

ISLAMIC ECONOMICS, what Went Wrong?

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Historical background

Before discussing the subject of this presentation I like to make a quick review of my perception of the history of contemporary Islamic economics.

Although the word “Islamic Economics” was used for the first time by Islamic writers of the Sub-Continent in the 1940s, writing on Islamic economics date back to the thirties with the beginning of the contemporary Islamic political movement both in the Sub-Continent and the Arab world. Anwar Quraishi (1948) was perhaps the first economist who attempted to discover an Islamic Theory based on the prohibition of Riba. Since then we started having publications and research on Islamic economics by three breeds of people: socio-political activists, Shari’ah scholars with little exposure to some kind of economics and Western trained economists with little or not so little exposure to Shari’ah scholarship. Sorting these writings and publications is very important to understand the development of Islamic Economics in the second half of the past century.

The first category of writings is normally general, political oriented and condensed in the form of social and political slogans. The second category is loaded with Fiqh in both methodology and focus; with extremely few exceptions it is more of Fiqh al Mu’amalat than any economics. Lastly a considerable chunk of the writings in the third category is based on a precept of self-proclaimed distinctiveness. It is essentially the third category writings that should be the focus of our study and evaluation. Of course, there are other economic and political writings, In Arabic and Other languages of the Muslim countries, that did not claim being Islamic or associated with the Islamic ideology/economics. These are completely outside our consideration although some writers likes to group them within Islamic economics for objectives in their own hearts.

Islamic Economics:

Paradigm, discipline and independence

Is Islamic economics independent from economics? Does it make a paradigm of its own? Does it depend of a set of assumptions and analytical tools that is different from economics? Does it make a discipline of its own?

Many Islamic economists have an undoubted affirmative answer. They argue that it is independent and they take upon themselves the task of attempting to invent an “appropriate set” of tools to understand the behavior of Muslim consumer, firm, macro numbers. The fervor of this attitude was very apparent when the world of economics had two-part Apartheid: communism and capitalism. In fact, communist writers also

attempted to identify theirs as an independent paradigm while the capitalist have hidden their agenda under the plain name of “economics” for a long time.

To the Islamic religion and ideology, capitalist and communist thinking stem from a common utilitarian ideology that looks only at the human as a “homo-economicus.” It is therefore natural that many Muslim economists would view a multi-dimensional motive in the behavior of women and men and would rise against the purely utility motivated man as a basic assumption of economics. This would certainly call for a paradigm that is completely different from the paradigm of economics! But although the majority of capitalistic economists hide their real assumptions behind a thin layer of “a purely rationalist science of economics,” economics itself grew out of their shell to develop studies on altruism, philanthropy and other non-utilitarian motives.

Ibn Khaldun, the real founder of Economics as a branch of social studies, established his newly invented science on an absolute human basis and aimed to understand the individual and collective behavior of human beings “as they are” without imposing on them any pre-structured ideological, religious or societal assumptions. He did not have a “stigma” of distinctiveness that would have required him to “alienate himself from the rest of the human race, infidels or fidels alike. He even did not need to add a prefix “Islamic” in every sentence and before every variable and tool of analysis, although he recognizes the Divine Revelation as the Major source of knowledge. He also did not have an urge to “Islamize” the heritage of knowledge as it is handed over from one nation to another throughout history.

If we were to extend Ibn Khaldun to the subject of our debate today, we would find him discussing “economics” without being afraid to loose his identity; he would accept or reject theories and assumptions on their own merits and according to their reflection of the behavior of women and men, in their individual endeavors (micro) as well as in their association together (macro) on the basis of the “totality” of human beings without departmentalization or segmentation; he would also be able to criticize the established or accumulated ‘economics’ on the basis of its deficiency of its basic utilitarian assumption that ignores other intrinsic human motives.

From the point of view of the Khaldunian social science, Economics is itself Islamic Economics without having to use the “prefix” and without shying from criticizing the established capitalist wisdom (and/or the communist quasi-wisdom) as being partial and inadequate.

The Discipline

On the other hand, the looseness of our economic jargon gives room for terms like ‘capitalist economics,’ ‘socialist economics,’ ‘communist,’ ‘welfare’ and what-not economics. These are in fact studies of branches of economics that make a subset of the whole but they have their own assumptions and peculiarities. They include the study of an economic system within certain ideological and legal framework and the study of the individual and collective behavior of the units within the system.

Islamic economics is also looked at as the study of the individual behavior of units and of the macro variables within the legal and ideological framework created/envisioned by Islam.

Some people may like to question whether Islam has a legal and ideological framework of a society. I take this issue as outside the scope of this meeting and put it in the following form: Islamic economists, along with a great number of Muslims believe that Islam set forth a socio-political-cum-legal framework of a society in addition to its ideological foundation based on the belief in the Oneness of God and the imperative nature of His Revelation.

Accordingly, **Islamic economics is a branch of economics that studies the units and variables within the Islamic legal and ideological framework, actual or assumed.**

Over Statements

It is natural in any new endeavor to see some professionals carried out to different kinds/levels of exaggeration. In Islamic economics, we have our full share of overstatements. You find such things in writings that deal with the factors of production where terms such as 'Islamic capital' 'Islamic labor' Islamic land and 'Islamic production function' are used. You also find writings that deny renting of land and physical capital because as an extension of the prohibition of interest, being pre-determined fixed return on capital. You will also find overstatement of the uniqueness of the Islamic market on the ground that it is a market that is pure of cheating, fraud and monopoly, not realizing that any reasonably competitive market is also void of such practices. These kinds of exaggeration are usually short-lived as they cannot stand critical evaluation.

Islamic Economic System

In the short history of contemporary Islamic economics, we also encounter two other interesting phenomena: an overstatement of the uniqueness of the objectives of the Islamic Economic system, and a mix up or confusion of principles and tools of analysis.

Driven by a sense of idealism, some of us attribute a special status to the general objectives of the Islamic economic system: Full employment, satisfaction of basic human needs, economic-cum distributive justice, development or improvement in the quality of economic life, economic power, etc. But a closer examination of these objectives indicates us that they are the same for each and all economic systems as usually expressed in their economic-political rhetoric throughout the human history. More specifically, these objectives are also the core objectives of socialism, communism and capitalism even anarchism and all or "isms." The same also arises with regard to the institutions of market, factors of production and the principle of government intervention whereby some Islamic economists try to draw a so called "Islamic" picture that is very different from the conventional wisdom that is common to other economic systems.

This is not to deny a certain uniqueness of the Islamic economic system. This uniqueness is founded on the principles of Islam as a revealed religion as they strike a balance way of life that is not tilted in either direction. A uniqueness that lies essentially in two things:

The explicit acceptance of the Divine Revelation as a source of knowledge and certain detailed pivotal institutions such as the prohibition of Riba (interest), the private-public mix of property/ownership, the spiritual-material mix of success, Zakah, Awqaf, etc. in other words, while the general objectives and the tools of analysis of Islamic economics are the same in economics itself, the some aspects of the institutional setting of the Islamic economic system are different, or the means this system uses to reach the common goals are not exactly the same as in other system the utilitarian capitalist which is generally given the name economics and the utilitarian communist which is dictatorial by definition.

Another important area of uniqueness of the Islamic economic system must be brought out explicitly. It is the moral characteristic of its articulation, on both the principles' level and the level of the practical rules and regulations. This moral characteristic makes a boundary of the accessible set of actions/decisions/ behaviors of the economic unit. The economic unit in the Islamic system is equipped with the ability to judge possible courses of action on moral grounds, the same way one finds in all societies and systems but to this the Islamic system adds an external screen apparatus that is manifested in the set of morally-based rules of do and do not that takes the form of the Shari'ah or the Islamic law. Some of Islamic economists call this characteristic "the moral internal and external screening." We must realize, however, that the Shari'ah based morality includes items that are not conventionally taken as moral matters such as 'pork production' but we must also realize that the contemporary moral standards of the capitalist utilitarian societies is subject to an accelerating dynamism that associate relativity to all conventional morals.

Moreover, the Islamic economists also argue that because of it is sourced out in the Divine Revelation, the Islamic economic system is balanced in a way that brings it closer to the human nature (al Fitrah). Accordingly, you will find in it apparent similarities to certain aspects of other economic systems because undeniably the latter are the product of human mind/experience mix.

Consequently, it is normal that the means to reach the common goals, in the Islamic economic system, include a free market-exchange with emphasis on honoring consensual contracts (some will see it as à la capitalist free market), prohibition of monopoly (à la interventionism), great concern about the satisfaction of the basic human needs and about economic justice (à la socialism) and assignment of a substantial chunk of natural resources to the whole society as represented by its government (à la communism). Add to it all, the prohibition of interest that denies any rewardability to most of the purely financial transactions unless it is formed as means of production and thus deprives them from the functionality that is conventional in the capitalist framework.

Islamic Banking:

Is it a System or a Beginning of a Change? Where is it Heading?

Once upon a time, when the movement of Islamic banking started in the 1970s there were professional economists who saw in it a totally new economic system that does not only restructure the economy but the whole society as well. Some writings envisaged Islamic

banking as a different system of motivation for saving and investment as well as a dreamed solution of bridging the gap caused by the saving/investment dichotomy. The biggest blow to these writings came from the fact that Islamic banks came to blend and co-exist within a conventional system of banking, making no economic revolution and upsetting nothing in the prevalent economic equations. Islamic banks, whether commercial or investment, actually took the same shape and approach that are adopted by their interest-based counterpart, to the extent that they can be loaded with the same criticism addressed to conventional banks, ‘they give the umbrella when it is shining and take it back when it rains or they give the cake to the rich and nothing to the poor.’ In fact, there are professionals, within the ranks of Islamic economists, who still argue that the experiment of Mit Ghamr was not merely an attempt of an early version of “banks for the poor, the Islamic way” but it was the true form of Islamic banking that was brought to an end by the conspiracy and conspirators!¹

Another frustration was the outcome of a large gap between theory and practice. Is it a disobedient practice or a misguided theory? The problem of Islamic banks is that they were born in a milieu of two extremely polaristic paradigms: the reality of interest-based conventional banks that came to take its present shape after more than four centuries of natural development, growth and boundary expansion and the idealistic fictitious theorization that imagined a framework of Islamic banking on the basis of a simplistic Mudarabah and two tier Mudarabah. Writings in Islamic banking preceded the actual establishment of the first such bank by nearly two decades.² Throughout this period, most of our emphasis was on Mudarabah as the “Islamic” trademark of banking, Ju’alah and Wakalah were also presented by some writers, but when the early Islamic banks were born they had to wait for two years to start any banking business until the “Murabahah to the purchase orderer” was invented!³ Is it only a case of mismatch? Did Islamic banks go astray and deviated from their presumed course? Or was the theory wrong?

Until today, many Islamic economists insist on their Mudarabah theory and pray to God that Islamic banks come back to their lap! They will not. . . **It is not a case of miscarriage or birth defect but of an erroneous unrealistic pre-nuptial theory that was formulated in isolation of banking experience.** Islamic theory was born before Islamic banks and delivered by non-specialized idealists. The first reference to the inadequacy of Mudarabah in fund utilization came with the survey of Saudi small businesses that indicated a preference for Murabahah; and Islamic economists started recognizing the risk of Mudarabah and its stringy institutional requirement only in the late nineties and the new century with the rise of concern about risk analysis in Islamic banks! This is in spite of the tremendous success Mudarabah encountered in funds mobilization.

This brings us close to the controversy of whether the **Islamic banks are mere financial intermediaries or direct actors** in the real (physical) market. Although many Islamic economists started to incline toward the intermediary idea, most Islamic bankers argue for larger authority. The nature of Islamic financing requires Islamic banks to make

¹ The same way they defend the flunked ‘Islamic investment companies’ as the victim of conspiracy!

² The earliest written formulation came about in 1956, and the first Islamic banks started operation in 1974.

³ Some of them went on real estates speculative trading (non-banking business) that almost wiped out a great part of their assets.

transactions in physical goods and services, but while many of us like to see them done only on initiatives from businesses that need financing, Islamic bankers cling to holding larger authority.⁴ I think Islamic banks have to be restricted to an financial intermediary role only, otherwise the conditions of competitiveness in the market should be reconsidered and a signorage charge has to assessed for the right to accept deposits and issue credit.

We also find professional writings in Islamic economics that load Islamic banks with a social philanthropic role that uniquely singles them out from among all the economic units. While all economic units are expected to participate in philanthropy, and they actually do whether for altruistic or public relations reasons, charging the Islamic banks with a unique social role that is not required from their conventional counterpart nor from other businesses puts them in an uncompetitive position. In fact, the actual practice of Islamic banks indicates that the majority of them do not interfere even in the payment of the obligatory Zakah for their shareholders let alone the depositors, and the amount of charitable and other donations they give is very trivial compared with their revenues, net profit or assets.

There are also writings that want to **deprive the Islamic banks from the right to issue credit** through the process of demand deposits creation caused by the partial reserve system. They argue that the demand deposits in Islamic banks should take the legal form of 'Wadi'ah' as known in the Fiqh with a slight change that is implied in physically putting all deposits in one vault and using checks and transfers to manipulate them. Some writings reinforce their view by the argument that since the Shari'ah calls for monopolizing the issuance of currency (minting gold and silver coins) in the hand of the government, money creation in all forms including the creation of credit as demand deposits should be strictly held in the hands of the government through a 100% reserve system.

Once more, to the dismay of these writings, the short history of Islamic banks and the development of Fiqh positions on demand deposits took a completely different direction: Demand deposits are treated as loans in order to justify the 100% guarantee for the principal of deposits' and loans do not require preserving a physical presence of lent assets. On the other hand, central banks apply the same rules of partial reserves to Islamic conventional banks alike. Additionally, the theoretical argument for full reserves is itself borrowed from conventional economics; it is controversial, socially costly and anti the trend of Fitra (that has been the actual real-life basis on which the creation of credit relied) that is growing now toward creating electronic credit in the form of means of payment.

Then comes the latest frustration in the form of the recently prevalent Tawarruq. Regardless of whether it is permissible or not and regardless of what conditions the Shari'ah compatibility may impose on it, Tawarruq brings the whole Islamic banking theory to square 1. The Essential virtue of Islamic banking that is so much elevated by

⁴ The new Islamic banking act (2003) in Kuwait admits in its explanatory memorandum that Islamic banks are mere financial intermediaries but the law itself allow them to initiate direct non-financial business on their own or on behalf of their clients. The compromise came is preventing real estates trades and in subjecting such transactions to the control and supervision of the central bank that is granted authority to impose limitations and restrictions.

the most liberal Islamic economists is that Islamic Financing has to be stick to the real market transactions and it does not allow for the provision of cash. Now, this new Tawarruq, domestic and international, provides cash at a higher cost than interest.

The last two points that I want to raise about Islamic banking are related to **justice between share holders on one hand and the depositors on the other hand;** and the **effect of globalization.** While the present system of Islamic banks runs Shari'ah compatible contracts, it leaves out in the air the effect of the negotiation power on the final products of such contracts. In fact, banks in general and Islamic banks in particular have, much more negotiation power than their contractors under normal circumstances. This is one of the theoretical reasons for regulating the banking industry. Islamic banks are left alone to determine the share of profit distribution between depositors and share holders and reap, alone too, the profit that is generated from the investment of demand deposits. Additionally, although owners of Mudarabah deposits share the risk with the bank they are left up in the cold when it comes to the management of the bank. These elements together have created a clear disparity between the rate of profit of distributed to share holders and that given to depositors.

To face any potential side effects of Globalization, Islamic banks were expected to integrate and consolidate. The reality over the last three years indicates that although the total number and aggregate size of Islamic banks increased, their average size remained virtually stagnant. There are indications of deepening their markets and improving the services they provide especially in countries that have more than one Islamic bank. But it seems that merger and unification are not taking their toll in the Islamic banking industry!

All the above requires a revision of the theory of Islamic banking to reassess its functioning and whether it is really distinct from the conventional theory!

Strategic Focus of Islamic Economists, Was it correct?

Since the rebirth of Islamic economics, writers have been busy talking about Islamic banking and finance, Islamic modes of finance, development models derived from the Western models of the sixties and seventies and lately models for corporate finance that copy the American studies in this area.

For such a long time we tried to convince ourselves that the real road to development is through the Islamization of the banking sector. We were overtaken by making it founded on the double-tier Mudarabah to the extent that we spent a considerable amount of ink and paper, and probably energy too, on the issues of Murabahah and Mudarabah while the real practice of Islamic banks has been drifting toward Tawarruq! It was a beautiful illusion for which we neglected the main concerns of our societies as well as the core of Islamic economics: the socio-political requisites of economic development. We even neglected the basic institutions of the Islamic economic system.

For apparent reasons, we concentrated our effort on developing Islamic banking, and they grew to an extent that may make them a monster that destroys the purity of the economic thinking of our elite activists. Islamic banks banking and finance also consumed the

abilities of the elite Shari'ah specialists as if it was the most important issue of the life of our generation. I still remember the cry, about two decades ago, of one Islamic economist for the need to discuss issues in the Islamic political economics, it went with very little response!

It was only recently that a few Islamic economists started dealing with issues of development, political economics of the role of government and of the economics of poverty reduction in spite of the lip service to these issues we find in a few generalist writings that are spayed over the past five decades of Islamic economic. Additionally, the institutional setting of the Islamic economic system and the role of the non-profit sectors have just started to be recognized as important fundamentals of Islamic economics.

There is a serious need for re-examining the existing writings on Islamic economics and to see whether it is acceptable to permit the past trend to take its hold on the future of Islamic economics. There is a need to shift our focus to studying the economics of poverty in the Ummah and how to recruit the economic rhetoric to become an instrument of change and to develop a new generation of our traditional socio-economic institutions that would help reconstruct the interaction between the human element and the organizational setting in a way that creates an environment of development and growth.

The thinking of Islamic economists must lead the Shari'ah specialists to develop structures and rulings that motivate and regulate such reformed institutions instead of being led by, and restrictively limited to, the boundaries developed by scholars who applied the principles of Shari'ah to their socio-economic atmosphere a thousand years ago! The richness of our Shari'ah lies in its ability to respond to changing circumstances and "modes of production" on the basis of its overwhelmingly powerful and universal principles and guiding rulings.

Islamic economics' Institutions:

There are two kinds of institutions in any society: institutions that are inculcated within the souls of women and men that make them pursue a futurist pattern of behavior construed to create more and more material welfare for every body in one's environment, like the spirit of Omar Bin al Khattab who had always kept looking for improvements in every things and on all fronts. These are the within institutions that make a necessary condition for development. They are similar to the internal screening of Chapra but they are developmental in nature while Chapra talked only about a moral control screen.

The other type of institutions makes the sufficient condition. They are manifested in the external organizational setting that enables the human element to implement its developmental ideas and plans. These institutions include the rule of law, the right of private ownership and private growth, role of women, the setting of the third sector, the charity, that covers the organization of non-exchange transfers including the role of Zakah and Awqaf. While the second type of institutions is very important and is normally regulated by law, all of its components have internal reflects.

In the writings on Islamic economics over the last half a century, we've neglected both types of institutions as well as the internal reflect of the latter. We did not give adequate attention to building developmental mentality and spirit; we did not emphasize the ethics of thrift, perfection and growth of which our religion is the richest of all religions on earth. We've always thought that what matters is –by an act of law- eliminating Riba and that will do the needed miracle, all of it.

Although we've studied the minute details of the institution of the prohibition of Riba especially from a legalistic point of view, we did not gave enough time to studying the institution of Private ownership or the economic role of woman in the Muslim society. We shied away from scientifically criticizing the status qua because we did not want to be thought of as generalists or Islamic activists. We neglected a major factor of the vicious circle of backwardness, women left behind of development, and even some of us thought of it as an Islamic pride!

The external institutions of Zakah and Awqaf have recently received some of our grace but unfortunately with very little original thinking and a lot of third Hijri century formulation. We dared not rethinking these institutions under contemporary setting. Instead we assimilated the traditional Fiqh of these two institutions with little attention to changing circumstances, forms of assets, modes of production and the changing functions and functionaries of money.

The Zakah and Awqaf institutions we think of today are exactly the same that were applied when agriculture was irrigated by “the Saniyah” and a nice person is appointed as a Mutawalli regardless of the invention of the concept of corporation!

Institutional restructuring requires fresh innovative thinking that is only restricted by the necessary uncontroversial implication of the Revealed Truth. We need to revitalize the functions of the two pillars of the third sector, Awqaf and Zakah, in a way that makes them fulfill in a contemporary system, their envisioned role as they did in a simple economy in the past; and we need to integrate their functions within the overall framework of the Islamic economic system and philosophy.

Public Finance: Why Did we Miss Creating a Theory

Public finance is the part of Islamic social studies that historically received more attention than any other part of Islamic economics. Detailed discussions of public revenues and public expenditures are available in the classical Fiqh and Fatwa writings. Here again a question arises: Did we fail in establishing a general theory of public finance within an Islamic economic framework? The dust around the idea of whether taxation is permissible or not and under what conditions is not yet settled. Also not settled are the debates of private ownership protection against the government, rights of the poor in the public properties and revenues, the functions of taxes, economic or financial, and the restrictions on the economic role of the government.

The Public Finance area is probably the richest of all sub-branches of Islamic economics, yet most writings in this area are heavily influenced by the Western training of the writers and rarely have direct links to the original sources of the Islamic religion or to the

fundamental classical writings on public finance. We need to develop a general theory of taxation and government in Islamic economics that is based on the sources of knowledge of the Islamic economic system and that looks critically at the classical writings on the subject.

Future of Islamic Economics

Seeing it as a teaching discipline and a job-creating platform in the academia and the research centers, Islamic economics is there to stay and expand. In fact, the amount of accumulated knowledge in Islamic economics warrants a full fledged teaching program that can afford undergraduate as well as post graduate studies and degrees.

However, when we take a closer examination at the existing status of Islamic economics we see a mission unaccomplished. There is a need to set clear demarcation lines between Islamic economics and finance on one hand and Islamic Fiqh, especially the Mu'amalat, on the other hand. There is a need to measure the size of Islamic economics and stop being pretentious and as pointed out earlier in this paper there is also a need for more rigorous research in several critical areas of Islamic economics.

Islamic economics is a new but definitely fast growing field of economics. Its trade mark, the non-presence of interest, is not only unique but also affords it a claim of innovation. It has an integrated institutional structure. All it currently needs is that its promoters should wise up and tighten up their theoretical vigor.

On the applied side, it is certainly incorrect to attribute to Islamic economics any of the claims and ineffectiveness of political leaders and dictators of some Muslim countries. Besides, Islamic economists did not provide any agenda for political economics founded or derived from their branch of human knowledge inspite of the need for such an agenda.

It seems to me that the present generation of Islamic economists is exhausted and already consumed in the activities of Islamic banking and finance that the best it can do is to hand over the torch to a second generation that may carry deeper theoretical analysis and fill the gaps left by our generation.