economy allows one to become operative.¹¹

Another example can be devised, this time related to the shifting of the demand curve to the right (from D_1 to D_2), in Figure 8 below. This could result from changed expectations of the entrepreneurs due to technological innovations or to the transfer of technology, which would shift the investment schedule outward.

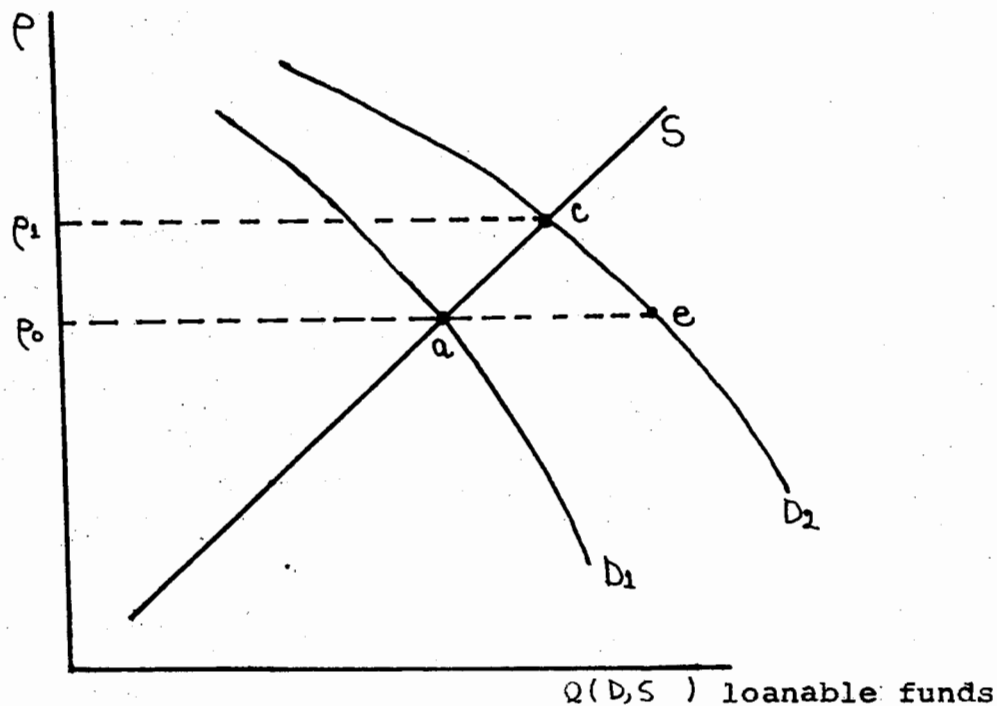


Fig. 8--Comparative Statics: Technological Change.

In the short run, as P changes (from P_0 to P_1), the movement up along the supply curve suggests that enough resources are released from idle balances in the checking accounts or hoarding to accommodate the increased demand. The increase in P also leads to a partial check on investment. Thus, the increased demand for loanable funds

can be read off the new equilibrium point c rather than point e , which would have resulted if p had not changed.

The analysis above shows that a competitive market for loanable funds can be theoretically relied upon to determine the equilibrium percentage profit-shares. This conclusion contrasts starkly with the analysis of those Islamic economists who recommend a legislated profit share as an instrument of monetary policy.¹² Another misconception says that abolishing interest will enable all potentially profitable projects (no matter how low the profit) to be financed.¹³ Given that the supply of loanable funds for P.L.S. is not infinite, but rather varies positively with p , the above clearly cannot be the case.

Monetary policy in a P.L.S. banking system will be discussed in section eight. Before that, I will consider some extensions of the basic P.L.S. model and, after that, some economic implications associated with this model.

VII. Some Extensions of the P.L.S. Model.

The extensions considered here are those that would follow from relaxing some of the assumptions of the model. So far, the muḥāraba contract, in which the lenders provide all the funds, has been analysed. Let us now allow for the possibility of the entrepreneurs' providing some of their own funds from retained earnings, as is the case in the mushārīka contract.

The working of the model remains essentially unchanged. The total funds forwarded for investment, k , now include the entrepreneurs' contribution.

$$k = k_e + k_l$$

(where e and l represent the entrepreneur and the lender).

It is assumed that there is no source of funds provided on a basis other than P.L.S. ρ is still determined in the market for loanable funds and can now be interpreted to be the return on funds--utilized by entrepreneurs--for the bearing of uncertainty. $(1-\rho)$ continues to be the return for the entrepreneurial role of innovation and control. The return to capital provided from either source must be the same and so

$$\frac{\rho\pi}{k} = \frac{\rho\pi_e}{k_e} = \frac{\rho\pi_l}{k_l}.$$

Let $\rho\pi$ be the share of the operating surplus, due on capital, from one project financed on a mushārika contract. The return due to the lenders would be $\rho\pi_l$ ($\pi_l = \frac{\pi k_l}{k}$), whereas that due on the capital provided by the entrepreneur would be $\rho\pi_e$ ($\pi_e = \frac{\pi k_e}{k}$).

Extending the model to allow banks to be active parties to the P.L.S. contract such that they are no longer pure intermediaries may change the model significantly. Two cases can be considered here, those of a competitive and a non-competitive banking sector.

When the banking sector is competitive, then the return to the bank for management will tend to equal the bank's administrative fee under P.L.S., and the profit rate on funds provided by owners of a bank's stock will tend to equal that on funds deposited in a bank's P.L.S. account. Thus, there is nothing significantly different in this case. The fee for the bank and the return to its share-holders will be drawn from the difference in profit-shares the bank gets from entrepreneurs on funds loaned and that it offers to depositors of funds deposited in the bank.

When the banking sector is highly concentrated, banks are in a position to set profit-shares and thereby sever the direct link between the money and real sector. To explain this, some additional terminology has to be introduced and some issues reinterpreted.

Let $\rho\pi$ now be the bank's share of operating surplus since the bank is now effectively the lender. Part of this surplus has to be forwarded by banks to depositors in its P.L.S. accounts. Let ϕ be the share of operating surplus forwarded on P.L.S. accounts so that

$\phi\rho\pi$ =lenders' share of operating surplus;
 $(1-\phi)\rho\pi$ =share of operating surplus retained
 by the banks.

The two quadrant diagram below illustrates the determination of profit-shares to the lenders, banks, and entrepreneurs.

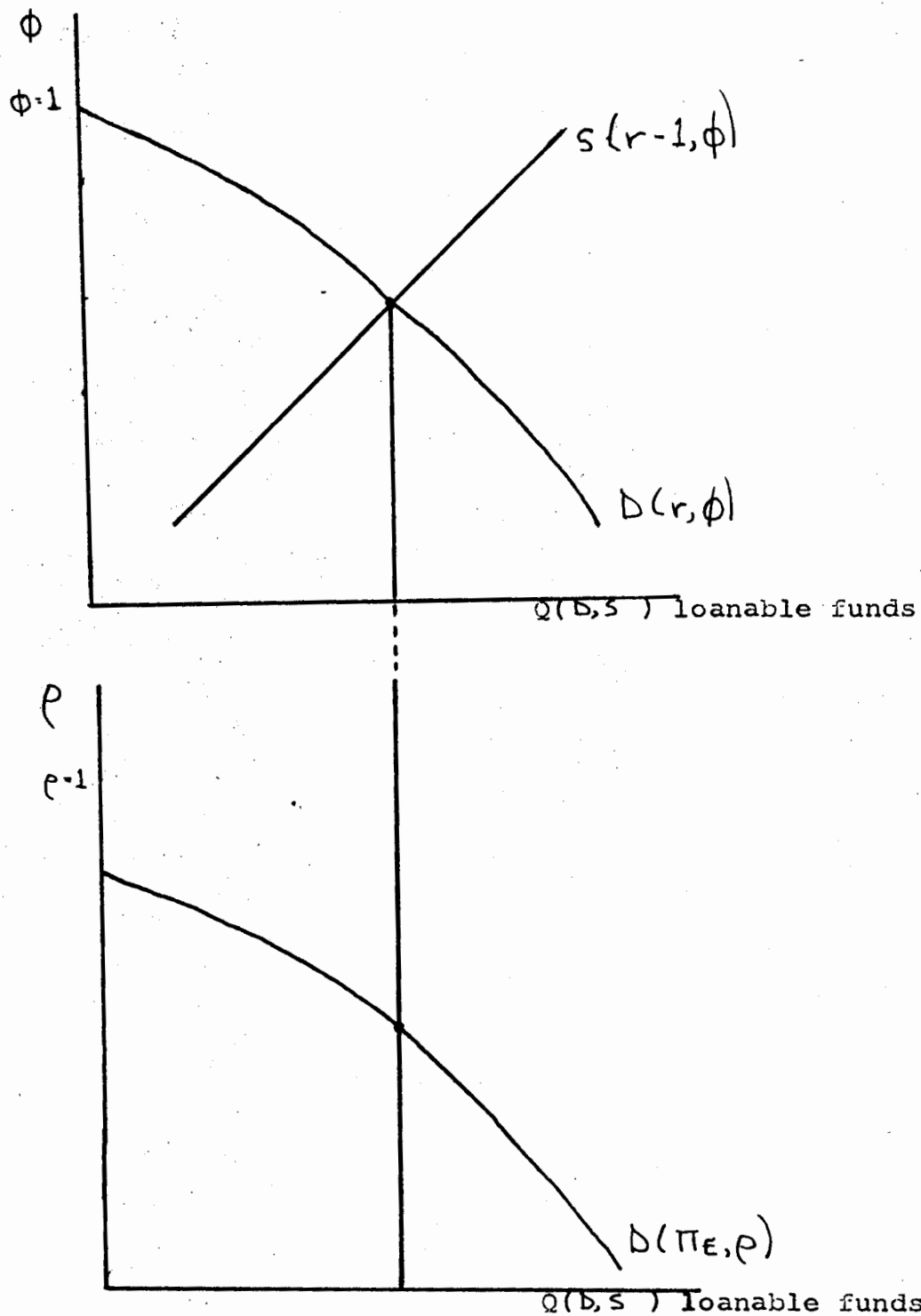


Fig. 9--Determination of Profit-Shares with Banks Not Being "Pure-Intermediaries."

The upper quadrant shows the determination of the

equilibrium of profit-shares between the bank and its depositors and also the level of loanable funds the bank possesses to forward to entrepreneurs at the equilibrium level of profit-shares. This is shown to be carried down to the lower quadrant in the form of a fixed supply, which interacts with the entrepreneurs' demand for loanable funds to determine profit-shares between entrepreneurs and the banks. The banks' demand for loanable funds in the upper quadrant is based on the actual average profit rate being registered at the banks at some given time so that the vertical supply curve would shift with a change in this profit rate.

Now, given that a bank faces a downward sloping entrepreneurs' demand curve for loanable funds, it can manipulate its supply to maximise its own share of operating surplus drawn from the entrepreneurs. It is no longer clear that a shift outward in the supply of loanable funds--say due to more funds being brought into circulation as a consequence of dis-hoarding (in the upper quadrant)--will mean an increased supply of funds to entrepreneurs at a lower ρ (in the lower quadrant).

This can be seen by analysing the condition under which it will not be in the banks' interest to increase the supply of funds. We can term the banks' net share of operating surplus π_B , so that

$$\pi_B = \rho\pi - C(K)$$

(where $C(K)$ is the variable cost of supplying funds).

The condition we are looking for is one that makes

$$\frac{d\pi_B}{dK} < 0 \quad . \quad \text{Now}$$

$$\frac{d\pi_B}{dK} = \underbrace{\rho \frac{d\pi}{dK}}_{(+)} + \underbrace{\pi \frac{dp}{dK}}_{(-)} - \underbrace{\frac{dc}{dK}}_{(+)} .$$

The first term (on the right of the equality sign) shows that the total operating surplus will increase as more funds are utilized by entrepreneurs at a given rate of profit-sharing. The second term shows that the profit-share of banks, ρ , will decrease as more funds are supplied. So $\frac{d\pi_B}{dK}$ will be < 0 ,

$$\text{if } \pi \frac{dp}{dK} + \frac{dc}{dK} > \rho \frac{d\pi}{dK} .$$

As one might expect, this says that the banks will not offer more funds if the fall in their share of operating surplus due to a fall in their profit-share plus the marginal cost of supplying these loans exceeds the increase in operating surplus accruing to them due to the increased funds forwarded to entrepreneurs.

VIII. Monetary Policy. ✓

The discretionary power of monetary authorities in an Islamic system is considerably restricted. In Chapter Two, I explained why the usual open market operation was not an acceptable tool of monetary management from an Islamic perspective. Altering a discount rate is obviously an option not even available. Finally, since banks here are pure intermediaries, there is 100%

reserve banking and consequently no scope for altering reserve rates to affect the money supply.

In the absence of these discretionary tools, some alternative criteria would have to be evolved to form the basis of the variation in the money supply. In other circumstances, various criteria have been suggested, such as a steady growth in the supply of money "to correspond with a roughly stable long-run level of final product prices."¹⁴ The following is an analysis of the mechanism of discretionary monetary policy under P.L.S. if its use is deemed necessary.

Two alternative options are presented here for altering the supply of money without using any of the conventional tools of monetary policy mentioned above.

First, to finance public sector projects that can yield a profit, P.L.S. shares can be issued which are transferable on the conditions described in Chapter Two.

Then, through the Central Bank, these and other such private sector shares can be bought and sold very much as in open-market operations. The difference here is not in the procedure of altering money but in the nature of the financial instruments that are bought and sold.

Second, even though fractional reserve banking as practiced by conventional commercial banks is considered prohibited by several Islamic economists, a variation on it may still be acceptable. As long as the banking system is nationalized, the profit-share drawn from loans that are

based on the creation of credit by the banking system is not privately appropriated but rather accrues to the whole community. Therefore, it may be acceptable for the central bank to permit reserve banking by its subsidiary (pure intermediary) branch banks. The need for this may arise, for example, if there is an increase registered by branch banks in the demand for loanable funds. By undertaking fractional reserve banking, the system as a whole creates credit. Since investment accounts by definition commit funds to projects (i.e., zero reserves), the process implicitly involved will be that of using checking and saving account deposits on a fractional reserve basis to provide credit beyond investment deposits. The issue is then what to do with the profit shares that accrue to banks on this credit? One option would be to bring back to par the checking and saving accounts (i.e., to 100% reserve), and forward the remainder to a "monetary reserve fund." This kind of periodic use of fractional reserve banking would provide the nationalised banking sector more flexibility to meet liquidity needs of the economy.

The fund mentioned above could be used as a means of financing public sector infrastructure projects which do not lend themselves to financing on a P.L.S. basis and where fiscal revenues are not adequate. Using the fund for state financing of its projects may be found objectionable for two reasons. It could lead to financial irresponsibility; and, Islamic economic purists may object that

the state intervention in the market for loanable funds will alter profit-shares, and only the shares determined by the market are fair. The state could counter this stand from the perspective of Islamic Law if it can establish that the intervention and the subsequent use of the monetary reserve fund was in the public interest. (See the discussion in Chapter One, p. 51.)

IX. Some Economic Implications of P.L.S.

One concern that has been expressed about doing away with interest is that efficient financial decisions will no longer be possible since the mechanism for allocating scarce available funds will have been dispensed with. In the absence of interest, critics query, what will reflect the opportunity cost of loanable funds?

In a perfect (conventional) capital market for loanable funds, the scarcity value of these funds is reflected by the (average) marginal return foregone on either bank deposits or from the purchase of financial assets. The analysis in this chapter has shown that despite the change in institutions and financial instruments on the financial market, the same forces of supply and demand for loanable funds will still generate a market exchange signal.¹⁵

Thus r , the profit rate on funds forwarded for P.L.S., will reflect the scarcity value of funds. This could be utilized, for example, in discounting the cash flow of projects over time to arrive at present values in social benefit-cost analysis. Just as there is in practice a whole structure of interest rates varying by riskiness and term, there is likely to be a corresponding structure for r 's; r will

be an average in the same sense as the wage, interest, or price in a macro-model. So any change in r theoretically arrived at using the model should reflect the direction of relative movement in the whole structure of r 's .

I offer here comments of a tentative and speculative nature on several other issues, related to P.L.S., that are of importance. More definite statements must await the actual implementation of a full-scale system based on P.L.S. Two of these issues are the size and the composition of total investment. The impact of P.L.S. on the supply side was explored earlier in this chapter. Here, the demand side is considered.

It is certainly true that interest will no longer figure as a cost of production. In its stead, P.L.S. will mean the sharing of the operating surplus if there is any. A given firm may be tempted to expand its operations if eliminating fixed interest charges is interpreted as a shift down in the marginal cost curve, given competitive conditions. New firms will also be attracted into an industry if the lower marginal cost, given the market price, enables them to cover costs. Having to share profit will not affect a firm's price-output decision if the profit-share is interpreted to be a profit-tax.

P.L.S. may also encourage entrepreneurs to undertake more risky projects that have a promise of a greater operating surplus. This is so because the threat of

liquidation will be lower where there is no obligation of a fixed sum for the use of funds. Paying out a share of profits will be a more disagreeable prospect in a situation where the entrepreneurs are fairly certain of the outcome of the venture. Thus, my guess is that P.L.S. may change the composition of investment to one that entails more risk.

There are still the questions of what kinds of projects will be preferred by banks that are pure intermediaries and whether the P.L.S. system is biased towards large firms. Banks that are pure intermediaries may be more susceptible to influence and patronage. Since large firms have more weight to throw about, there is clearly a danger of smaller firms being squeezed out. However, if corruption is not a serious problem, then there is no a priori reason to believe that larger firms will draw most of the funds. In an interest based system, where banks are assured a fixed rate of interest and no more, credit worthiness becomes of prime concern, and large firms may be more qualified in this regard. Under P.L.S., credit worthiness may have to be traded off with profitability, where size does not automatically mean a higher operating surplus. Thus, the more innovative and profitable smaller firms may have greater access to funds.

Finally, one may argue that a contract with fixed interest puts more cost pressure on firms to be efficient than under P.L.S., leading to survival of the more

efficient firms. P.L.S., on the other hand, may be considered more suited to helping firms survive conditions of economic instability; the consequences of a recession that affects individual firms would be lower profits, or losses, more widely shared, but there would be fewer liquidations and no closures due to losses and defaults. This might protect some efficient as well as some inefficient firms. In the long run, firms showing below average rates of profit on a sustained basis would find it difficult to survive even under P.L.S., given the existence of perfect competition.

A parallel can be drawn here between fixed rent and share cropping as alternative land tenure arrangements to approximate the fixed interest and P.L.S. cases in industry. In the fixed rent case, most of the risk is borne by the farmer, who is also responsible for making most of the decisions. As in the fixed interest case for the entrepreneur, the farmer has considerable pressure on him to be efficient, but he also stands to gain most from a successful season. In share cropping, the risk is shared by the farmer and landlord, who contract for some percentage division of output and contribution of inputs; they probably also share in the decision making. In the case of an unforeseen disaster or simply poor economic conditions, the farmer need forward less in absolute amounts to the landlord, and so he has more protection than in the fixed rent tenure. However, a successful

season would also imply having to forward a greater turn to the landlord. Therefore, less risk may mean potential return. How P.L.S. fits in as an alternative tenure arrangement is deferred to the next chapter, since explaining it requires a prior discussion of various legal issues related to property and tenure.

On an institutional level, it is probably true that considerable loss of flexibility would result from the elimination of private sector banking. This would follow from the bank's loss of its ability to create credit to respond spontaneously to the needs of borrowers. On the other hand, one could argue that by eliminating reserve banking and financial assets that are subject to capital gains and losses a much closer link is forged between the money and the real sector of the economy. This would come about because free reserves of businesses and individuals would not have the option of buying existing assets in the financial markets. Energy freed from speculative pressures could be utilized in constructive long run forecasting and to that extent encourage a more efficient allocation of resources.¹⁶

Monetary policy would become more efficient since a powerful banking sector would no longer be able to thwart it by its ability to accumulate excess reserves. The complete elimination of debt financing would contribute to stability insofar as high debt-asset ratios of borrowers add to the general fluctuations in economic

activity by precipitating financial crises. Also, since intermediaries will function solely as financiers of production and distribution, the likelihood of bank failure that results from unwise speculative financial practice occasionally indulged in by banks will no longer be there.

Strictly speaking, the above institutional advantages would follow from converting banks into pure intermediaries. P.L.S. could claim credit by allowing the former to function with some degree of efficiency normally attributed to free-market transactions. It should be noted that although P.L.S. (as described in this chapter) is to operate within the framework of nationalized banking, the allocation of financial resources is still to be established by the free interplay of market forces. P.L.S. does allow the policy makers to affect the allocation of resources in accordance with their development goals by specifying loan priorities to intermediary banks. The influence of the central bank may also of course become operative through its control of the money supply.

Conclusion.

The main object of this chapter was to illustrate the working of the market for loanable funds when P.L.S. is substituted for interest. My analysis shows that essentially the same market forces are operative, and profit-shares (based on expectations) instead of interest equilibrate the market for loanable funds. Risk assumes

a much more critical role in a financial market which allows P.L.S. as the only form of investment since the returns are variable.

Perhaps the greatest challenge to P.L.S. comes from the lack of an a priori guarantee that a comparable quantity of loanable funds will be available under P.L.S. as in an interest based system. It was shown in section four that lenders unconditionally will be less well off if risk free assets with positive return are eliminated from a system of P.L.S. banking. However, it was not possible to theoretically establish how the welfare of lenders would be affected if conventional interest based banking (without P.L.S.) is entirely replaced by P.L.S. with no risk free assets with a positive return. Whether or not there would be an adequate supply of funds is therefore an empirical question. It does appear, however, that viewing P.L.S. as a constraint on options available to lenders would adversely affect the supply of loanable funds. On the other hand, there is the possibility of tapping otherwise unavailable funds from devout Muslims.

Given an adequate supply of loanable funds, the level of investment may be higher under P.L.S. because the entrepreneur can pass off part of the uncertainty of production to the lenders and because there are no competing financial assets diverting funds from real investment. The ability to pass risk on to the lender may well encourage the composition of investment towards the

more risky. However, this ability may also reduce cost pressures for business efficiency which a fixed interest rate imposes. The absence of a fixed interest rate for loans, however, would lower the cost of production and encourage output, whereas the specification of a profit-share (which essentially acts as a profit-tax) will not affect the price output decision.

This chapter has a wide scope, but the gain in coverage may be a loss in depth. My analysis of risk is preliminary, and given the importance of the issue, more study is needed on how it affects both suppliers and demanders of loanable funds. Also, as a recommendation for further research, I would suggest the modeling of the market for loanable funds within a general equilibrium framework--in the context of a particular economy.

Finally, one should bear in mind that Islamic proponents of P.L.S. (or any other mechanism on which to base a ribā-free banking system) look for advantages primarily on the ethical and the related social level. From this perspective it is more important to establish the economic feasibility of a proposed mechanism to avoid ribā than it is to demonstrate economic optimality. The ethical and social gains from adhering more closely to the Islamic value system may be viewed as outweighing possible losses in economic efficiency.

Notes to Chapter Three

¹For a general coverage of interest-free banking including details about the operating principles see Muhammad N. Siddiqui, Banking Without Interest, 2nd ed. (Lahore: Islamic Publications, 1976). For a slightly different approach, see Muhammad Uzair, Interest-free Banking (Karachi: Royal Book Company, 1977).

²Some of the issues I cover are analysed in a recent unpublished paper by Muhammad N. Siddiqui, "Economics of Profit-Sharing," mimeo (Jeddah: King Abdulaziz University, 1981). Siddiqui analyses a market for loanable funds. He does not, however, attempt to derive or explain the demand and supply schedules. Also, there are some serious errors in the analysis, the most important one being an interdependence in the demand and supply schedules in the way the model is specified. I am, however, indebted to him for his general approach.

³See, for example, Frank H. Knight, Risk, Uncertainty and Profit (New York: Sentry Press, 1964), pp. 22-50, and J.P. Weston, "The Profit Concept and Theory: A restatement," J.P.E., 42, no. 2 (1954), pp. 152-170.

⁴Joseph Conrad, An Introduction to the Theory of Interest (Berkeley: University of California Press, 1959), pp. 43-44.

⁵For readings on economic, psychological and sociological theories on the supply of entrepreneurship, see Entrepreneurship and Economic Development, ed. Peter Kilby (New York: MacMillan, 1971). Kilby provides a useful survey of these theories in the same source in an article titled, "Hunting the Heffalump." Kilby's own speculations on the supply of entrepreneurship (pp. 35-40) seem to be more relevant in explaining cross cultural differences in managerial ability and not in explaining the presence of an "innovator" within a cultural context. Insofar as performance within a given cultural context is not uniform, Schumpeter's innovator is likely to be an important explanatory factor.

Kilby (p. 6) disputes the relevance of the innovator in a third world context, given the presence of "a backlog of unapplied production techniques" potentially available from a transfer of technology. Surely the Schumpeterian innovator's ingenuity was related to bringing about "new combinations" by drawing on inventions and not in being an inventor. In fact, the existence of the backlog in techniques and a relatively less developed

A.B.M. Chawdhuri, "A Mathematical Formulation of Mudāraba, the Profit-Sharing in Islam," in Association of Muslim Social Scientists Proceedings, Third National Seminar (Gary, Indiana: May 1974), pp. 19-28. For some doubts expressed about P.L.S., see Syed N.H. Naqvi, Ethics and Economics: An Islamic Synthesis (Leicester: The Islamic Foundation, 1981), pp. 135-137.

¹⁶J.M. Keynes, The General Theory of Employment, Interest and Money (New York: Harcourt, Brace and World, Inc., 1936), p. 154.

CHAPTER FOUR

THE EXTENSION OF P.L.S. TO AGRICULTURE AS A TENURE ARRANGEMENT

I: Islamic Concepts of Land Ownership and Tenure

This section examines the related issues of land ownership and land tenure in Islamic economics, which are again subject to considerable controversy. The main issue dealt with in this section, after a cursory discussion of private property in Islam, is the legitimacy of the various tenure arrangements from an Islamic perspective. The controversy surrounding share-cropping and the renting of land is examined. Both of these tenure arrangements are also viewed in the context of the concept of ribā that was explained in Chapter One and has been adopted for this dissertation. Finally, as an alternative tenure arrangement, I present P.L.S., which, along with owner cultivation, does not involve ribā.

a.) Ownership. One view regarding ownership is that the concept was introduced into Arabian socio-economic organisation by Islam. Prior to Islam, the man-land relationship was predominantly characterized by himā (common land), which was displaced by iqṭā (private

estates) with the rise of Islam. Also, the Prophet himself made a practice of making land grants, thereby legitimizing individual ownership.¹

The contrary view that has been asserted is that the lands distributed by the Prophet were mainly barren and the purpose of their distribution was to encourage production. This particular position is not, however, undisputed.² A more extreme view with regard to ownership is that state grants of land were made in exchange for rent and conferred no ownership rights; it was after the records of these grants were accidentally burned that lands conquered by the Muslims were appropriated into individual ownership.³

Evidence of collective ownership during the time of the Prophet and especially during the time of the first two caliphs is now regarded as one point favoring the view that Islam endorses state ownership of land.⁴ Another argument used in support of this contention is based on the sayings and actions of the Prophet that precluded grass, water, fire, or salt from private ownership. It is argued by analogy that public ownership should extend to all resources, including land.⁵ State ownership of land has also been inferred from certain verses of the Qur'ān.⁶ This position, however, is representative of a minority of contemporary scholars, and controversy among the rest is not on the issue of private versus state ownership but on the kind of private land tenure system Islam has

validated.

b.) Land-Tenure Systems. The critical question is whether the return to absentee land owners implied by sharecropping or the leasing of land for a specified rent is acceptable or not. The controversy results from the interpretation of historical events involving the Prophet, the significance attached to the practice of the Prophet's companions, and from the apparent inconsistency in the sayings of the Prophet. The inconsistencies seem to stem from the recorded sayings of the Prophet that both allow and disallow sharecropping and the renting of land.

1.) Sharecropping. Haque (1977, p. 98) sets out to show in his detailed study (emcompassing the origin and the development of the legal theory of land tenure) that the hadīths (sayings of the Prophet) in support of sharecropping do not stand the test of historical criticism. He indicates that three of the four most prominent Sunnī jurists (Abū Ḥanīfa, Mālik, and Al-Shāf'ī) regard sharecropping as having been forbidden. The fourth, Ibn-Ḥanbal, accepted sharecropping as did other famous jurists, such as Abū Yūsuf (d. 798-799) and Shaybānī (d. 804-805). An important element in Haque's work is his endeavor to show that changes in legal theory concerning land tenure occurred to accomodate the changing socio-economic conditions, which partly resulted from the interaction of Islamic ideology with the existing

institutions in the conquered lands (p. 52).

Much of the current (and even early) controversy about sharecropping originates from the interpretation of a contract between the Prophet and the Jews concerning the Khayber lands, which had been conquered by the Muslims. The Jews had been permitted to continue cultivating the lands for fifty percent of the crop for an unspecified time period. This contract has been viewed as an endorsement of sharecropping.⁷ Several reasons are forwarded in the literature to refute this stand. One argument indicates that the contract was not between two individuals freely engaging in a commercial association, but rather a political act dictated by the political economic realities of the time.⁸ In fact, the contract was interpreted by Abū Ḥanīfa to be a form of tribute.⁹ That the contract was not between two Muslim parties is further held to invalidate its significance for legal analogy.¹⁰ Another argument made to the same effect is that the Prophet was averse to letting land lie uncultivated and that he had to rely on the Jews because the Muslims at that time did not have the requisite man-power and skills.¹¹

Orthodox writers also find support for their justification of sharecropping in the adoption of this tenure arrangement by the companions of the Prophet and in the Prophet's acceding to a sharecropping contract between the immigrants from Mecca and their benefactors in

Medina.¹² An opposing view is that the above facts do not legitimize sharecropping and that they can be explained by the special circumstances during the very trying early period of Islam.¹³ The companions' continued use of sharecropping has been explained by drawing a distinction between the earlier and later periods of Mohammed's tenure as a Prophet/statesman. Sharecropping is theorized as having been banned in the later period, but it continued to be practiced since word did not reach many companions, who were by then geographically widely dispersed. This is one writer's explanation for the celebrated self-dispossession of land by a rich and famous companion, 'Abdullah-ibn-^cUmar.¹⁴ Finally, a more technical issue raised is that the contract alluded to above--and also the Khayber contract--involved the sharing of output on existing orchards, which is not the same as sharecropping on farming land.¹⁵ This argument will be discussed more fully later.

At this point, it is useful to examine sharecropping in the context of the concept of ribā that was introduced in Chapter One and is briefly recalled here. Ribā is said to be taken or given in contracts that entail the drawing of value without a compensating legally acceptable return or countervalue. Ribā is literally the "increase" or faḍl that is implicit in such contracts. Some of the categories of contracts that could lead to an unjustified increase and hence to ribā were as follows: 1.) contracts

that lead to the specification of a fixed pre-determined return to one party irrespective of the outcome of a venture that is the subject of the contract; 2.) those that specified a flow of income to one party solely on the basis of either ownership or economic power; 3.) those that entailed a measure of uncertainty or ambiguity in the way they were framed. In addition, Haque (1980, p. 22) cites some evidence to indicate that jurists also forbade contracts based on output-sharing where the livelihood of the operator and hence that of the family may be threatened.

Share-cropping can lead to ribā because mere ownership and not effort on the part of the landowner is guaranteeing a return. One may well assert, however, that the land was acquired by income which was itself a return for effort. Even if this is true, as is likely to be the case, it still does not justify a return merely due to ownership. Income from past effort invested in the acquisition of land procures the privilege for the owner of further investing on the land or cultivating it himself. This is the reward for past effort. Thus, the owner is provided with an income earning opportunity in return for his past effort, but not a guaranteed stream of future income.

The nature of uncertainty implicit in the sharecropping contract can once again lead to ribā being involved in it. For example, while shares are specified, the absolute return to the two parties remains indeterminate. This indeterminacy can result in ribā because in sharecropping the gross returns are shared. Thus even if the sale of gross output is unable to meet costs, the cultivator still has to share it with the owner. Ribā results in this case from the fact that the value drawn by the owner in his share of output may well be positive when there is actually no net output.

The point can be better illustrated by considering why P.L.S. does not lead to ribā. On first appearances, it would seem to because even when profit-shares are agreed upon, the absolute returns to the two parties to a contract are once again indeterminate. However, in P.L.S. the net returns (if any) rather than gross returns are shared. Thus, only if there is a profit does the landowner's contribution in funds

Prophet's statement permitting renting for cash was a reference to land that was irrigated. The principle deduced from this was that rent was allowed the owner who had invested in the land in some form.¹⁶ However, the very authenticity of the sayings that permit renting has been questioned.¹⁷ Moreover, the hadīths forbidding renting are held to be definite and in the Prophet's own words, whereas the contrary ones are in most cases the appended opinions of the narrators of the hadīths.¹⁸

Renting of land as a form of tenure found greater acceptance among the great Islamic jurists. According to Haque (1977, pp. 316-333), all four of the major Sunni jurists accepted the leasing of land for a fixed sum of money since it avoided the aleatory element in the sharecropping contract. He does recount that another famous jurist, Ibn Qazm (d. 1063-1064) took issue with this view and equated rent with interest since it is a fixed predetermined sum earmarked for the owner irrespective of the outcome of the cultivation (p. 80). The same view of equating rent with a ribā contract continues to be expressed in current Islamic writings on the subject.¹⁹

In the context of the concept of ribā delineated above, renting of land amounts to ribā on the first two counts. First, it is a return based solely on ownership and not any productive contribution. Second, even if the owner specified a rent after having

improved the land, say by infrastructure development, the contract would still entail ribā since it prespecifies a fixed return. This follows once again from the possibility of the cultivator being unable, for various reasons--other than negligence--to show a profit on the land. The value then accruing to the landlord is not based on any countervalue contribution since in reality there was a loss. Hence a contract that prespecifies a fixed rent is considered a ribā contract much as the fixed interest case in banking.

Sharecropping and renting have been considered unacceptable from an Islamic viewpoint by some scholars. There is, however, consensus on the legitimacy of owner cultivation.

3.) Owner Cultivation. A number of different arguments have been forwarded to show that the spirit of the Law is in favor of owner cultivation. A verse of the Qur'ān, to the effect that the individual only has a right to that which he strives for, has been interpreted to imply owner cultivation.²⁰ Support for this view has been drawn also from a saying of the Prophet that exhorted people to cultivate their own lands, lend it free to their brothers, or leave it fallow.²¹ The last section of the above saying has also been

translated as "be dispossessed of the land," rather than "leave it fallow."²² The former interpretation is certainly more consistent with the Prophet's concern, earlier mentioned, of not leaving land uncultivated. It also ties in with 'Umar ibn al-Khatah's (the second caliph) dispossession of land granted to Bilal ibn-Aziz (a prominent companion) because he was not utilizing it. This precedent constitutes an additional reason on which the case for owner cultivation rests.²³ Finally, a hadīth that attributes ownership of "dead land" to those who cultivate it is used as yet another argument for owner cultivation.²⁴

Despite these reasons, Haque asserts that there is not enough evidence to infer the conscious promotion in Islam of owner cultivation (p. 32). He surmises, instead, that the sayings of the Prophet referred to merely reflect the "cohesive unity" of the pristine Muslim community. Haque seems to be referring to the promotion of owner cultivation as the sole tenure arrangement. Given that sharecropping and renting of land have been found wanting, the question is whether an alternative tenure arrangement can be developed that allows the owner to lease the use of the land without thereby engaging in ribā.

c.) Profit and Loss Sharing. So far, I have shown that each of the conventional tenure arrangements is subject to controversy in past and contemporary Islamic

writings. Here, I suggest an alternative policy that appears consistent with many Islamic views. This alternative tenure arrangement is based on principles deduced for tenure policy by several authors, some of whom suggest a land tenure arrangement that closely resembles P.L.S.²⁵ Since the aim is to be consistent with the Islamic political economic principles mentioned in Chapter One, it should come as no surprise that this alternative tenure arrangement is essentially a counterpart to the contracts between lenders and borrowers in the non-agricultural sector. The recommendation of P.L.S. as a tenure arrangement is closely tied to a particular view of ownership (particularly that of natural resources) in Islam.²⁶

First, there is the view in Islam of property as essentially a right to utilize wealth.²⁷ To this can be added the principle that sets a limit (three years) on how long an owner can leave land uncultivated before being dispossessed of it.²⁸ Second, the return from the power of the soil is God's gift to the whole community--as are other natural resources--and not meant to be appropriated by the landowner exclusively. Third, the owner is entitled to a return from land only if he invests in it and to the extent that he invests in it.²⁹ Thus, these principles jointly are consistent with and reinforce the application of P.L.S. as an alternative tenure arrangement. The attempt to justify tenure

policies by the analogy of mudāraba (P.L.S.) has considerable legal precedence.

Malik and Shāfi'ī accept the application of sharecropping to orchards by viewing it as a P.L.S. contract. Trees that have been nurtured by the efforts of the owners are viewed as their capital. To them can be applied the time and effort of the operator to irrigate, pollinate, maintain and harvest. The remuneration of the two parties in this case is thus deemed to be legally based on P.L.S. principles.³⁰ Other jurists such as Abū Yūsuf, Shaybānī, and Ibn Ḥanbal apply the analogy of P.L.S. to sharecropping in general, viewing land as the capital of the owner.³¹

The latter argument does seem difficult to accept, particularly if one accepts the view that the fertility of the land is a gift for the whole community. Furthermore, while capital is actually being risked by the owner in P.L.S., land essentially remains in existence even if there is a crop failure. Finally, P.L.S. entails the distribution of the operating surplus, whereas in sharecropping the gross returns are distributed.

Using P.L.S. as an alternative tenure arrangement--in conjunction with the qualifications on ownership mentioned above--would result in a significant change in the bundle of rights that are vested in the individual ownership of land and in the nature of contracts, involving land, that can be legally entertained. The land owner would have the

privilege of investing in the land or else being an owner-operator. If both of these options were forsaken, the owner would not be entitled to any return from the land and would in fact forfeit--with compensation--the ownership privileges, if the land were not utilized beyond a certain specified time period. If a P.L.S. contract were undertaken, the owner would be entitled to an agreed upon share of the operating surplus. The remainder would accrue partly to the operator and partly to the community by the levying of a tax that appropriates the return to the land.

Such a contract would certainly avoid both a predetermined return to the owner without compensating socially productive effort, and also uncertainty in the framing of the contract, which would involve ribā. However, to distinguish in practice the shares of the various parties--owner, operator, and the community--and hence to make the contract operational is extremely complex. Some comments on this very tricky problem are offered in the next section. The discussion follows essentially the same approach to analysing the P.L.S. contract as was utilized in Chapter Three.

II: Analysis of P.L.S. as an Alternative Tenure Arrangement. This section analyzes the mechanics of applying the P.L.S. contract to the agricultural sector and the determination of the share of the operating surplus from land

that accrues to the state, the operator, and the landowner. The presence of land, as an additional factor, considerably complicates the already complex issue of determining the share of various agents contributing to production.

One way of approaching this issue is to identify and sequentially analyze the causes of differential operating surpluses per acre of agricultural land. By far the easier element in this process is the identification of the causes. This will be done first. The sequential analysis will follow.

The obvious natural phenomenon contributing to these differential surpluses is the variety in the fertility of the soil, which will affect output per acre. Location can also affect the operating surplus. For example, there may be a significant reduction in transportation costs by having easier access to roads and market towns. There are several other causes that can lead to a differential in operating surpluses. First, it could result from the differences in the quality and the quantity of human skill employed on the land. Second, it could result from the differences in the extent of capital investment on the land. Capital investment is categorized into structural and non-structural in this analysis. Non-structural investment would include what normally is referred to as working and fixed capital, such as seeds, fertilizers, tractors, and tubewells. Structural investment is one whereby the future value of the land itself

is significantly altered. This could result, for example, from the following: the reclamation of the soil, the clearing and leveling of it, building irrigation or drainage channels.

To distinguish the contribution of these various elements, I start with a model using many simplifying assumptions. These are sequentially relaxed in the subsequent stages of the analysis.

To begin with, the P.L.S. model is reintroduced and illustrated using the simplifying assumptions of homogeneous soil with no locational differences, homogeneous labor, and the complete absence of long-term structural investment. Next, the assumption about the homogeneity of the soil and of the locational factors is relaxed to bring the issue of differential rent and land taxation into focus. Differences in the quality of human skill employed on the land will then be allowed for, to see if that significantly affects the analysis. The analysis is then extended to include differences in structural investment on the soil.

a.) The P.L.S. Contract with Homogeneous Land and Labor and with No Structural Investment. The basic P.L.S. model of Chapter Three is re-introduced to refresh the reader's memory and to clarify the different elements in it. The principle actors in it are now the farmers and landowners. The farmers in this case are viewed to be entrepreneurs and will hereafter be referred to as

operators. They will in all likelihood work on the farm themselves, although they will also perform the overseeing function and make the entrepreneurial decisions. The pool--in the existing institutional setting--from which they may be drawn includes tenants, owner cultivators, and landless laborers.

Landowners are viewed as investors. They are constrained by the qualifications on ownership mentioned in section one to invest something to retain the privilege of ownership. Beyond that, the extent of their investment is likely to be based on alternative opportunities to invest and their taste for investment as opposed to consumption. The implications of the various qualifications on ownership need clarification in the context of this model.

Ownership rights include the "first right" of investing on one's land. This first right need not preclude others from investing on the same land in conjunction with the owners, although the latter may preempt other investors by advancing all the funds needed by the operators. To allow for non-owner investment on the land, the broader term "investor" will be used in the model. Owners also have the right to choose among competing operators and in addition, they may choose the option of becoming owner-operators themselves.

In principle, the modelling of profit-shares between investors and operators would be the same as that

described in Chapter Three.

Let π = operating surplus or profit per acre.

$r_A \pi$ = profit-share of investors per acre in return for the investment of their capital.

$(1 - r_A) \pi$ = profit-share of operators per acre.
 (A is a reference to the agricultural sector and is later to be distinguished from M, which is a reference in this chapter to the nonagricultural--or manufacturing-sector.)

The calculation of a profit rate is implicit; it is not needed for the working of the model here, which is based on the distribution of absolute sums. For example, if K is the total invested funds, then the profit rate is

$$r_A = \frac{r_A \pi}{K}$$

If there are losses in a given time period (for example due to a natural calamity), the investor loses all or part of his capital (i.e. K is eroded), whereas the operator loses his expended time and effort.

K can be thought of as the monetary value of the investment in an accounting period coming from all sources. This approach implicitly assumes that the marginal and average investment on the land are equally risky and therefore does not distinguish between the qualitatively different kinds of investment that may be occurring on the land. This can be a problem where there is more than one investor (or the operator contributes to the investment himself) and the investment process is

lumpy. However, if the investment priorities are jointly arrived at and there is joint contribution of funds in any investment, this omission is not serious.

Assumptions for this simple model include perfectly competitive and smoothly functioning markets, homogeneous factors of production, and multi-factor production functions, including land, fixed and variable capital, operators, and hired labor as inputs.

All of the symbols above, stated on a per acre basis, are applicable to farms of a given size. Differences in farm size are allowed for at the onset of the analysis. The reason for this is that production functions may vary across farm size.³² Identical production functions, however, are assumed for farms of the same size. Two points related to farm size need further consideration.

First, the use of any factor per acre across farms of the same size should be equalized. For example, a difference in operating surplus due to a difference in capital per acre may take the form of quasi-rents, which by definition would not persist in the long run, i.e. the capital per acre across farms of the same size would be brought into equality due to diminishing marginal product. From each farm, the rate of return to the i th investor on the farm (given that there is more than one investor) will be $r_i \pi \frac{k_i}{K}$, where $\frac{k_i}{K}$ represents the capital advanced by the i th investor as a proportion of

total investment.

Second, even where land is homogeneous and there is no structural investment on it, operating surpluses may vary in the agricultural sector across farm size. Who captures this operating surplus and how are some of the important questions this raises. Before answering these other questions, I illustrate the simple model for the determination of profit-shares for a given farm size.

The demand and supply curve for funds would slope in the same way and for similar reasons as in the P.L.S. model for the manufacturing sector. The demand curve may be represented by

$$D_A = f(P_A, \pi_E),$$

where π_E is the expected operating surplus. The latter will be based on expectations regarding factors like flood conditions, the prevalence of pests in the area, government policy, resource availability, market demand conditions, and the technology in use on a farm of a given size. D_A will also be affected by technological change. The fixity of land will clearly have a bearing on the technology utilized. In fact, this rigidity can be thought of as a constraint on the position of the demand curve. In the demand curve shown below, as P_A falls (i.e. lower share of profit to landlords), more people may opt for becoming operators. In the

limit, it could draw back workers, or the unemployed in the cities who have farming experience. The slope of the curve is hence explained by differences in talents and local information and therefore in opportunity costs. As p_A falls, more people will find operating a farm a feasible proposition.

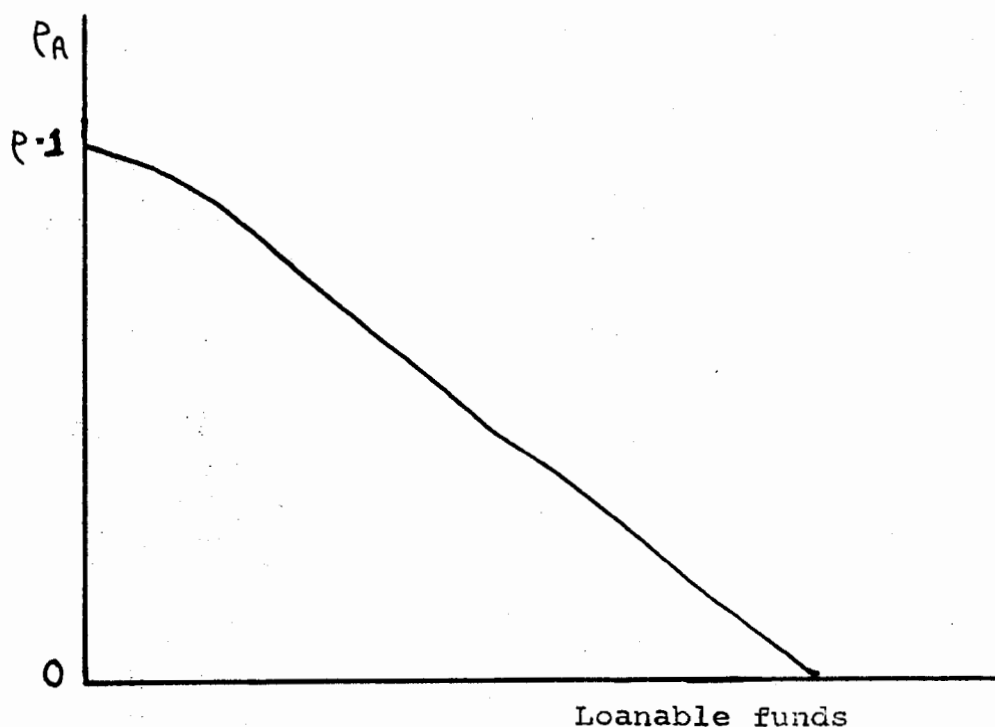


Fig. 10.--Demand for Loanable Funds in Agriculture

The supply curve may be represented by

$$S_A = f(p_A, r_A - 1, r_M - 1),$$

and it may be pictured as shown in figure 2 below.

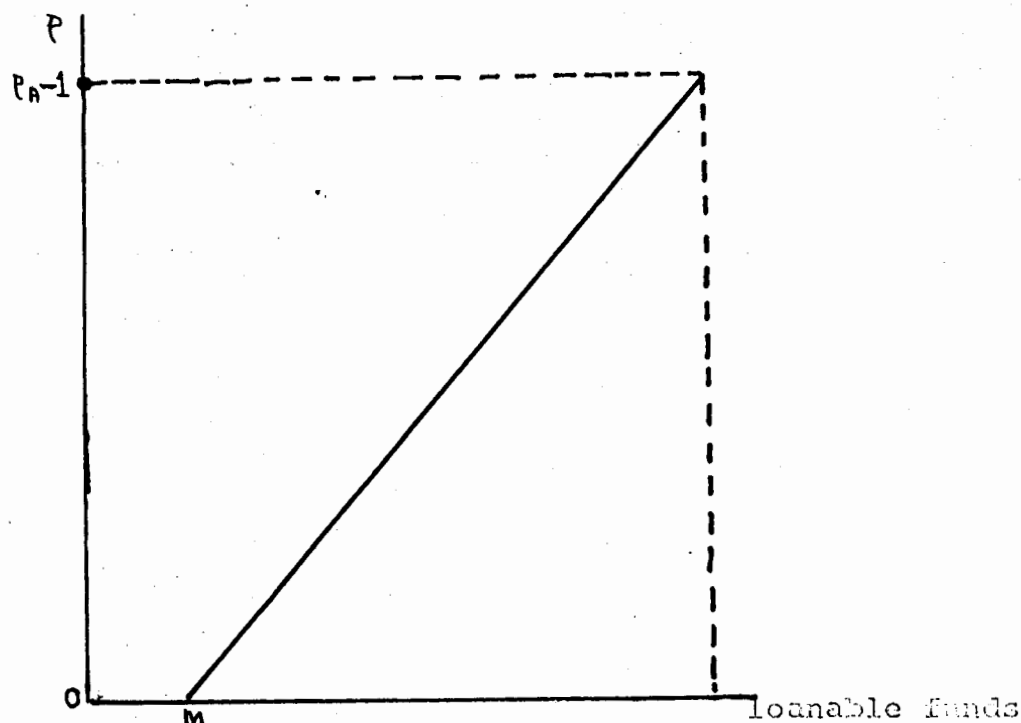


Fig. 11.--Supply of Loanable Funds in Agriculture

The supply curve may differ in shape from that in the manufacturing sector due to the qualification on property rights. The horizontal intercept, M , indicates that in order to retain possession for the purpose of future investment, it is possible that even if P were zero, some people may still invest on the land. The supply of funds will respond to some lagged function of profit in agriculture as compared to industry. Supply will vary negatively with past profits from investment in the manufacturing sector. As a simplification, -1 is used to represent the lag. This time, as P_A becomes lower, more landowners could be expected to become owner cultivators. A higher P_A is shown to induce the flow of more funds into agriculture.

Thus, I am assuming that the information set of the operators and the investors is different. This is likely to be true where the investor sees the forwarding of funds to the land as merely a financial investment and leaves management to the operator. It is less likely to be true the more involved the investor becomes in the agricultural production process and the more interaction engaged in with the operator. Nevertheless, distance from the land as well as less direct experience on it, relative to the operator, will certainly limit the investor's knowledge.

The intersection of the supply and demand curves will determine the level of investment of loanable funds in agriculture and the relative shares of profit. The contracts will specify the share of the profit rather than an absolute amount of profit--which is not known at the time the contracts are agreed upon. Prespecifying an absolute amount of profit would amount to ribā and hence be unacceptable from an Islamic perspective.

The working of this model can be illustrated by some comparative static exercises. Several factors could result in a shift of the demand curve. Out-migration of people who possess farming skills, from rural to urban areas or abroad, would cause the demand curve to shift back. In this case, p_A could be expected to be lower. The lower level of investment in the agricultural sector reflected in the move down along the supply curve would

indicate a smaller numbers of farms operating on the basis of a P.L.S. contracts.

Another shift, this time in the opposite direction, could result from, for example, technological innovation. The premium on funds this implies would result in an increased e_A . The movement up along the supply curve would show the increased capital intensity of cultivation.

Similarly, several shifts in the supply curve can be hypothesized. For example, tax breaks to induce investment in agriculture would cause the supply curve to shift out. On the other hand, a change in taste, such that it becomes more socially acceptable to become owner operators, would shift back the supply curve.³³

In this framework, an increased cost of production, perhaps due to higher energy prices, would merely reduce the operating surplus and not shift either of the curves if that change occurs after the contract has already been engaged in. However, the expected profit of the operators would be reduced, causing a shift back in the demand curve, if the higher prices are anticipated to persist or rise further.

Having outlined the workings of the simple model for farms of a given size, the questions related to the co-existence of farms of different sizes can now be addressed. Suppose large farms consistently show a greater operating surplus relative to medium or small sized farms. Operators would then prefer to work on them and

hence bid p_A up and $(1-p_A)$ -- the share of the operators -- down. However, the total operating surplus on large farms will be greater, leaving remunerations to operators on larger farms higher than on medium or small sized farms in compensation for the greater effort.

In equilibrium, the profit rates across farms of all sizes will be equalized, and this will also be reflected in the return on funds invested tending to equality so that, for example,

$$r_L = \frac{A_{TL}}{K_L} = \frac{A_{SL}}{K_S} = r_S$$

(where L stands for large and S for small).

Having assumed homogeneous land, I have naturally said nothing so far about differences in operating surplus that may result across farms of the same size due to the intrinsic contributions of the land itself. This is the subject matter of the next sub-section.

b.) Allowing for Non-Homogeneous Land. One of the Islamic principles identified in section one was that returns to the land itself are to be shared by the whole community. Given non-homogeneity of land then, even across farms of the same size, the operating surplus on infra-marginal land (that which is more fertile or better located) will be higher. This higher operating surplus realized on infra-marginal lands is akin to differential rents, whose existence was identified and explained by Ricardo (1951, pp. 67-83). This point needs further

elaboration.

The existence and size of Ricardian rents depend on different qualities and location of land. Scarcity is implicit in their existence since infinite amounts of different qualities of land would not result in Ricardian rents. Theoretically, if farms of the same size (and with the same inputs) show different operating surpluses, then this difference is what would be captured by Ricardian rents in tenure arrangement that allow for the renting of lands.

The concern here, however, is not with scarcity rents in general or Ricardian rents in particular, but rather with identifying that value which is a contribution of the land due to either fertility or location. The question that follows is how accurately does the difference in operating surplus across farms of the same size reflect the difference in the contribution of the land itself? If it is a completely accurate gauge, then the following land value tax per acre for farms of a given size (and using the same inputs) would follow:

$$T = \pi_h - \pi_l$$

(where h and l indicate categories of land with high and low fertility).

Administratively, such a tax would require the grading of land into different categories based on local level knowledge and past profits realized. Then the differential in average operating surplus between marginal and infra-marginal categories of land on farms of the

same size (and using the same input) would constitute the land value tax and also the Ricardian rent where a zero tax is assessed on marginal land.

This tax may be said to correspond to the ushr--the counterpart of zakāt on land--the land tax prescribed in Islam on the productivity of land itself, for any earning beyond the niṣāb (prescribed minimum). A higher tax rate is prescribed for land that is rain irrigated than that for which the owner has provided the irrigation. The reason, once again, is that in the first case the whole community should gain from what is provided by nature, whereas in the second case, the owner is solely entitled to the return of his effort.³⁴

Of course, there is still the possibility that factors other than land contribute to differences in operating surplus across the same sized farms. It was earlier indicated that the use of factors on farms of the same size would tend to equality. This would include the use of capital and hired labor. These factors have been assumed to be homogeneous so far, and this assumption is retained for the rest of the analysis. Some comments on allowing for differences in skill among operators are noted below.

c.) Allowing for Non-Homogeneous Operators. Differences in operating surplus between different categories of land for farms of the same size could, for individual farms, be due to differentials in operator

efficiency. However, when computing the land value tax across different categories of land for farms of the same size, such differentials will average out, assuming that operators are randomly distributed across farms of differing fertility. The remaining difference will be due to the fertility of the soil.

The average profit shares that will be determined for operators on the market will result from the performance of average ability. These shares will probably apply in a first time contract between investors and operators. Operators with greater than average ability will therefore initially be benefitting their investors, while those with less ability will be being subsidized by them. There is no reason why the efficiency of individual operators should not eventually show up in a lower p_a in individual contracts. Similarly, operators with less than average performances on a consistent basis would have a problem getting contracts renewed.

Another reason for the differentials in operating surplus on farms of the same size may be due in part to improvements on the land. This issue has been recognized and discussed before by proponents of a tax on the value of land. In the next sub-section, I review the ideas of one of the pioneers of land value tax, and in this context the issue of structural investment on the land will be considered.

d.) Allowing for Structural Investment on the Land.

Taxing the rental value of land has been proposed before for both ethical and economic reasons. In particular, this idea was popularized by Henry George (1879, pp. 326-331), who provided the inspiration for the "single tax" movement. The ethical justification for taxing the return to land was that, given scarcity, land value exists either due to the fertility of the soil--which is a gift of nature--or due to the location--which results from the existence and progress of the community. In neither case is the landowner justified in appropriating the rent since it is not the creation of his effort. The Islamic view on this issue has been interpreted to be the same, as was explained in section one.

It has been observed that appropriating the whole rental value of land will result in the capitalized value of land falling to zero.³⁵ This can be seen from the following formulation:

$$C_0 = \frac{R_1 - T_1}{(1+i)} + \frac{R_2 - T_2}{(1+i)^2} + \dots$$

where

C_0 = current capitalized value of land;
 R_i = expected rental value at time i ;
 T_i = the tax at time i adjusted to the rental value;
 i = interest rate.

George was aware of this but felt that this was part of the strength of such a tax, since it would discourage land speculation--which he considered to be one of the prime causes of the economic ills of society (p. 262). However, this is felt to be inequitable to those who

recently purchased land since they in effect paid for the rental values which they would be denied with the tax. George anticipated this claim and devoted a whole chapter to an emotional refutation of it on grounds of justice (pp. 356-365).

George conceded that complete accuracy in tailoring of a tax, such that it appropriates only and all of the rental value, would not be possible (p. 424). In particular, it would be very difficult to distinguish the contribution of land from past structural improvements of the land due to past investment on it. In the limit, the land itself could have been reclaimed from the swamp. To avoid discouraging capital investment of a structural kind (digging canals or wells, building embankments against flood or reclaiming land that is waterlogged or suffers from salinity), he asserts that the returns should accrue to the individuals responsible for the improvement (p. 396). In the context of this model, this would imply that the contribution to value by structural improvements be separately assessed and subtracted from the taxable operating surplus by looking at the differences in returns to structural investments.

$$P^I \pi^I > P^U \pi^U$$

(where I represents a farm embodying the structural improvements and U , an otherwise comparable farm without the improvements).

The return to structural improvements would show up

in the share of owners/investors in the P.L.S. model. Given competition, the return to operators on farms with and without improvement--but otherwise the same--would be equalized. Operators competing to work the land that embodies the improvement would bid up the share of investors so that

$$p_A^I > p_A^U;$$

hence

$$(1-p_A^I) < (1-p_A^U),$$

but

$$\pi^I > \pi^U,$$

so that one may expect a tendency towards equalization of $(1-p_A^I) \pi^I$ and $(1-p_A^U) \pi^U$. Given that the return to operators is the same on farms with and without improvements, the return to the improvements that comes in the form of a tax break will accrue to the investors, i.e. the ones responsible for the structural improvements.

Conclusion.

This chapter is sub-divided into two major sections. The first section discussed the controversies in Islamic literature about various forms of tenure arrangements including sharecropping and leasing land for a fixed rent. These two tenure arrangements were explored in the context of the concept of ribā that was discussed in Chapter One and found to be wanting from an Islamic

perspective. I proposed P.L.S. as an alternative tenure arrangement to be adopted in the framework of various qualifications on ownership that were mentioned in this section.

In the second section, I attempted to show that it may be possible to extend P.L.S. to agricultural contracts.³⁶ The main claimants in the contract would be the operators, landowners, and the state. The latter would claim the rental value of the land that is either due to location or to the fertility of the soil, and hence from an Islamic perspective, the right of the whole community.

Given no structural investment on the land, across farms of any given size, the difference in operating surplus is part of the inherent value of the land, as in the Ricardian concept of rent. A tax could be designed to appropriate this difference in operating surplus.

The problem is that structural investment on the land also contributes to the operating surplus. This problem can be dealt with by separately assessing and subtracting the value of improvement from the tax on the operating surplus.

The P.L.S. contract as an alternative tenure arrangement is likely to be even more difficult to enforce than sharecropping, which is known to have a higher contract cost than the fixed rent tenure. The reason is that in sharecropping the owner has to watch for the gross output

only. In P.L.S., the operator can overstate costs as well as trying to understate output. To some extent, the market can enforce honesty in transactions, unless, of course, everyone is cheating, since operators consistently showing an operating surplus below the average for their farm size and fertility grade will get a lower share or be fired. If dishonesty does prove to be a serious problem, there would be a tendency towards owner cultivation.

The latter may also be the case since P.L.S. forces more risk bearing on the owner/investor than is true in sharecropping. The investor is only guaranteed some return if there is a profit, unlike sharecropping, where the gross output is sub-divided. In fact, an analogy can be drawn from the portfolio model presented in Chapter Three to compare P.L.S. with other tenure arrangements. Once again, the simultaneous availability of the fixed rent and sharecropping options will dominate (for the lender in welfare terms) the situation in which P.L.S. is the only option. The consequent negative impact on the level of investment may be offset by two factors. On the supply side, there would be the constraint on ownership that entails a positive investment on the land in order to retain ownership. This may encourage total investment on land. On the demand side, operators are now assuming less risk than in the fixed rent contract (most of the risk borne by the operators) or sharecropping (risk is shared between the operator and owner); under P.L.S.,

most of the risk is borne by the investors. The impact of this reduced risk may have a positive effect on the level of investment. As in industry, it may also change the composition of investment towards undertaking riskier investment.

Also, as in the case of industry, the share of investors essentially functions as a profit tax. Thus, this tenure arrangement will not violate the marginal requirements of an efficient contract.³⁷

The P.L.S. contract is weighted in favor of those actually operating the lands, and in aggregate terms, it may mean a redistribution away from absentee owners towards operators. Of course, this assumes well functioning markets with equal bargaining power. Griffin (1974, p. 90), has found evidence of monopoly leading to contracts weighted heavily in favor of the landowners in share-cropping. The same would apply to the determination of profit-shares given the presence of such monopoly power.

The most significant aspects of P.L.S. may be the following: 1.) The traditional form of absentee ownership would be eliminated. 2.) There may be a gradual elimination of unutilized holdings, because use becomes a requirement for possession. 3.) Also, borrowing from local money lenders at extremely high interest rates by operators strapped for cash may be successfully blocked out. This would come about not only by having laws against ribā, but also by having alternative sources and

arrangements for the supply of funds.

An in-depth analysis comparing P.L.S. with the conventional tenure arrangement would be needed to establish the relative economic viability of this tenure arrangement. The object here was to present the mechanisms of P.L.S. as an ethically motivated (from an Islamic viewpoint) alternative tenure arrangement.

Notes to Chapter Four

¹Ali Abd Al-Kader, "Landed Property and Tenure in Islam," Islamic Quarterly, 5, No. 1 and 2 (1959), pp. 4-6.

²For the view that mainly barren lands were distributed, see Zia-ul-Haque, Landlord and Peasant in Early Islam (Islamabad: Islamic Research Institute, 1977), p. 254. For an opposing view, see Frede Loekkegaard, Islamic Taxation in the Classical Period (Philadelphia: Porcupine Press, 1950), pp. 58-59.

³Syed H. Nadvi, "Al-Iqta--Or Theory of Land Ownership in Islam," Islamic Studies, 9, No. 4 (1971), p. 258.

⁴See, for example, Nasir Ahmed Sheikh, Some Aspects of the Constitution and Economics of Islam (Woking: The Woking Muslim Mission and Literary Trust, 1961), p. 173.

⁵Fazlur Rehman, "Islam and the Problem of Social Justice," Pakistan Economist, Aug. 1974, p. 31.

⁶This (XLI: 10) has been interpreted in this fashion by Ghulam Ahmed Perwaz, "Economics and the Social Structure of Islam," Some Economic Aspects of Islam, ed. M.N. Huda (Karachi: Motamar al-Alam al-Islami, 1964), p. 39.

⁷See Maudoodi's arguments presented by Afzal-ur-Rehman, Economic Doctrines of Islam (Lahore: Islamic Publications, 1974), III, p. 182.

⁸Mahmoud Abu al-Saud, "The Exploitation of Land and Islamic Law," The Islamic Review, 40, No. 10 (1952), p. 7.

⁹Haque, p. 78.

¹⁰A.A. Abu-Sulayman, "The Theory of Economics in Islam: The Economics of Tawheed and Brotherhood," in Contemporary Aspects of Economic Thinking in Islam (Indianapolis: American Trust Publications, 1976), p. 23.

¹¹Sheikh, p. 173.

¹²Shaikh M.A. Al-Sayis, "Ownership of Land and its Benefits," Proceedings of the First Conference of the Academy of Islamic Research (Al-Azhar, Mar. 1964), p. 145.

¹³Shamsul Alam, "Islamic Economy: Some Thoughts about Sharecropping," Islamic Review, 53, No. 4 (1968), pp. 24-26.

¹⁴Afzal-ur-Rehman, p. 202.

¹⁵Sheikh, p. 164.

¹⁶Abu Sulayman, p. 10.

¹⁷Haque, p. 344.

¹⁸Haque, p. 345.

¹⁹Al-Saud (Sept. 1952), p. 10; H. Masud, "Some Reflections on the Economic System of Islam," in International Economic Conference (Rawalpindi: Islamic Research Institute, 1968), p. 100.

²⁰Mahmūd Abu-Sa'ūd, "The Economic Order within the General Conception of the Islamic Way of Life," Islamic Review, 55, No. 3 (1967), p. 13, XXIX: 58.

²¹Yusuf, 1957, p. 32.

²²Shah Mohammed Rashad, "Land Ownership and Tenure in Islam," Islamic Thought, 6, No. 2 (1959), p. 31.

²³Al-Qadar, p. 5. Once again, Loekkegaard doubts the historical accuracy of this action (p. 17). In general, Haque counters his allegations and demonstrates, partly by citing other works, that his doubts are unfounded (p. 7).

²⁴Iqbal H. Qureshi, "Land Tenure in Islam," in Mada, 1965, p. 70.

²⁵Farooq Hassan, The Concept of State and Law in Islam (Washington, D.C.: University Press of America, 1981), pp. 186-188; Syed A.H. Al-Khatib, "Landed Property and Ownership in Islam," in Mada, p. 118.

²⁶For a general discussion of ownership, see Sheikh al-Khafeef, "Individual Property and its Limits in Islam," Academy of Islamic Research, pp. 79-103.

²⁷S.M. Yusuf, Economic Justice in Islam (Lahore: Mohammed Ashraf, 1977), p. 19.

²⁸C.N. Ahmed, Principles and Objectives of an Islamic Economy (Calicut: Ansari Press, 1964), p. 57; Ahmed Husani, "Social Justice in Islam," Islamic Studies, 10, No. 3 (1971), p. 397.

²⁹Abu Sulayman, p. 22 and also Alam, p. 25.

³⁰Haque, pp. 316-317, p. 332.

³¹Haque, p. 66.

³²Moazam Mahmood and Madeem-ul-Haque, "Farm Size and Productivity Revisited," Pakistan Development Review, 20, No. 20 (1981), pp. 186-187; Mahmood H. Khan, Underdevelopment and Agrarian Structure in Pakistan (Boulder: Westview Press, 1981), p. 195.

³³As an example of this kind of phenomenon, see Jerry B. Eckert, "Farmer Response to High-Yielding Wheat in Pakistan's Punjab," in Tradition and Dynamics in Small Farm Agriculture, ed. Robert D. Stevens (Ames: The Iowa State University Press, 1977), p. 173. Eckert points out how the new technology of the "green revolution" made it a mark of status for the innovative landowners to be the leaders in introducing new inputs and techniques, and much displacement of tenants occurred.

³⁴Abdul Q. Shaikh, "Zakah and Taxation," in Outlines of Islamic Economics, Proc. First Symposium on the Economics of Islam in North America, Mar. 1977 (Indianapolis: Association of Muslim Social Scientists, 1977) p. 9.

³⁵Arthur S. Otis, Added Revenue Without Burden (Boston: Christopher Publishing, 1958), pp. 26-27.

³⁶For an exhaustive taxonomy of land tenure contracts see Keith B. Griffen, The Political Economy of Agrarian Change (London: Macmillan, 1974), pp. 24-25.

³⁷For a comparative economic analysis of renting and sharecropping, see Steven S. Cheung, The Theory of Share-Tenancy (Chicago: University of Chicago Press, 1969), pp. 10-21; Cheung uses a constrained optimization problem that is set up to maximize the landowner's total rental to show that since the constraint is the same under sharecropping and land renting--i.e. the opportunity foregone by the tenant labor--the allocation of resources will satisfy the same marginal conditions under either tenure arrangement. With slight modifications, P.L.S. fits easily into the framework he develops, and one can once again show the same marginal conditions being satisfied as long as the constraint is the same.

CHAPTER FIVE

REVIEW OF PROGRESS IN ISLAMIC BANKING

Introduction.

This chapter reviews the evidence pertaining to the practice of Islamic banking. This evidence is scanty because this banking concept has only been put into practice, in any significant way, fairly recently. The earlier attempts made at instituting Islamic banking will be discussed separately from what has been referred to as the "Islamic banking movement," which came into effect in the mid-seventies after the oil embargo.¹ I will not discuss the operational mechanisms of Islamic banking or their underlying ethical issues in much detail here, since that was largely the subject of analysis in Chapter Two.

This chapter is therefore divided into two sections. The first briefly reviews the attempts at instituting Islamic banking prior to the establishment of the Islamic Development Bank (I.D.B.) in Jeddah in 1974--which may be considered the starting point of the practical implementation of the Islamic banking movement. The second concerns itself with this movement and is presented in three sub-sections. First the overall progress of the

of the movement to date will be discussed. Second, the progress of three separate banks, in three different countries, that came into existence as part of this movement will be examined in greater detail. Finally, the case of Pakistan, which is ostensibly the most ambitious example of this movement, will be reviewed. This merits special attention because Pakistan has undertaken to Islamize its whole banking system.

I. Early Islamic Banking Experiments.

Efforts to establish transactions on an interest-free basis date back almost as far as the first theoretical works on the issue. Unfortunately, very little information is available about the details of these experiments, but for the record, it is possible to state where and when they occurred.

The first attempt to establish an interest-free bank in Malaysia came in the mid forties. This was unsuccessful, but in 1962, the government started a Pilgrim's Management Fund, which invested prospective pilgrims' savings in real estate and plantations according to Islamic Law.²

India's Jamat-e-Islami Hind started an interest-free loan system in 1969, in which a mere ten dollars was circulated among about fifty users, as and when the need occurred. By 1981, the total resources of these interest-free loan societies increased to \$.5 million, and over three hundred thousand people had used their services.

About one hundred of these societies are now operating in thirteen of India's twenty-two states. Their basic function is to rely on donations and deposits to make small scale interest-free loans against collateral such as jewelry. No interest is paid on the deposits.³

More is known about the most innovative and successful experiment with interest-free banking, which took place in rural Egypt in 1963. This was described in some detail in Chapter Two (pp. 90-92), as one of the alternative institutional forms embodying interest-free banking. Here its progress over a three-year period is reviewed.

These rural banks operated three accounts. First, a saving account could be started with a minimum deposit of five piasters (about ten cents). No interest was due on these accounts, but depositors were entitled to a small short-term interest-free loan for productive ventures they chose to undertake. The bank's technical assistance was made available to them for this purpose. Second, an investment account drew deposits, but unlike saving accounts, restricted withdrawals from it. These funds were invested on a P.L.S. basis, either directly by the bank in rural projects or through the agency of local entrepreneurs who were in need of funds. Third, a social services fund drew zakāt from the charitable in the community and distributed it to those who were in difficulty as a result of unforeseen misfortune. The categories and operation of these accounts are very similar, if not

identical, to those adopted by current Middle Eastern joint stock Islamic Banks (Chapter Two, pp. 75-81).

The table below reviews the progress of this Egyptian experiment over a three year period.

Table 15
Rural Islamic Banking Project in Egypt
(Egyptian £ 's)

	<u>1963</u>	<u>1966</u>
Saving Deposits:	25,000	125,000
Investment Deposits:	35,000	75,000
Investments Financed:	0	30,000

The growth reflected in the numbers above is impressive, especially considering that the project started out with one room and a small staff. The bank functioned on a cautious basis, rejecting, on the average, 60% of loan applications in its first three years. The default ratio was zero in economically good times.⁶

The success of the project in part resulted from the direct participation of the local community. This resulted in a favorable response of savings. Also, because transactions were based on intimate contact and mutual trust and because the interest of the community was directly at stake in the transactions, a fair amount of social pressure was present as a check on the borrowers. Demands from neighboring communities, which appreciated the ethical and decentralized approach of the bank, mushroomed. In 1967, four more branches were added to the initial (Mit Ghamr) bank, and eight new banks were opened.

After three years, there were sixty thousand depositors, and when the project ended, there were close to a million.⁷ It seems that the very success of the banking project was actually the cause for its failure.

Training the required personnel, who were very carefully selected, was part of the problem.⁸ More serious was the challenge this project presented to vested interests. Traditional banks became antagonistic as funds were transferred to Islamic banks, and the local bureaucracy was threatened by the local leadership and participation engendered by the decentralized approach of the banks.⁹

Egypt was also responsible for producing the first successful urban-based experiment in the form of an Islamic welfare oriented bank, called the Nasser Social Bank.¹⁰ This was established in September 1971, started operations in July 1972, and is still in existence. The main objectives of the bank were stated to be the granting of interest-free loans for small projects on a P.L.S. basis, assistance to persons facing unusual misfortune, and loans to needy students for university and higher institute education.

The account structure of the bank again is similar to that described in Chapter Two. The bank's capital also includes funds allocated by presidential decree from extra-budgetary resources, appropriations from the state budget, and contributions from the Ministry of

Wakfs (charitable foundations).

Some evidence of the size and direction of the bank's activities can be gleaned from the following table.

^aTable 2
Nasser Social Bank, Egypt
(million Egyptian f 's)^b

	<u>1977</u>	<u>1978</u>
Assets:	126.1	163.9
Deposits:	34.5	60.0
Social and Productive Loans:	25.8	33.5
Investments:	12.8	17.0
Current Surplus:	3.1	10.7

a Table drawn from a balance sheet presented in "Banking Structures and Sources of Finance in the Middle East," ed. by Bankers' Research Unit (London: Financial Times Business Publishing, 1980), pp. 178-180.

b \$1.00 U.S.=1.22 Egyptian in mid-September 1981.

Despite its welfare orientation, the bank does claim to be financially viable and in 1979-1980, it announced a profit rate of 9.5% on investment accounts.

II. Islamic Banking Movement.

a.) General Description. The main elements in the Islamic Banking Movement are the I.D.B. (Islamic Development Bank) and the more recent umbrella organisation called the Dar-al-Mal Al-Islami (Islamic House of Funds) or the D.M.I. (registered in the Bahamas) founded in 1981. In addition, there is the International Association of Islamic Banks (I.A.I.B.), which was set up as a technical advisory institution for Islamic banks in August, 1977, and an

International Institute for Islamic Banking and Economics, set up in Lefkosa, Cyprus. The various institutions exchange information in frequently held seminars. The Institute, which is designed to be the training center for a cadre of Islamic bankers is, along with the I.A.I.B., one of the co-ordinating elements of the movement, which has already seen establishment of individual Islamic banks in Egypt, Sudan, Dubai, Sharjah, Kuwait, and Bahrain. Perhaps the most critical element in this movement will be the outcome of the experiment to Islamize the whole banking system which has proceeded in Pakistan and is under active consideration in Sudan.

The I.D.B. has an authorized capital of two billion Islamic dinars (I.D.--about \$1.25 U.S.). It started out with twenty-seven member countries and now has a membership of forty-one. Its main objectives are to promote a harmonious and balanced development of member countries through mutual financing and economic co-operation. It encourages trade and the transfer of technology among member countries, provides technical assistance, and funds research. The cornerstone of its policy is stated to be the replacement of interest by co-operation in all international dealings on the basis of P.L.S.¹¹

I.D.B. accepts deposits from individuals and the government. It disburses its funds for productive projects on the basis of either direct interest-free loans, equity financing, or P.L.S. In 1981, out of a total of

I.D. 114.85 million devoted to project financing, 23.6% was allocated to agriculture and agro-based industries, 52.5% to industry and mining, and 23.9% towards infrastructure and utilities. Forty percent of project financing was based on equity participation and about twenty-seven percent on interest-free loans.¹²

Since its inception, the financing of foreign trade has drawn most of its funds. About seventy seven percent of the value of its 1981 activities (I.D. 507 million) was related to foreign trade.¹³ The cumulative total percentage of its operation devoted to foreign trade up to 1981 was about sixty-seven percent. (\$1.5 billion).¹⁴ It has shown an interest in promoting trade among member countries and in particular the exports of poor Muslim countries.¹⁵ This focus on trade reflects the fiscal conservatism that is central to the I.D.B.'s operations.

Recently, it declared its intention to provide grants to its poor members, for the preparation of feasibility studies. A lack of suitably prepared project proposals is said to deter them from getting their "fair share" of project and loan allocations.¹⁶

The I.D.B. has found a shortage of trained manpower to be one of the main bottlenecks retarding the progress of its operations. To cope with this, it intends to open a training institute in Jeddah in the near future.

The D.M.I. seems more dynamic in terms of the overall growth of the Islamic banking movement. It intends to

raise one billion dollars (\$350 million raised so far) through the sale of equity and use these funds as a basis for establishing an international network of businesses run exclusively on interest-free Islamic lines.¹⁷ These include Islamic investment and insurance companies and banks. Since its foundation, it has opened subsidiaries in Guinea, Gabon, Bangladesh, Malaysia, and Turkey. The last two are reportedly resisting D.M.I.'s overtures since it insists on majority participation (at least 51%) in the operations it helps to establish.¹⁸ It is, however, currently in various stages of negotiations with Senegal, Nigeria, Niger, Upper Volta, Benin, Toga, Philippines, Singapore, and Pakistan. In addition, to cater to Muslim communities in the West, it has established operations in the Isle of Man, Luxembourg, London (First Interest-Free Finance Consortium) and Philadelphia, and it has planned investment houses for New York, West Germany, Melbourne, and the Netherlands.

Two other large Middle Eastern financial companies have also manifested interest in operating banks on an interest-free basis in the West. One of these is a subsidiary of the Luxembourg registered Islamic Banking System (1979). It is responsible for Britain's first Islamic bank, opened in August 1982 in London. It reportedly seeks to attract small investor deposits among Britain's Muslim community of two million.¹⁹ The other

is the Riyadh based Al-Rajhi Company for Currency Exchange and Commerce. It also has initiated a venture run on Islamic banking principles in London, called the Al-Rajhi Company for Islamic Investment.²⁰ However, these companies seem to be following a more cautious policy, and none of them has shown the same interest in international expansion that D.M.I. has.

The D.M.I. president also jointly heads the International Association of Islamic Banks (I.A.I.B.) and the International Institute of Islamic Banking and Economics. The I.A.I.B. was set up to proffer technical, legal, and managerial advice in the formation of Islamic banks. It is mainly research oriented, and in this capacity as an information collecting and disseminating organization, it has helped in the establishing of several of the currently operating Middle East banks, including the Faisal Islamic Banks of Egypt and Sudan, which will be reviewed in more detail below.²¹ One of its important current projects is the preparation of an encyclopedia of Islamic banking. It also recently participated in organizing a symposium (along with the Syma Institute in Koln) in Baden-Baden, West Germany on Islamic banking.²² The association is also attempting to play a role in forging co-operation among the various Islamic banks and in coordinating their activities.

The I.A.I.B. significantly participated in the formation of the International Institute of Islamic Banking

(I.I.I.B.). The I.I.I.B. is designed to be a multi-lingual educational and training center. Its short-term goal is to meet the immediate need of banking personnel in the Islamic banks, by awarding a one year diploma, starting with one hundred students in October, 1982.²³ It plans to be awarding masters and doctorates by 1985-1986 in Islamic economics and banking.²⁴

There are a host of supporting academic and financial institutions that directly aided the formation of this institute and are in general providing the impetus to the Islamic banking movement. These include the Al-Azhar University, Islamic University in Islamabad, the Islamic Secretariat, and the Islamic Council of Europe, among others.²⁵ There are also other research institutes that are co-ordinating research activity in this field, such as the International Centers for Research in Islamic Economics in the King Abdul Aziz University, Jeddah, the Islamic Foundation, Leicester, and the School of Islamic Economics, in the Islamabad University.

Islamic operations appear to be cropping up spontaneously in several countries along with the main movement that has its origins in the Middle East. In India, plans were announced for the conversion of an urban credit co-op society (Bait Un Nasr), founded in 1976, into a P.L.S. Islamic bank. South Africa has Jamme Ltd., established in 1976, and more recently Wonder Accessories Ltd. These companies function on a P.L.S. basis, but

unlike banks cannot accept deposits. The Amanah Bank in the Philippines, which had earlier started interest-free deposit accounts, has recently started a Muslim development fund to operate on a P.L.S. system.²⁶

The Middle East banks that were established in the late seventies now appear to be fairly well entrenched. They function on the operating principles described in Chapter Two. The Kuwait Finance House (started in 1979) is reported to be doing well and is outmatching commercial banks run on an interest basis. The table below illustrates some of its growth statistics.

Table 3 ^a			
<u>Kuwait Finance House</u>			
	(million \$ U.S.)		
	<u>1979</u>	<u>1980</u>	<u>1981</u>
Gross Assets:	----	596	1240
Total Deposits:	----	526	1050
Profits:	13	44	(over 132)

a This table is drawn from statistics reported in Arabia, Sept. 1982, p. 52 and from an article by Pamela M. Smith, "O.P.E.C. Surplus Funds: Arab Institutions Play a Greater Role," Middle East Review (Essex: World of Information, 1982), pp. 57-58.

The Kuwaiti Finance House is a state venture and is active in promoting and participating in Islamic institutions in Pakistan, Bahrain, and Dubai.

Dubai's Islamic Bank was established in 1974. It reported the following table in its Annual Report as an indication of its progress.

Table 4^a
Dubai Islamic Bank

	<u>1979</u>	<u>1980</u>	<u>1981</u>
Checking Account Holders	1622	1955	3883
Saving and Investment Account Holders	2023	2278	2915
<u>Muqāraba and Mushārika Operations</u>	141	335	953

a Based on Dubai Islamic Bank: Annual Report 1981 (Dubai: Dubai Islamic Bank Printing Press, n.d.), p. 10.

Although the bank admits to having had to liquidate projects that were proving to be failures, it still reported a net profit of over 16.3 million dirhams in 1981, which was a 46% increase over the 1980 profit figure of 10.9 million dirhams.²⁷

The Bahrain Islamic Bank, (founded in 1979) announced a profit share amounting to a 9.5% return on its investment accounts. It also announced a 5.25% return to saving account holders, which is a questionable practice from an Islamic viewpoint. Interestingly enough, the bank mentioned the high rate of interest in the U.S. dollar was causing funds to incline towards deposits in dollar accounts and hence resulting in a local liquidity shortage.²⁸ Also notable is that Saudi Arabia, which has large equity participation in several Middle East banks, has as yet not granted a license for the formation of a local Islamic bank.²⁹

I have been able to procure more detailed information on three of these first

generation joint stock Islamic banks in the Sudan, Egypt, and Jordan. A separate sub-section has been devoted to reviewing the progress of these banks, in the context of the respective country's movement towards Islamic banking.

b.) Islamic Joint Stock Banks--A Review of Progress.

1.) Sudan. Sudan's first venture into P.L.S. banking is the Faisal Islamic Bank (Sudan). This started operations in 1977 and is capitalized at six million Sudanese pounds (\$1 U.S.=1.11 sudanese f's). The Faisal Islamic Bank offers the usual checking, saving and investment accounts as depositing options.³⁰ Checking account deposits are guaranteed. The explicit consent of depositors is needed to invest these funds since no return is due on guaranteed deposits. Saving accounts differ in that to encourage deposits in these accounts depositors may be given the special privilege of drawing funds for financing a small project or the purchase of productive or consumer durable goods on a muḍāraba or interest-free loan basis. No interest or profit, however, is due on these deposits. Funds in investment accounts are not guaranteed and are forwarded to borrowers on the basis of mushārīka, muḍāraba, or murābāḥa; these were described in Chapter Two (pp. 75-81) as alternative financial instruments on which P.L.S. banking functions.

As a general policy, for its share of the effort in arranging, appraising and managing projects, in a

mushārika (partnership) contract, the bank claims 25% of the profits--although this share can vary at the discretion of the bank. Where the bank is content to let the borrowers (entrepreneurs) manage a project, it allows them between 25% to 35% of the profit as a share for management. The remaining profit is shared according to the share of each party in the capital of the operation. For muḍāraba, where the bank merely supplies the capital, the management share of the profit goes to the borrower.

The bank claims that in practice no fixed percentage profit share applies, and each case is dealt with on its merits depending on development priorities and duration and difficulty of the project.

The bank has cited several problems in its operation that are noteworthy. First, the calculation of fixed assets in valuing a partner's contribution to a project has been problematic. For example, objections have been raised about using the book value of a plant to determine the yearly capital contribution of fixed assets. Second, Sudanese tax laws have prevented the inclusion of a bank's share of profit as an item of cost, whereas interest is generally allowed to be included as such. Third, the bank has had partners that refused to liquidate after their operations have been delayed beyond a stipulated time. Questionable intentions may have motivated some of these delays. Fourth, the bank has had some problems explaining its new mode of operation and

gaining acceptance for its formulae for profit and loss sharing. Fifth, the bank has found itself coping with a heavy managerial burden that included project evaluation, close follow-up scrutiny, and obtaining data to assess information supplied to it by clients. In general, the bank found sudden changes in the state's financial and monetary policies, together with bad management among its borrowers, to be the cause of lower profits than anticipated. Despite these problems, the bank does seem to be showing signs of success and growth in its first few years of operation. For example, in 1980, ninety nine percent of its operations realized a profit--out of more than five hundred completed.³¹ Table 5 below summarizes some of the salient growth statistics.

Table 5^a
Faisal Islamic Bank of Sudan
(million Sudanese £'s)

	<u>1979</u>	<u>1980</u>	<u>1981</u>
Assets	31.41	67.35	138.36
Deposits			
Checking	15.13	26.12	49.40
Saving	.77	1.29	2.7
Investment	2.72	8.06	40.08
Investment Operations	10.78	25.31	44.15
Net Profits	1.05	2.59	10.29
Percentage Return on Investment Accounts	14.7	14.8	15.9

a Data drawn from the 1980 and 1982 Annual Reports of the Faisal Islamic Bank of Sudan. The numbers are probably not in constant prices.

It seems that the overall public response to the bank is fairly positive, even though until 1981, the forwarding

of funds to the investment account shows a cautious attitude on the depositors' part. The success of this experiment has started a move for its expansion. Faisal Islamic Bank itself is expanding, and two new branches were added in 1981 to make a total of eight. Also, three companies run on Islamic principles (Islamic Insurance Company, Islamic Company for Trade and Services, and the Islamic Company for Exchange) have been set up that are affiliated to it. The Islamic Bank of Western Sudan has acquired a license for operation, and the Gezina Bank and the Islamic Solidarity Bank have applied for them.³² The Sudanese government is planning a study on the Islamization of its entire banking system, and in the interim, it is planning to open interest-free banking units within each commercial bank.³³

2.) Egypt. Egypt already has three Islamic banks. There is the earlier discussed Nasser Social Bank, following which came the Faisal Islamic Bank (1977). The latter has a similar operation procedure as the Faisal Islamic Bank of Sudan. It too offers a checking, saving, and investment account. It accepts a minimum of \$200 for at least a six month period in its investment account. Funds in investment accounts are again forwarded on the basis of mushārīka, muḍāraba (authorized), and murābaḥa. Deposits in "authorized" accounts are intended for specific projects financed by the bank, whereas those in "unauthorized" accounts merge into a bank's

general investment fund--which include the bank's own funds drawn from the owners of its stock

In mushārika ventures, the share of management is first agreed upon, and the rest is divided according to the share in the contribution of total funds by the borrower, the bank, and the depositors. The share of profit returned to the bank is allocated between its shareholders and investment account holders according to the ratio of the bank to the investment account depositors' contribution of funds. Similarly, in the nuḍāraba contract, the borrower, who contributes no funds, is only entitled to an earlier agreed upon share of profits for management. In the case of loss, unless negligence can be proved, the suppliers of funds bear the financial burden. The bank operates a reserve fund to cover losses into which ten percent of the bank's distributable share of profits go. This deduction ceases when the fund equals one hundred percent of the bank's capital.

The murābaha sale is conducted slightly differently in this case as compared to the Sudanese bank. The Sudanese bank clients, on behalf of whom a specified commodity has been purchased by the bank, are not liable to repurchase it from the bank. The Egyptian bank considers the repurchase mandatory. This procedure is clearly a departure from P.L.S. in that a fixed predetermined return is specified. The Sudanese bank

justifies its fixed mark-up on the grounds that it is assuming the risk of a client not repurchasing a commodity the bank acquired on his or her behalf.

The Faisal Islamic Bank of Egypt's Annual Reports do reveal some success. Although it was initially capitalized at eight million, this was said to be raised due to popular demand to forty million by 1979. Deposits were then coming in at a rate of \$4.5 a month with an addition of a thousand new clients a month.³⁴ It has been observed that this success is despite the fact that a return of 12% on the bank's investment account for its first year in operation was less than what a corresponding amount invested in an interest bearing account would have yielded.³⁵ Actually, where both fixed interest and P.L.S. options are available, borrowers undertaking high risk projects may be expected to patronize Islamic banks, whereas the demand for projects with a fairly certain outcome may well be met elsewhere on a fixed interest basis.

The following table sheds some light on the progress of this bank.

Table 6^a
Faisal Islamic Bank of Egypt
(million \$ U.S.)

	<u>1979</u>	<u>1980</u>	<u>1981</u>
Assets	38.74	197.56	588.88
Deposits: Investment	16.06	131.73	436.36
Checking and Saving	7.56	8.27	32.84
Investment Operations	24.08	129.19	290.19
Net Profit	1.37	9.81	32.37
Percentage Profit	-----	12.03	12.50

- a Data drawn from the 1980 and 1981 Annual Reports of the Faisal Islamic Bank of Egypt. The numbers are probably not in constant prices since there is no mention of any adjustment of the figures.

This table does indicate the rapid rate of growth of both deposit and investment operations. The enthusiasm following this initial success has lead to the establishment of three new branches in Alexandria, Assuit, and Cairo, and three new ones in Tanta, Suez, and the Cairo suburb of Heliopolis are to begin operations shortly.³⁶

The success of Faisal Bank has probably also been the cause of the formation of the Islamic International Bank for Investment and Development in 1982, based in Cairo (capitalized at \$12 million) with branches at Minya and Tanta, and a network of up to seven branches planned. This bank came equipped with a host of subsidiary organisations, such as the Islamic International Contracting, Real Estate, and Trade Companies. Other subsidiaries planned are an insurance company and a technology center.³⁷

3.) Jordan.³⁸ The Jordan Islamic Bank, formed in 1978 with an authorized capital of four million Jordanian dinars (\$1 U.S.=about .33 J.D.), was Jordan's first venture into P.L.S. (joint stock) banking. This bank maintains two kinds of accounts. Trust deposits receive funds which are intended for safekeeping and are therefore guaranteed. The bank is authorized to use these deposits at its own risk and responsibility,

although no return is paid on these accounts. In addition to trust deposits, there are investment accounts, which are referred to as "joint" or "specific" investment accounts. They are the same as unauthorized or authorized accounts.

An additional feature is the subdivision of investment accounts into saving, notice, and fixed accounts. They are distinguished for P.L.S. purposes by the proportion of total deposits in these sub-accounts which participate in investment. For example, 90% of a fixed account participates in investment, whereas only 70% of a notice account does so. These participation ratios are used to determine what proportion of the profit share that is due on investment accounts will accrue on the various sub-accounts. Thus, if the net profit share on investment amounts to an 8.2% return on capital (figure for 1980), then 7.4% ($.9 \times 8.2$) is forwarded on the fixed investment sub-account. The bank's policy as determined by the Board of Directors in 1979 is to allocate 50% of the net profits realized by investment operations to an unauthorized investment account, 30% to the bank for its management, and 20% for a reserve fund to cover investment losses. The deduction to the reserve fund collected is reduced to 10% when the fund equals the bank's capital and is eliminated when it is twice that. Priority in

investing funds is given to the deposits in investment accounts. The bank can invest its own funds (those drawn from its stockholders) and draw its share of profit on it, when the amount needed for investment exceeds the total balance in investment accounts. In the case of authorized investment accounts, 75% of the profits returned to the bank go to the depositors, and the bank retains 25%. The bank's literature does not explain the mechanism of P.L.S. sharing between itself and the borrowers.

Investments are once again based on muḍāraba, mush-ārika, and murābaha. In addition to using funds in the investment account and its own funds, the bank can issue bonds. These are a counterpart to the authorized and unauthorized deposit accounts, so that the holders of the former share in the profits or losses of a specific project, while the holders of the latter share in the outcome of the bank's generalized investment. Islamic participation certificates (another name for these bonds) were described and compared with common stock in Chapter Two (pp. 103-105).

The Jordan Islamic Bank also indicates a fairly rapid growth rate in its deposits, as shown in Table 6 below. Jordan has also shown signs of expanding its commitment to Islamic banking, though not at the same rate as Sudan or Egypt. Since the formation of the head office in Amman, a new branch was set up there in

1981. A third branch was set up in Amman in 1981, as was one in Zerqa. Another bank is currently being established in Irbid.

Table 7^a
Jordanian Islamic Bank
(million Jordanian dinar)

	<u>1979</u>	<u>1980</u>	<u>1981</u>
Assets	7.26	13.71	26.94
Deposits:			
Checking	2.53	4.52	10.71
Investment	2.41	6.03	11.85
Investment Operations	.73	2.47	9.75
Net Profits	----	.014	----
Percentage of Profits	----	8.5	----
Distributed to Depositors	----		

a Data drawn from the 1980 and 1981 balance sheet and from the 1979 and 1980 Annual Report of the Jordanian Islamic Bank.

In 1982, a new Islamic Investment House was set up, with an authorized capital of JD four million. This company is not intended to undertake short-term transactions, but rather to involve itself in medium to long run projects, unlike the Jordan Islamic Bank, which focuses solely on short term transactions.

All three of the banks for which some data are presented do seem to indicate a fairly notable take-off. A few qualifications concerning their performance are in order. The Jordanian Islamic Bank itself stated in its 1980 Annual Report that "banks usually do achieve big leaps in the beginning of their lives."³⁹ Growth from a small base can lead to a misleading impression about

a bank's long run success, especially when the data is converted into percentages. Interestingly enough, the Jordanian bank also revealed that it was drawing depositors who were hiding bank notes at home for years, or depositing funds elsewhere without claiming interest. The drawing of such clients is of course what the success of these joint stock Islamic banks is premised on.

Another point to note is that these banks have been investing in relatively risk free trade oriented projects. The Faisal Islamic Bank of Sudan, 4% of whose investments were allocated to industrial projects in 1981, noted that this was deliberate policy. In its 1980 Annual Report, it noted as an objective: "the realisation of reasonable profit in the shortest possible time to prove the feasibility of realising profits through a non-interest system of banking."⁴⁰ It has since indicated diversifying towards medium term finance.⁴¹ The Faisal Islamic Bank of Egypt also increased its production (as opposed to commercial) operations in value from \$.7 to \$3.45 million.⁴² In Jordan, as mentioned above, a new investment house was set up to cater to medium and long run operations. This trend would have to continue since the ability successfully to provide venture capital for development projects is stated (as was pointed out in Chapter Two) to be one of the strong points of Islamic banking.

Finally, there is a dearth of independent hard

evidence on the progress of these banks, and therefore I have relied on bank reports to assess their performance. While deliberate misrepresentation is unlikely, it is clearly in the various banks' interest to present a positive picture.

Having discussed the experience of some individual joint stock Islamic banks in different countries, I now turn to the examination of an experiment to Islamize the whole banking system.

c.) Pakistan: An Effort to Islamize the Banking System. Pakistan has embarked on a phased process of Islamizing its banking system. Prior to the official announcement of the inception of phase one, several government investment corporations were said to be already operating on P.L.S. principles. Starting July 1, 1979, interest was said to be eliminated from the operations of the National Investment Trust (N.I.T.), the Investment Corporation of Pakistan (I.C.P.), and the Home Building Finance Corporation (H.B.F.C.). A couple of financial instruments were introduced to facilitate this process.⁴³

Participation term certificates (P.T.C.) were introduced to eliminate the use of debentures in these corporations, and, in the long run, from corporate finance in general. P.T.C.'s resemble preferred stock insofar as the owners have claim to profits prior to

common stock holders, and no ownership rights are implied by their possession. They are also readily transferable. One important difference is that instead of deferring dividends during down periods, P.T.C. owners are intended to share losses (beyond retained earnings) in the same proportion as they were expected to share in the profits.⁴⁴ This implies an erosion in the value of the funds put forward by the individual investor.

The flotation of the Muḍāraba Control Ordinance in 1980 gave rise to the second of these two financial instruments.⁴⁵ Companies were encouraged to float muḍārabas and issue muḍāraba certificates for specific projects to raise risk capital on a P.L.S. basis. The prospectus of the muḍārabas, which includes the proposed business operations and policies, its capitalized value, and the mode of profit distribution, has to be cleared by a religious board appointed by the government. Bankers Equity Limited was launched in October 1979 as a government corporation designed to act as a muḍāraba company.⁴⁶ These two instruments are a way of raising funds without the intermediation of the banks. P.T.C.'s are in this case the equivalent of unauthorized accounts, whereas muḍāraba certificates are like funds forwarded into authorized accounts.

Funds used by selling time certificates are intended to be used for financing industrial projects, real estate, trading activity, and the leasing of industrial

equipment.⁴⁷ They were also intended to draw some of the funds deposited in the P.L.S. accounts, when the first phase of interest free banking was instituted.

On January 1, 1982, the first phase was officially instituted, and all existing banks began operating P.L.S. account counters. These accounts function in much the same way as those described in Chapter Two. P.L.S. saving accounts allow eight withdrawals in a year, and up to a maximum of Rs. 15,000 (\$1=about Rs. 12.75, Oct. 1982) can be withdrawn in any given month. Investment accounts accept only multiples of Rs. 1,000 for a six month to a five year period. Advance notice is required for withdrawals.⁴⁸ The operational procedure of the banks envisages pooling the profits returned to minimize risk on any individual account. A minimum of 5% to 10% of these profits are also to be earmarked for a reserve fund. It was stated that the greater the fund, the greater would be the bank's ability to insulate members against risk.⁴⁹

The issues of having unauthorized accounts and insulating members against risk again raises the same kind of ethical questions that were discussed when reviewing Islamic joint stock banking in Chapter Two. Once again, having mudāraba certificates transferrable is questionable on the same grounds as was the encouragement of a market in participation certificates. Other practices in the Pakistani experiment have also touched off a

heated debate in the Pakistani press.

In the first phase of the interest-free banking, the P.L.S. funds are being allocated to safe avenues and on a questionable basis. These include the following: the financing of government trade and commodity operations on the basis of a fixed mark-up in the price; dealing in letters of credit for export bills on the basis of a specified commission or exchange rate differential; dealing in import bills on the basis of a mark-up in price.⁵⁰ In each case, the element of a fixed predetermined return to the banks has been found objectionable.⁵¹

Another issue brought up is that the funds in P.L.S. accounts (less than 4% of total deposits in banks)⁵² are not yet being forwarded as venture capital.⁵³ The next phase of interest-free banking, due to be instituted in fiscal 1983, is now being discussed, and it is intended to rectify this shortcoming. Several financial instruments are being forwarded as the basis of financing working and fixed capital.⁵⁴ These, however, are likely to keep the above-mentioned debate going, since at least two out of the three financial instruments mentioned still appear to involve in their formulation a fixed pre-determined return to the lender--the exception being mushārika, to be used to finance working capital in industry.

The other two, hire purchase and leasing, are claimed to be increasingly used in the West to purchase the finance of fixed capital.⁵⁵ As instituted in Pakistan, the leasing contract leaves ownership rights with the lessor (bank) while the lessee acquires possession and utilization rights for a pre-specified rent. This rent is said to be justified by the owners' having to bear the risk of wear and tear and the loss of the article. Hire-purchase is presented as a joint ownership contract. The bank agrees to finance the purchase of the machinery. The user pays a fixed rental and part of the principal (purchase price), and in proportion, the ownership rights are transferred to the user. So in neither case are the P.L.S. principles implicit in these contracts.

There is another concern being expressed about instituting P.L.S. in Pakistan. Borrowers are said to have the ability to understate profit by devious accounting practices. A couple of solutions to this problem have been put forward. One of these is to have bank officials represented on the board of directors of borrowing firms. The idea is being resisted by the corporate sector as one which is threatening to their autonomy.⁵⁶

An alternative suggested solution is to have auditing procedures instituted in selected cases where the firm

is declaring a profit below an average rate for the industry as evident from past experience.⁵⁷ If there is an across the board understatement of profit on any significant scale, then this would not solve the problem since the average itself would be an understatement. Perhaps the solution is to institute a system of random checks.

Whatever the final outcome, there is evidence that the experiment has had some initial success.⁵⁸ On the day P.L.S. accounts were first opened, banks are said to have received Rs. 92.7 million.⁵⁹ After six months from the opening day, there were 300,000 P.L.S. accounts reported to be in existence. The profit rate on P.L.S. saving accounts (announced bi-annually) varied from 8.5% to 9% among the five branch banks. This was said to be higher than the return on the corresponding interest bearing accounts.⁶⁰ One of the banks announced that by August, 1981, deposits in the P.L.S. amounted to 9% of its total interest based accounts.⁶¹

Some data on the growth of P.L.S. accounts and the profits reported has been presented in Tables 7 and 8 below. Table 7 does seem to indicate some public endorsement of interest-free banking. The amount deposited in the P.L.S. accounts by Dec. 31, 1981 was reported to be 12% of total saving and fixed term deposits with the banks.⁶²

Table 8^a

Deposits in P.L.S. Accounts, Pakistan
(million Rs.)

	<u>Saving Acc.</u>	<u>Investment Acc.</u>	<u>Total</u>
Jan. 29, 1981	----	----	973
Mar. 26, 1981	1,423	440	1,863
Dec. 30, 1981	----	----	6,489
April 1, 1981	2,473	5,717	8,190

a Items 1) and 3) are taken from Dawn Overseas Feb. 12, 1982, p. 3. Item 2) is taken from the Pakistan Economic Survey, Govt. of Pakistan, 1981-82, p. 95. Item 4) is from Dawn, May 7, 1982, p. 20.

The profit rates are reported by the bank bi-annually as earlier mentioned. Table 8 below, in four parts, lists the percentage rates of these banks.

Announced profit rates appear to show a slight decline. What is significant is that banks are announcing profit rates so far in advance. They advertise these to be based on past performance. What they do not state is whether these are expected profit rates or a categorical promise to pay a certain percentage return on deposits. The latter probably is the case, since even though P.L.S. accounts exist, according to one report the funds in them are not invested on a P.L.S. basis. In fact, much of the income that forms the basis of a return on these deposits is drawn from mark-ups, rent-sharing commissions, and service charges.⁶³

Table 9^a
Profit Rates Announced by Branch Banks, Pakistan

<u>National Bank of Pakistan</u>			
	<u>6/30/81</u>	<u>12/31/81</u>	<u>6/30/82</u>
Saving Account	8.50	8.50	8.50
Six Month Term	10.75	10.75	10.50
One Year Term	12.00	12.00	11.75
Two Year Term	12.50	12.50	12.25
Three Year Term	13.50	13.50	13.25
Four Year Term	14.00	14.00	13.75
Five Year Term	14.50	14.50	14.25
<u>Allied Bank</u>			
Saving Account	8.50	-----	8.50
Six Month Term	10.75	-----	10.50
One Year Term	12.00	-----	11.75
Two Year Term	12.50	-----	12.50
Three Year Term	13.50	-----	13.50
Four Year Term	14.00	-----	14.00
Five Year Term	-----	-----	15.00
<u>Muslim Commercial Bank</u>			
Saving Account	8.50	9.50	
Six Month Term	10.75	12.00	} 11.75
One Year Term	12.00	13.50	} 13.00
Two Year Term	12.50	14.00	} 14.00
Three Year Term	13.50	14.50	} 14.50
Four Year Term	14.00	15.00	} 14.75
Five Year Term	-----	15.50	
<u>Habib Bank</u>			
Saving Account	9.00	9.00	-----
Six Month Term	11.50	11.50	-----
One Year Term	12.75	13.00	-----
Two Year Term	13.25	13.50	-----
Three Year Term	14.25	14.50	-----
Four Year Term	14.75	15.00	-----
Five Year Term	15.75	15.50	-----

- a Figures for column one were taken from Interest-Free Banking: Introduction and Operation in Pakistan, pp. 73-78. The figures in column two were drawn from Dawn Overseas, Jan. 29, 1982, p. 3. The figures in column three were drawn from Dawn, July 20, 1982, p. 20.

Despite the mildly declining trend in announced profit rates, banks have been able to declare profits on P.L.S. accounts which are greater than interest rates on corresponding term and saving accounts.⁶⁴ It is probable that at this stage, the state may well be subsidizing or supporting the banking sector--which is nationalised anyway--to attain credibility for "interest-free banking." This occurs indirectly anyway since P.L.S. deposits in part finance the fairly safe and lucrative state commodity and trading activities.

State subsidisation and the form in which deposits in P.L.S. accounts are being invested raise some serious questions about whether there really is any Islamization of banking in Pakistan and whether any deposit account should really be referred to as P.L.S. One could answer in the affirmative, in that the public does seem to be responding to the ethical principles that motivate P.L.S. banking. However, the investment activity of the banks, perhaps to avoid the loss of confidence in P.L.S. accounts, falls far short of these very principles.

Investment in ordinary shares and units of state investment corporations (such as the National Investment Trust, N.I.T.) do in principle allow for the possibility of a loss. However, the opinion has been expressed that the N.I.T. units practically guarantee a dividend.⁶⁵ In any case, the government has made plain its intention

to subsidize N.I.T. so that it can compete effectively in an environment where some interest bearing transactions are still afoot.⁶⁶ N.I.T. recently announced the highest returns on its dividends since its inception, and the N.I.T. chief mentioned that these dividends included a government subsidy. A higher still guaranteed dividend has already been announced for 1983.⁶⁷

Discussions have begun on the second phase of Islamization of the banking system (slated to proceed in fiscal 1983) where, among other things, banks will forward their P.L.S. funds as venture capital for financing working and fixed capital for industry. As mentioned earlier, some of the suggested financial instruments like hire-purchase and leasing still appear to involve ribā. Banks are said to be edgy about this next phase of "P.L.S." banking. One suggestion even called for a guaranteed twenty percent return, on the justification of it being the expected profit from industrial projects. Given that there are said to be about thirty eight thousand cases of default in repayment of loans pending in courts, the banks' edginess may be understandable.⁶⁸ Nevertheless, the next phase of interest-free banking is dawning on them, and Habib Bank has already announced its first mushārika agreement.⁶⁹

Conclusion.

The important difference between attempts at establishing Islamic banking prior to the formal launching

of the Islamic banking movement in the mid-seventies and those that came in the wake of the movement is in the presence or absence of government involvement. The lack of government backing in the early spontaneous and decentralized experiments (i.e. the Egyptian venture) may have made them an ideal prototype, but this lack of government support probably also caused their ultimate failure. The Nasser Social Bank of Egypt, which has survived, did have considerable government support. The joint stock banks and the movement to Islamize banking systems in more recent years all have their origins in direct state initiative or encouragement.

In view of this initiative of the state, an observer may wonder whether the movement is based on genuine indigenous sentiment for conformity with Islamic norms or merely the desire to churn out showpieces to please Middle Eastern interests; these interests, in turn, may perceive their masses to be motivated by Islam and are hence concerned with acquiring legitimacy by promoting such activities. It is clearly too early to predict. In some sense, the founders and backers of this movement cannot lose out, since it is one whose outcome may in large part depend on the presence of Islamic sentiment among the masses. If this is true, then the responsibility for the final outcome rests with the masses.

Going beyond speculation to the evidence available,

one can observe that some individual joint stock banks clearly have shown signs of progress. This may suggest some support for the assumption that the success of Islamic banks was partly premised on. This was that funds of the devout were being hoarded rather than put into interest-based institutions and would find their way into Islamic banks.

The expansion of the D.M.I. is proceeding at a fast pace. Time will tell whether, apart from being an ambassador for Islamic financial reform, it can consolidate its current and prospective expansion and be economically viable. The Islamic banking movement made a big investment in establishing the infra-structure of financial institutions and the supporting research, training, and co-ordinating institutions. Even though this investment cannot guarantee the movement's ultimate survival, it certainly has given it a great deal of momentum for now, a momentum large enough to attract the attention of Western observers.⁷⁰

The Pakistani experiment is also in its very early stages and proceeding very cautiously. Judging from the liability side of the banks' balance sheets, the Pakistani public has shown some willingness to participate and endorse this venture by patronising "P.L.S." accounts. So far, the risk these funds should in theory be subjected to in the asset side of the balance sheet is being either minimized or avoided. The second phase

of the interest-free banking reform is intended to rectify this. The ability of the banks to continue showing profit rates when P.L.S. funds are used as venture capital (in conformity with Islamic norms) will be the true test of the viability of interest-free banking and its ability to contribute to development. Such an ability was widely proclaimed to be one of its major advantages.

The final phase of interest-free banking was originally scheduled to begin in January, 1982, in Pakistan. Interest was expected to be completely eliminated from domestic transactions in this phase. Banks were due to cease accepting all interest-based deposits, and all inter-bank and state activities were to be put on an interest-free footing. International transactions and aid were also planned to be engaged in free of interest. Presumably, this was envisaged to follow from fairly complex negotiations. This program has been delayed, but according to official statements by no means abandoned.

In fact, these moves towards Islamization may well be irreversible in a country where the sentiment for Islam is strong even if the political regime changes. The course for banking in Pakistan seems set, and one that the authorities may find it was easier to get into than out of. Yet, even if this is so, it remains to be seen whether the nationalized banks will follow it in

consistency with the ethical principles that banking reform was premised on or whether they will attempt to circumvent those principles and bypass structural change by devising financial instruments that amount to tinkering with the form but not changing the substance. Judging from evidence of current "P.L.S. practice," the latter course may well be the case.⁷¹

Notes to Chapter Five

¹This term was used by Pamela Ann Smith in "OPEC Surplus Funds: Arab Institutions Play a Greater Role," Middle East Review (Essex: World of Information, 1982), p. 57.

²Arabia, April 1982, no. 8, p. 46.

³Arabia, March 1982, no. 7, p. 53.

⁴This description is drawn from Ahmad A. El-Naggar, "Islamic Banks: A Model and the Challenge," in The Challenge of Islam, ed. Altaf Gauhar (London: Islamic Council of Europe, 1978), pp. 221-234. Dr. El-Naggar, the founder of this experiment, has since become one of the leading figures in the Islamic banking movement.

⁵Data is drawn from R.K. Ready, "The Egyptian Municipal Saving Bank Project," International Development Review, June 9, 1967, pp. 2-5.

⁶Ready, p. 4.

⁷Asif Huda, "The New Islamic Bankers," Middle East, 89, March 1982, p. 68.

⁸Ready, p. 4.

⁹El-Naggar, p. 228.

¹⁰Information on the Nasser Social Bank is drawn from a report edited by Banker Research Unit, titled Banking Structures and Sources of Finance in the Middle East (London: Financial Times Business Publishing, 1980), pp. 177-180.

¹¹For a more detailed description of the I.D.B.'s objectives and policies, see Afzul Rehman, Banking and Insurance (London: The Muslim School's Trust, 1979), IV, 419-424.

¹²Arabia, July 1982, No. 11, p. 66.

¹³Arabia, July 1982, No. 11, p. 66.

- ¹⁴ Arabia, March 1982, No. 7, p. 52.
- ¹⁵ Dawn, May 26, 1982, p. 11; this news item cites the promotion of jute exports to Bangladesh as an example.
- ¹⁶ Arabia, July 1982, No. 11, p. 66.
- ¹⁷ Arabia, Nov. 1982, No. 15, p. 52.
- ¹⁸ Arabia, Nov. 1982, No. 15, p. 52. For an account of D.M.I.'s activities also see Arabia, June 1982, No. 10, p. 56 and Aug. 1982, No. 12, p. 50.
- ¹⁹ Dawn Overseas, Aug. 13, 1982, p. 16.
- ²⁰ Arabia, Nov. 1981, No. 3, p. 74.
- ²¹ For a detailed account of the establishment of the I.A.I.B. and its objectives and activities, see A.A.A. El-Nager et. al., One Hundred Questions and One Hundred Answers Concerning Islamic Banks (Cairo: International Association of Islamic Banks, 1980), pp. 138-151.
- ²² Arabia, Dec. 1981, No. 4, p. 79. Other conferences have been held in Texas, Geneva, and Stockholm.
- ²³ Arabia, Aug. 1982, No. 12, pp. 50-51.
- ²⁴ Dawn, June 24, 1982, p. 2. Also see Interest-Free Banking: Introduction and Operation in Pakistan (Karachi: Asian Secretariat, I.A.I.B., n.d.), pp. 107-112. This source contains a more detailed description of the formation and intended role of the I.A.I.B. and the I.I.I.B.
- ²⁵ Arabia, June 1982, No. 10, pp. 56-57.
- ²⁶ Arabia, Sept. 1982, No. 13, p. 35, and Oct. 1982, No. 14, p. 53.
- ²⁷ Dubai Islamic Bank: Annual Report 1981 (Dubai: Dubai Islamic Bank Printing Press, n.d.) pp. 7-8.
- ²⁸ Bahrain Islamic Bank: Annual Report 1980 (Bahrain: Arab Printing and Publishing House, n.d.), p. 13.
- ²⁹ Arabia, Sept. 1982, No. 13, p. 37.
- ³⁰ This account is based on Abdel-Rahim Hamdi, The Operations of Faisal Islamic Bank (Sudan) (Khartoum:

National Printing and Publishing House, n.d.) pp. 7-27.

³¹Faisal Islamic Bank (Sudan), Report of the Board of Directors to the First Annual Meeting of Shareholders, April 1980 (Khartoum: Sudanese Colourphoto Laboratories, n.d.), p. 19.

³²Arabia, August 1982, No. 12, p. 50.

³³Arabia, August 1982, No. 12, p. 50.

³⁴Simon Proctor, "Growing Influence of Islamic Banks," Financial Weekly, Nov. 4, 1979.

³⁵Arabia, Oct. 1981, No. 2, p. 68.

³⁶Arabia, Oct. 1981, No. p. 68.

³⁷Arabia, April 1982, No. 8, p. 46.

³⁸This information is drawn from Jordan Islamic Bank's Board of Directors' Annual Report for 1979 and 1980.

³⁹Jordan Islamic Bank, Board of Directors' Annual Meeting (Amman: Al-Sharq Press and Library, n.d.) p. 16.

⁴⁰Faisal Islamic Bank (Sudan), 1980, p. 5.

⁴¹Faisal Islamic Bank (Sudan), 1982, p. 2.

⁴²Faisal Islamic Bank of Egypt, Annual Report 1981 (Cairo: Sharouk Press, n.d.), p. 48.

⁴³Interest-Free Banking, pp. 41-53.

⁴⁴D.M.Qureshi, "Budget in the Context of the Islamic Economic System," Pakistan Economist, July 26-Aug. 1, 1980, No. 30, pp. 10-11.

⁴⁵Pakistan Economic Survey (Islamabad: Govt. of Pakistan, Finance Division of Economic Advisor's Wing, 1980-1981), p. 95.

⁴⁶Interest-Free Banking, p. 55.

⁴⁷Pakistan Economist, July 26-Aug. 1, 1980, No. 30, p. 10.

⁴⁸Pakistan Economist, Dec. 20-26, 1980, No. 51, p. 5.

- 49 Pakistan Economist, Dec. 20-26, 1980, No. 51, p. 5.
- 50 Pakistan Economic Survey, pp. 96-97.
- 51 Pakistan Economist, March 28-April 3, 1980, No. 13, p. 12.
- 52 Arabia, Oct. 1982, No. 14, p. 52.
- 53 Dawn Overseas, April 9, 1982, p. 7.
- 54 Dawn, May 7, 1982, p. 20.
- 55 The discussion of these two contracts is based on Abdul Jabbar Khan, "Interest-Free Banking: What It Means," Dawn, March 23, 1982, p. viii.
- 56 Dawn Overseas, April 9, 1982, p. 7.
- 57 Pakistan Economist, Jan, 10-16, 1981, No. 2, p. 11.
- 58 John Fullerton, "Time to Lift the Lid," Far Eastern Economic Review, June 4, 1982, p. 23, reports that the "P.L.S." is proving to be a success and the envy of Middle Eastern states; Oliver Scott, "Islamic Banking: Is It Here to Stay?" The Banker, 129, No. 646 (1979), p. 75. Scott reports that most Islamic institutions are doing well as measured by profitability for investors. A contrary view is presented in Arabia, June 1982, no. 10, p. 28.
- 59 Pakistan Economic Survey 1980-1981 (Islamabad: Finance Division of the Economic Advisor's Wing), p. 95.
- 60 Interest-Free Banking, p. 73.
- 61 Interest-Free Banking, p. 76.
- 62 Dawn Overseas, Feb. 12, 1982, p. 3.
- 63 See S.A.A. Rizvi, "Experiment with Islamic Banking," Dawn: Economic and Business Review, Sunday, Aug. 8, 1982, p. III
- 64 Dawn Overseas, Feb. 12, 1982, p. 3.
- 65 Latif Ahmed Khan, "N.I.T. Units Mean Guaranteed Dividend," Dawn, May 18, 1982, pp. 9-10.
- 66 Interest-Free Banking, p. 93.

⁶⁷Dawn, Aug. 1, 1981, p. .

⁶⁸Dawn Overseas, April 9, 1982, p. 7.

⁶⁹Dawn Overseas, Aug. 6, 1982, p. 3.

⁷⁰Scott, p. 73. Scott asserts that Islamic institutions and instruments of finance "stand in ever greater need of being considered seriously."

⁷¹The Council of Islamic Ideology in Pakistan is reported to have arrived at a similar conclusion about the experience to date of implementing P.L.S. in Pakistan. See Arabia, Oct. 1982, No. 14. p. 52.

CONCLUSION

In this concluding chapter, I will begin with a summary of the major findings of the dissertation. Following that, I will pick up the theme of social justice in an Islamic political-economic system (introduced in Chapter One) and discuss the following: a.) how profit-and-loss sharing (P.L.S.) contributes to social justice; b.) social justice with regard to the position of wage labor; c.) the relationship of equality and social justice. The first of the three topics is chosen because it relates directly to this study, and the second two because of the heavy emphasis on them by contemporary Islamic political economists. Finally, I will make recommendations for further related research.

I. Summary of Findings.

Social justice is identified in Chapter One as the primary goal of an Islamic political-economic system. This is one of the very few issues on which a consensus exists in the literature pertaining to Islamic political economy. Some scholars (secularists) question the very concept of an "Islamic state," whereas others (Islamists), who agree on the latter being a legitimate entity, differ on its basis and structure of authority. The most

important controversy identified among Islamists concerns the scope of ijtihād (independent reasoning) and in what form that right is to be embodied. This issue is critical in determining the future complexion of any state that seeks to put itself on an Islamic footing.

Islamists also differ on the scope of the prohibition of ribā (appropriation of value without provision of a corresponding socially productive countervalue). Modernists consider the ban to apply only to interest on consumption loans, whereas the orthodox assert that it implies a ban on a whole range of transactions, including all those involving interest. Since lenders largely bear the risk in a P.L.S. contract, the return to them is considered justified by the orthodox; risk related to productive ventures is considered a legitimate countervalue for the drawing of profit on a productive loan.

A study of the institutional operations of existing Islamic banks indicates that in many cases they are attempting to minimize or eliminate risk. "Unauthorized" P.L.S. accounts which pool risks, and for which banks maintain a reserve fund, are cases in point. Even where accounts are "authorized," i.e., deposits are directly linked to a project, ribā may still exist in covert form due to the existence of reserve banking or inflation.

P.L.S. banking seeks to replace the very complex capitalist financial market that competes for savers' funds by providing a mix of risk, return, liquidity and convenience. The resultant loss of financial flexibility

is all the greater because of the restrictions typically imposed on the transfer of P.L.S. participation certificates. On the other hand, the economic strength of a P.L.S. system lies in the degree to which it is successful in forging a closer link between the money and real sectors by having banks act as pure intermediaries and by diverting energy normally expended on non-productive speculation into productive activity. It should be noted, however, that Islamic proponents of interest-free banking are primarily concerned with the ethical and social benefits of P.L.S. rather than with any economic advantages.

The analysis in this dissertation does indicate that P.L.S. is a viable basis on which to operate a banking system and a market for loanable funds. In the absence of interest, profit shares would equilibrate the market for loanable funds. Profit shares would also reflect the opportunity cost of capital, since the average profit rate under P.L.S. would constitute an indicator of the amount foregone from the use of loanable funds in a particular activity.

In Chapter Three, I indicate why it is difficult to establish theoretically what would happen to the supply of loanable funds if P.L.S. were substituted for a conventional capitalist financial system. Insofar as a P.L.S. system restricts the financial options available to lenders, it would tend to reduce the supply of loanable funds. This might be

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In Chapter Three, I indicate why it is difficult to establish theoretically what would happen to the supply of loanable funds if P.L.S. were substituted for a conventional capitalist financial system. Insofar as a P.L.S. system restricts the financial options available to lenders, it would tend to reduce the supply of loanable funds. This might be

offset to some extent by the injection into P.L.S. accounts of funds that would otherwise be hoarded--in a form that kept them out of circulation--because of a moral disaffection with interest based institutions. As long as output prices keep pace with the general level of prices, borrowers and lenders will both be insulated from the effects of inflation. The purchasing power of fixed interest payments to lenders is however eroded by inflation. Thus P.L.S. can avoid a redistribution of income from lenders to borrowers and thereby encourage the supply of loanable funds.

On the demand side, P.L.S. could encourage investment since the borrower's payments to lenders takes the form of a profit tax rather than being a fixed cost of production as is the case with interest payments. Also, to the extent that P.L.S. allows entrepreneurs to pass off part of the uncertainty of production on to the lender, the demand for funds on a P.L.S. basis would increase. However, entrepreneurs would be less enthusiastic about engaging in P.L.S. where the profits are high and the outcome more certain. Thus it is likely that the composition of investment under P.L.S. would shift toward more risky ventures. It is not possible to predict, however, how the various mutually offsetting demand and supply side influences would effect the overall level of investment.

Insofar as a fixed pre-determined interest charge induces greater cost-consciousness, its replacement by

P.L.S. might result in a loss of efficiency. In the long run, however, firms showing below average rates of profit on a sustained basis would find it difficult to survive even under P.L.S., given the existence of perfect competition. In an interest-based system, firms often run up a high debt/asset ratio. This can exaggerate the instability of an economy. In a downturn, it could result in bankruptcies due to foreclosures and thus prolong a recession. With P.L.S., a downturn might be less severe because losses would be more widely shared and bankruptcies avoided. But the surviving firms would include some inefficient ones that would not normally have survived.

It was shown in Chapter Four that a P.L.S. land tenure arrangement could provide an alternative to sharecropping and land renting. However, this alternative is likely to have a higher contract cost than sharecropping. In sharecropping only the total output has to be monitored, but in a P.L.S. contract both costs and output have to be kept track of since the operating surplus rather than the total output would be shared. Since much of the risk is passed on to the owner of loanable funds--in all probability the landowner--and since the contract costs are likely to be very high, the proscription of sharecropping and land renting and the endorsement of only P.L.S. as a form of tenure arrangement might well lead to a progressively greater number of owner operated farms. Whatever the economic benefits or costs of such a trend, some Islamists look to the virtues of such a contract on an ethical level.

according to the interpretation of most Islamic scholars.

II. Social Justice In Islam.

a.) P.L.S. and Social Justice. Social justice is a very broad concept, and therefore its defining parameters need to be specified to assess whether an activity contributes to attaining or negating it in an Islamic context. For the Islamist, two premises are pivotal in defining these parameters: first, that the Qur'ānic legislation is just, and second, and following from this, that the other sources of Law are grounded on justice in general and social justice in particular. Thus, whether or not an activity contributes to social justice, in an Islamic sense, or negates it, should be discerned in the context of the Qur'ānic and other legislation pertaining to it.

This procedure is not free of controversy. Modernists have qualified the first premise by suggesting that certain specific Qur'ānic legislation was meant by the Qur'ān itself to be relevant only to the particular social context it was revealed in.¹ In fact, the principal identifying feature of a modernist may well be his emphasis on the eternal principles of the Law as opposed to any specific legislation.² Also, there are differences among the orthodox and the modernists on the sources of the Law in general and on the interpretation of specific legislation in particular.

It seems therefore that the only way to proceed with this discussion is to specify the interpretation adopted on specific legislation and assess an activity or contract in the light of that. In Chapter One, ribā was defined and discussed at considerable length, and a broad interpretation of it was adopted. The elimination of ribā clearly contributes to Islamic social justice. In the context of that interpretation, one must conclude that P.L.S. can contribute to social justice by allowing the framing of contracts for productive loans in such a way as to avoid ribā. P.L.S. also weighs the contract in favor of borrowers (entrepreneurs) as opposed to lenders. This is consistent with a widely expressed view in contemporary literature on Islamic political economy that Islam regards labor, or more generally effort, to be of primary significance in the production process.³

This latter statement indicates how restricted the scope of P.L.S. is with regard to its bearing on social justice. It concerns itself solely with the financial aspects of a productive venture--both in industry and agriculture. In both cases, wage labor stays very much in the background. Since wage labor undoubtedly contributes significantly to a productive endeavor, and since it is held in such high esteem in Islam, more needs to be said about it.

b. Wage Labor and Social Justice. Much of the

work on this subject emphasizes that Islam prescribes a harmonious relationship based on fairness to both employee and employer. Freedom from exploitation, in any form, has been shown to be explicitly prescribed in the Qur'ān and the Hadīth.⁴ These sources of Law stress in particular the right of the workers to a "just" wage without any delays. Chapra (1979, p. 15) infers from these sources an "ideal" wage to be one which would enable the employees to live as do the employers.⁵ This position is also said to be reflected in the Māl-iki legal view which, according to Mohammad Quth (1972, p. 135), holds that employees and employers contribute equally to production and should share equally in the revenue. To sum up, the position on labor in Islam, the employer has the right to the honest and industrious effort by the employee, whereas the employee has the right to freedom from exploitation.

If employers have power over their employees, there is clearly a potential for exploitation that cannot be dismissed by asserting, as does Mannan (1970, p. 131), that "Islam does not recognise exploitation of labor by capital." At least two steps are involved in bringing the reality of employer-employee relations closer to the Islamic ideal of harmony and freedom. First, a contract which embodies a just association--in an Islamic framework--between employer and employee has to be decided upon. Second, having agreed to that, the

institutional mechanism to enforce the contracts has to be agreed upon and made operative.

The second point, which involves examining questions such as the use of persuasion, the market, or institutional force, was discussed in Chapter One, and I will return to it. As to the contract referred to above, there is evidence that muḍāraba (profit sharing) was used by the medieval Near East societies as a form of association between employees and employers as is suggested by the following quote from Udovitch (1970, p. 184): "From the Geniza documents it is apparent that employment as a form of economic collaboration was eschewed, since dependence upon others for livelihood was considered degrading and humiliating. Consequently, many enterprises, no matter how modest a scale, requiring the combined efforts of more than one person would be organised in the form of partnerships and commendas (muḍāraba).". Islamic economists have also suggested the extension of muḍāraba, or what has been labeled as P.L.S. in this study, to employment in industry and agriculture.⁶

P.L.S. cannot be applied to wage contracts in the same way it was to financial contracts for productive loans. Whereas it is required that the contribution of loans be determined ex post, the same does not follow with labor. This is because once labor is actually

engaged in production, the effort is actually expended whether or not the final outcome of a venture is profitable. The same, however, could be said of entrepreneurs. The one difference may be that workers are often in a less financially secure position to risk their time and effort and hence the source of livelihood for a family. Haque (1980, p. 22) cites some cases where jurists forbade contracts based on output sharing in situations where the worker's livelihood--and therefore that of his family--is threatened. Such a situation does not have to be the norm, however, and the quotation from Udovitch above does seem to imply, in the modern context, some form of producer co-operative.⁷

The concept of "profit sharing," as developed in France by Edmé Jean LeClaire in 1835,⁸ may also be relevant to the formulation of an employment relationship consistent with Islamic Law. Profit sharing in this case means a fixed wage plus a share in the profits. This idea was developed as an alternative to producer co-ops that would be consistent with the wage system. Its advocates view its main advantage to be increased worker motivation and therefore reduced enforcement costs, more flexibility in depressed business conditions where profits' distribution can be cut back rather than having to lay off workers and more generally an increased identification of workers with the enterprise.⁹ Islamic economists view the latter

to be of a high priority, and some have even advocated exactly the same contract.¹⁰

P.L.S. may be viewed as a small part of a larger framework for attaining social justice in an Islamic context. The other important elements in this framework, apart from what was discussed above, include the elimination of ribā in its various forms (rent, black-marketing, fraud, non-productive speculation, monopoly) as well as the establishment of zakāt (welfare tax) and Islamic inheritance laws.

c. Social Justice and Equality. Equality is the one broader philosophical concept that relates importantly to social justice which Islamic scholars tend to feel most defensive about. They are emphatic in denying the relevance of the concept of "class" in Islam. The Qur'ānic injunction about the "brotherhood of man" is interpreted to be antithetical to the concept of class, as is the Prophet's saying about "all believers being equal as the teeth of a comb."¹¹ In fact, Mitchell (1964, p. 215) noted that the Muslim Brotherhood in Egypt objected to Sufism as "un-Islamic" because its orders were based on a class system. At the same time, however, the Qur'ān categorically reveals that men are not equal in their talents and abilities and that some are blessed with more than others in order that they may be tested.¹² Thus, while class is rejected, inequality per se is not. Syed Qutb (1970, p. 28)

asserts in his treatment of social justice in Islam that absolute equality itself may be unjust. He argues that it would be unjust to deny remuneration in proportion to talent, ability, or effort solely because doing so may lead to inequality. Thus imposing equality of one form may lead to inequality of another form.

A distinction is often made in the literature between economic and social inequality; while the former is considered acceptable, the latter is not.¹³ The measure of social justice is said to be the provision of equality of opportunity and not equality of outcome.¹⁴ The problem, of course, is that (social) inequality of opportunity tends to result from (economic) inequality of outcome, even if in theory access to all career building institutions is based on merit and the financing is provided by the state. Nonetheless, increasing equality of opportunity would be a significant step toward the goal of social justice. This leads to the issue of how this and other aspects of social justice are to be attained in an Islamic state.

From the discussion of this issue in Chapter One, I concluded that all three control mechanisms (persuasion, market, and authority) had a role in an Islamic political-economic system. However, where the market or persuasion failed in a particular circumstance to have a socially just outcome, authority would be relied upon, as a last resort, to bring it about. But authority

can only be relied upon if there is some guarantee that it will not adopt a partisan position. Some institutional mechanism would have to be devised to reduce widely held grievances where authority is found wanting, or authority itself is in violation of the Law. Without that, the talk of social justice would really amount to the rhetoric of political expediency in some cases and a utopian vision in others.

III. Suggestions for Further Related Research.

Probably the most critical related research need at this point is for empirical studies of P.L.S. At least one individual bank has been in operation for almost ten years, and several have been in operation for almost five. This is enough time for intensive case histories. These could be the basis of investigating several issues, particularly those that arise from having to function in a financial system that maintains the interest option. Where the banks have shown a success, it is important to attempt to identify its cause. For example, the success could be based on advantageous tax provisions, direct subsidies, or the patronisation of the banks by the devout. Again, it would be instructive to analyse the composition of the bank's investment to determine if it shows a pattern consistently different from interest-based banks. It would be useful to assess how a bank dealt with various operational problems like the heavy burden of management or with clients

that may have understated profits. These are, of course, some of the more obvious questions. Familiarity resulting even from informal interviews may also lead to more subtle insights. Given the resources, a cross-national survey may prove well worth the expense by gathering information on these and other issues.

The Pakistani experiment is in the early stages as yet. Still, insofar as it may be viewed as a test case, research and documentation of its various phases are important. Also of importance in this case would be attempts to measure the impact of introducing P.L.S. on key macro variables, such as savings, the composition of investment, the level and changes in the level of economic activity and the movement of the general level of prices.

In the second section of this concluding chapter, I discussed the question of social justice with regard to the position of wage labor. Given the emphasis placed on social justice in Islam by Islamic scholars, the need for further research into this issue cannot be overlooked. I suggested producer co-operatives and profit sharing contracts currently being discussed and in use in the West as possible directions for such research.

Since explaining the functioning of the market for loanable funds was a primary objective of this study, a

partial equilibrium analysis seemed justified to me.

A useful extension of the modeling done here would be the integration of a market for loanable funds into a general equilibrium framework to allow for an analysis of interaction with other macro variables such as income. This, of course, must be done in the context of a particular economy. For example, an analysis of a capital-scarce country is likely to proceed differently from that of a capital-abundant country.

In this sub-section I have concerned myself with presenting some of the issues related to P.L.S. that are in need of further research. Similar research agendas could be composed for other elements of an Islamic economy."

Notes to the Conclusion

¹Fazlur Rehman, Islam, 2nd ed. (Chicago: University of Chicago Press, 1979), p. 39; Asaf A.A. Fyzee, "The Reinterpretation of Islam," in Islam in Transition, ed. John J. Donohue and John L. Esposito (New York: Oxford University Press, 1982), p. 190.

²This point is made by Fazal Rahman in "Islam: Challenges and Opportunities," in Islam: Past Influence and Present Challenge, ed. Alford T. Welch and Pierre Cachia (Edinburgh: Edinburgh University Press, 1979), p. 326.

³See, for example, Abulhasan Bani Sadr, Work and Worker in Islam, trans. Hasan Mashadi (Tehran: Hamdari Foundation, n.d.), p. 9.

⁴M.A. Mannan, Islamic Economics: Theory and Practice (Lahore: Ashraf Press, 1970), p. 110; S.M. Yusuf, Economic Justice in Islam (Lahore: Ashraf Press, 1971), p. 110; Hakim M. Said, The Employer and the Employee: Islamic Concept (Karachi: Dar al-Fikr al-Islami, 1977), pp. 81-100.

⁵Chapra also defines a "just" or minimum wage and asserts (without proof) that the market wage will lie between the just and the ideal wage.

⁶S.A. Irshad, "Economic System for Interest-Free Islamic Society," in Some Aspects of Islam, ed. M.N. Huda (Karachi: Motamar al-Alam al-Islami, 1964), p. 58; Irshad Ahmad, "Islamic Economy and the Elimination of Interest," Voice of Islam, 12, No. 2 (1963), p. 84.

⁷For a discussion and references on producer co-ops see The Political-Economy of Co-operation and Participation: A Third Sector, ed. Alasdair Clayre (Oxford: Oxford University Press, 1980); in particular see the introductory chapter by the editor himself.

⁸Bert L. Metzger, "Evolution of the Profit-Sharing/Share Ownership Philosophy Worldwide" (Evanston: Profit Sharing Research Foundation, 1980), p. 1; Metzger is the president of the Profit Sharing Research Foundation

and a strong advocate of this contract as the solution to industrial relations problems and the prescription for declining productivity. He is the author of numerous other pamphlets issued by the same foundation in which he presents the profit sharing philosophy, almost as a panacea for industrial woes, and indicates that an increasing number of firms are taking the idea seriously. A celebrated advocate of profit sharing was Charles DeGaulle, who declared it to be the third way between capitalism and communism; see "Poor Man's Capital," Economist, May 3, 1980, pp. 84-85.

⁹ For some of the early advocates of profit-sharing see Sedly Taylor, Profit-Sharing between Capital and Labor (London: Kegan, Trench, and Co., 1884); Nicholas P. Gilman, Profit-Sharing between Employer and Employee (Boston: Houghton, Mifflin, and Co., 1889); Burrit et. al., Profit-Sharing: Its Principles and Practice (London: Harper, 1918); Johnson Foundation Education Center, A New Approach to Collective Bargaining? Progress Sharing at American Motors (Wisconsin: May, 1962). Several of these sources line up J.B. Clark as one of the prominent advocates of this contract. For a contrary view see Bryce M. Stewart and Walker J. Couper, Profit-Sharing and Stock Ownership for Wage Earners and Executives (New York: Industrial Relations Councilors, 1945), pp. 43-54.

¹⁰ Said, p. 102 suggests a wage policy that guarantees basic needs plus a share in the profits. Sadr, p. 54, expresses skepticism about such a policy, arguing that profits can easily be understated. He urges instead the idea of worker representation in management.

¹¹ A.H.A. Abu-Sulayman, "The Theory of Economics in Islam: The Economics of Tawheed and Brotherhood," in Contemporary Aspects of Economic Thinking in Islam (n.p.: American Trust Publications, 1976), pp. 21-24; M. Muslehuddin, Economics and Islam (Lahore: Islamic Publications, 1974), pp. 88; XXI: 92, XLIX: 10.

¹² Anas Zarqa, "Islamic Economics: An Approach to Human Welfare," in Studies in Islam, ed. Khurshid Ahmad (Leicester: The Islamic Foundation, 1980), pp. 11-12; Muhammad Hameedullah, "Review on J. Hans: Homo Oeconomicus Islamicus," Islamic Quarterly, 2, No. 2 (1955), pp. 142-146; VI: 165, XVI: 71.

¹³ Afzal-ur-Rehman, Economic Doctrines of Islam (Lahore: Islamic Publications, 1974), I, p. 83; Ayatollah Yahya Noori, "The Islamic Concept of State," Hamdard Islamicus, 3, No. 3 (1980), pp. 78-80.

¹⁴C.N. Ahmed, Principles and Objectives of an Islamic Economy (Calicut: Ansari Press, 1964); p.52
Amir H. Siddiqui, Studies in Islamic History (Karachi: Jamiyal-ul-Falah Publications, 1967), p. 98.

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