

# FUNDAMENTALS OF AN ISLAMIC ECONOMIC SYSTEM COMPARED TO THE SOCIAL MARKET ECONOMY

## A SYSTEMATIC OVERVIEW

*Volker Nienhaus*

Underlying the scholarly interest in comparing economic systems is often a tacit suspicion that, in view of the arrested development of many Islamic countries, this religious worldview is seemingly incompatible with a market economy that promotes development. However, if we consider the attitude of the founders of the religions, Jesus and Mohammed, towards the economy and the teachings and practices during the early phase of the Christianity and Islam, it is actually quite surprising that Christians raise doubts about the compatibility of Islamic teaching with the market economy – from an historical perspective, the reverse would have seemed more appropriate. On the other hand, we must remember that the social market economy is a concept that was created for highly developed and structurally differentiated economies only in the twentieth century in the Western world, where it has proved itself. In Islamic countries, most of which only gained their independence in the middle of the twentieth century, this concept was rather unknown.

In the light of the lasting development problems of many countries of the Muslim world – stretching from North Africa, across the Middle East to Southeast Asia – these states have by no means ruled out the search for economic concepts that promote development. Not least as a result of disappointment with the results of the capitalist and socialist economic systems, since the mid-1970s people have been progressively formulating ideas about an Islamic economic system, propagating them as an alternative to the unsatisfactory status quo. Against this backdrop,



Prof. Dr. Volker Nienhaus was President of the University of Marburg. He is now a visiting professor at the ICMA Centre, Henley Business School, University of Reading (United Kingdom).

therefore, it is worth investigating the general principles of the social market economy and their compatibility with such economic systems in order to share the experiences of our own economic system as part of the dialog surrounding development policy.

### **ISLAMIC ECONOMICS AND THE GENERAL PRINCIPLES OF AN ISLAMIC ECONOMIC SYSTEM**

The task requires to compare an intellectual construct (an Islamic economic system) with a concept that exists in reality in different forms (the social market economy). By contrast, no modern state in the Muslim world has practically implemented an Islamic economic system, perhaps with the exception of Sudan and Iran. The economic systems that exist today are more or less systematic advancements of systems installed as a secular sign after gaining independence in continuance of, or in a (revolutionary) triumph over colonial era systems.

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Even the academic discipline of Islamic economics, which seeks to combine secular economic theories or (neoclassical) models with teachings from Islamic philosophy and law, is a relatively new phenomenon. The earliest publications in this field did not originate from scholars at leading Islamic universities in the Arabic core of the Islamic world, but rather from academics in Asia. The efforts of Indian Muslims, beginning in the 1930s, to create a Muslim state on the former territory of British India following Britain's withdrawal gave rise to intense debates about an Islamic economic system – or rather, debates about an economic system for an Islamic State. Although the new state of Pakistan was created in 1947 as a type of "Muslim nation state" in parts of former British India, it still had a very secular character and many questions on the appropriate economic system had still not fully been answered. The constitution of 1958 turned the state into the "Islamic Republic of Pakistan," but this did not bring an end to discussions about economic policies that had been going on since the 1940s. Instead, it intensified them. People were looking for their own path, a path between Capitalism and Communism, which would also drive forward economic development. Most of the early treatises

on Islamic economics (right up until the 1960s), which have been reprinted and are still cited today, were written against this backdrop.<sup>1</sup> Similar discussions also took place in the Arab world in connection with the withdrawal of European colonial and mandatory powers from the middle of the 1950s onwards – without the context of founding an “Islamic” state.

During this early phase, many models had socialist traits: the models of “Islamic Socialism” were based on a redistributive state, which heavily controlled the economy. Thus, they contrasted starkly from laissez-faire capitalism. However, for the most part they did not question private ownership of the means of production – a significant difference compared with “godless” Communism. These models could be described as variations of Market Socialism. References to Islamic teachings and, in particular, to the commercial law aspects of Shariah were often only cursory or cosmetic and served more to legitimize and mobilize than provide a conceptual foundation. With the continued “academification” of literature, the increasing involvement of experts in Islamic law and more intense international discussions about Islamic economics, it has become clear that dominant control of the economy does not agree with private property and a market-based system, and that prevailing attitudes are increasingly moving towards a competitive economy with a state that primarily seeks to ensure monetary stability, proper competition, and a basic infrastructure (transport, education, healthcare, legal system). Such a state should pay particular attention to ensuring that income and wealth do not become too concentrated, especially in poorer countries, and initiate programs to fight poverty.

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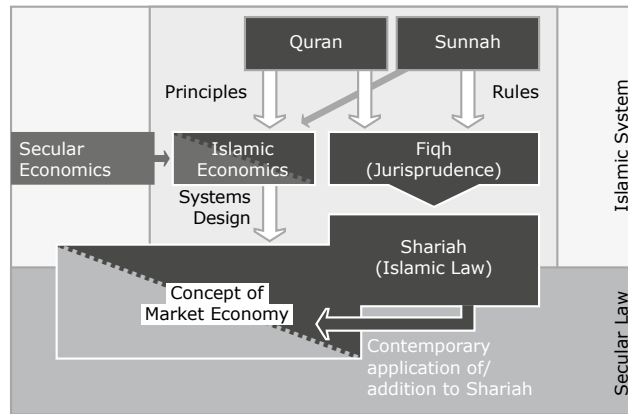
Over the past decade, public duties (both of society and the state) have broadened to include safeguarding sustainable economic activity and protecting the environment. Finally, the state should create favorable framework conditions for a private economy consistent with the requirements of Islam, something which can have particular implications

1 | For an overview of early literature, see Muhammad Akram Khan, *Islamic Economics: Annotated Sources in English and Urdu* (Leicester: Islamic Foundation, 1983).

for bank supervision and central bank policy in an interest-free financial system, for example.

Fig. 1

### Islamic Concepts of a Market Economy between Economics and Law



The prevalent doctrine of Islamic economics today can be summarized as follows:<sup>2</sup>

- Islam conveys a positive outlook on this life in general and provides a supportive value system for economic activities in particular.
- Islamic economic ethics exhibits considerable overlap with Western-Christian perceptions in the field of individual ethics. Great importance is ascribed to personal achievement.
- Individuals are expected to earn their living through their own work. A person's own achievement (physical and intellectual work) is the most important basis for legitimately obtaining material goods and wealth.

2 | Cf. Khurshid Ahmad (ed.), *Studies in Islamic Economics* (Leicester: Islamic Foundation, 1980); Aidit Ghazali and Syed Omar (eds.), *Readings in the Concept and Methodology of Islamic Economics – Translating Islamic Principles into Socio-Economic Realities* (Petaling Jaya: Pelanduk Publishers, 1989); Ausaf Ahmad and Kazim Raza Awan (eds.), *Lectures on Islamic Economics* (Jeddah: Islamic Research and Training Institute, 1992); M. Umer Chapra, *The Future of Economics: An Islamic Perspective* (Leicester: Islamic Foundation, 2000); Richard C. Foltz, Frederick M. Denny and Azizan Baharuddin (eds.), *Islam and Ecology: A Bestowed Trust* (Cambridge, Mass.: Harvard University Press, 2003).

- Neither individual human skills nor natural resources should lie idle unnecessarily, and it is forbidden to waste or wantonly abuse resources.
  - Legitimately acquired wealth should not be used to maximize the pursuit of a person's own wants (in this life): luxury is frowned upon; Islam preaches moderation; and the use of surpluses for social aims is meritorious.
  - The needy have their own claim to solidarity from the community, which is institutionally protected and based on the Quran: Muslims are required to pay *zakat*, i.e. a two and a half percent levy on assets or a five or ten percent levy on agricultural produce, which is used for specific (social) purposes. This is an obligation for the individual, and the claims of the needy should be satisfied by the community or the society (and only then by the state); this is very similar to the principle of subsidiarity.
  - Since Allah has made the goods of this world available to all human beings, inequalities in the distribution of income and wealth must not be allowed to become too great. If needs be, the state must intervene with corrective measures to fight poverty.
  - Humans, as God's custodians of the earth, only have the right to use creation. They must not inflict lasting damage on it and must consider the legitimate claims of future generations in what they do. This principle gives rise, among other things, to a collective ownership of non-renewable resources (natural resources, but also water) and, more recently, a duty to protect the environment.
  - Islamic law recognizes private ownership of the means of production. Nationalization and state control of the economy are only permissible in exceptional circumstances.
  - Land and capital become productive only as factors of production when combined with labour. Therefore, income may not be derived from merely owning land or capital. Financing, lease, and other contracts, which allocate returns and risks to the owners of factors of production, must meet particular criteria of justice.
  - Prices should be just, which means that they should be based on competitive markets. Monopolization and hoarding lead to an exploitation of other market participants and should be defeated.
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- Practices and courses of action that have antisocial and other damaging consequences are forbidden, thus implying that markets and competition should rule and that monopolies should be prevented.
- Furthermore, all transactions, where one party benefits at the cost of another – just as with gambling and speculative trading –, are banned.
- The objective of monetary policy is to ensure stability of the price level.
- Financial policy should preserve the equilibrium between tax revenues and public expenditure so that the national budget balances overall.
- The state must provide a basic infrastructure (including a judicial system) and particular public goods, and it should refrain from intervening in competitive markets.

Essentially, this list contains all the elements that constitute a social market economy, which have been summarized in the Konrad-Adenauer-Stiftung's publication entitled "Guidelines for Prosperity, Social Justice and Sustainable Economic Activity."<sup>3</sup>

3 | Cf. Konrad-Adenauer-Stiftung, *Guidelines for Prosperity, Social Justice and Sustainable Economic Activity* (Berlin: Konrad-Adenauer-Stiftung, 2009), [http://www.kas.de/wf/doc/kas\\_17025-544-2-30.pdf](http://www.kas.de/wf/doc/kas_17025-544-2-30.pdf) (accessed October 17, 2010).

Table 1

### Guidelines for a Social Market Economy and Fundamentals of Islamic Economics

Guideline <sup>4</sup>	Position of Islamic Economics
Legal framework	<ul style="list-style-type: none"> <li>• Law and the rule of law are important: linking government action to a superior law – <i>Shariah</i> (which only contains some directly applicable economic content) and <i>Shariah</i>-compliant secular law (the formulation of which gives great creative leeway)</li> <li>• Concepts of an Islamic economic system are compatible with different forms of government (democracy, monarchy, etc.)</li> </ul>
Property ownership and employment	<ul style="list-style-type: none"> <li>• Legitimacy and protection of private property, even relating to the means of production, positive assessment of entrepreneurial achievement (Prophet as a role model)</li> <li>• One's own work/achievements should be the primary source of income and legitimate wealth, assets must be used productively (desired growth and employment effects)</li> </ul>
Competition as a basis	<ul style="list-style-type: none"> <li>• Justice is important: price fairness Fair price = competitive price; state protection of competition against monopolization; occasional state intervention in the case of "sensitive" prices</li> </ul>
Application of the principle of liability	<ul style="list-style-type: none"> <li>• Strong emphasis on opportunity and risk (particularly in the financial economy), skepticism towards limited liability legal structures, such as limited companies (now acceptable), increasing importance of corporate governance</li> </ul>
Stability of the economic environment	<ul style="list-style-type: none"> <li>• Monetary stability is important: various models for stability-oriented monetary systems (gold standard, commodity currencies, one hundred percent money, monetary rules, etc.)</li> <li>• Regulation of financial markets (<i>riba</i> ban, linking financial transactions to the real economy, prohibition of purely speculative trading)</li> </ul>

4 | Konrad-Adenauer-Stiftung: *Guidelines for Prosperity, Social Justice and Sustainable Economic Activity*, Berlin 2009.

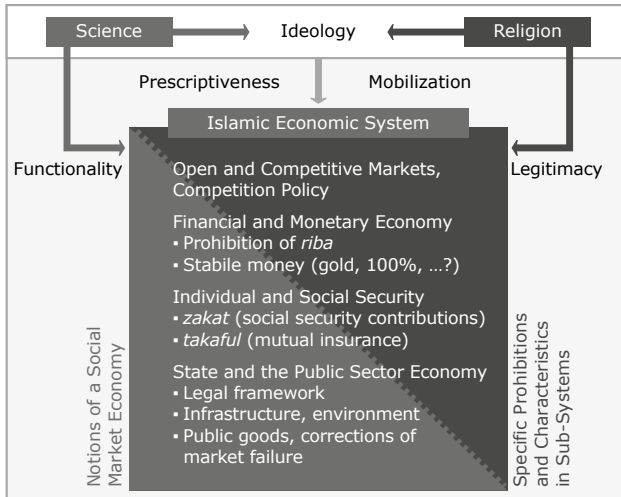
Provision of public goods by the state	<ul style="list-style-type: none"> <li>▪ Provision of a basic infrastructure (legal system, education, health-care, mobility) recognized as a legitimate duty of the state; discussion about science as a public good</li> <li>▪ Correction of market/competitive failure, no structural or procedural interventionism</li> </ul>
Solidarity and social security	<ul style="list-style-type: none"> <li>▪ Poverty reduction as a primary economic objective</li> <li>▪ <i>Zakat</i> at the core of a social security system that is independent of the family (claim of the needy in respect of society – state is subsidiary)</li> <li>▪ Calls for international solidarity within the Islamic world (<i>umma</i>)</li> <li>▪ basic principle of insurance that conforms to Shariah Law (<i>takaful</i>): mutuality, entry into a shared risk community instead of purchasing a risk coverage</li> </ul>
Incentive compatibility	<ul style="list-style-type: none"> <li>▪ Legitimacy of secular taxation (in addition to <i>zakat</i>) is now uncontroversial; exact structure can be defined according to time/place/circumstances, considering incentive compatibility</li> </ul>
Sustainability	<ul style="list-style-type: none"> <li>▪ Allah is the ultimate owner, human beings are merely custodians, duty extends to future generations (idea of sustainability)</li> </ul>
Open markets	<ul style="list-style-type: none"> <li>▪ In principle, for all open goods, services, and labor markets, but reservations with capital markets (issue of interest, speculative capital transactions)</li> </ul>

Neither the duties of the state nor the major economic sub-systems differ in functionality from those of Western systems; and Islamic economists draw on secular (mainly neoclassical) theories in order to explain the mechanics of sub-systems, such as goods and factor markets, or the monetary system. The Islamic component within the relevant systems is not the functionality of the elements, but the justification for their design and combination. This is achieved by reference to Islamic teachings and argumentation patterns.



Fig. 2

### Elements and Superstructure of an Islamic Economic System



There are two exceptions to this statement within Islamic economics – particular sub-systems that do not just combine well-known elements with justifications taken from Islamic teachings, but also require the implementation of functionally distinct Islamic institutions. On the one hand, this is the interest-free financial sector (banks, capital markets, and insurance) and, on the other, a social security system with *zakat* at its core.

### SOCIAL SECURITY BASED ON ZAKAT

*Zakat* is a levy paid by Muslims, whose wealth exceeds a particular exemption allowance, and it is used for social purposes, details of which are set out in the Quran.<sup>5</sup> The act of paying *zakat* is one of the most fundamental religious duties for a Muslim. Islamic economics emphasizes that

5 | Cf. Farishta G. de Zayas, *The Law and Institution of Zakat* (Kuala Lumpur: The Other Press, 2003 [first published: Damascus: Al-Jadidah Press, 1960]); Mohammed Akhter Saeed Siddiqi, *Early Development of Zakat Law and Ijtihad* (Karachi: Islamic Research Academy, 1983); Ahmed El-Ashker and Sirajul Haq (eds.), *Institutional Framework of Zakah: Dimensions and Implications* (Jeddah: IRTI, 1995); Volker Nienhaus, "Zakat, Taxes, and Public Finance in Islam," in: Sohrab Behdad and Farhad Nomani (eds.), *Islam and the Everyday World – Public Policy Dilemmas* (Abingdon and New York: Routledge, 2006), 165-92.

*zakat* represents the needy's claim to share in society's wealth and, as such, is at the core of the social security system. The *zakat* system can be organized by the state if, for example, Muslims fail to perform their payment duties adequately on a voluntary basis. Unlike taxation, the state may not use *zakat* revenues for the general budget. Instead, they may only be used to help entitled recipients for the purposes set out in the Quran. Nevertheless, there is a need to reevaluate and clarify these legitimate uses and recipients in light of modern developments. In addition, the form in which the *zakat* funds are supposed to be used (e.g. as direct monetary transfers or to finance institutions which provide benefits to the entitled recipients) must also be determined.

The example of *zakat* illustrates the principle of pragmatic legislative development which, on the one hand, allows flexible adjustments to be made to the legal system in view of new phenomena or changed conditions, but also leads to controversy and partisan inconsistencies on the other. The literature often gives the impression that the Prophet implemented an immutable *zakat* system on the basis of the Quran valid for all times.

**The literature often gives the impression that the Prophet implemented an immutable *zakat* system on the basis of the Quran that is valid for all time. That is not the case.**

That is not the case, however: the basis of assessment for *zakat* laid down by the Prophet was changed by his immediate successors as well as the levy rates.

For the early caliphs, the *zakat* rules of the Prophet were evidently not considered invariable rules given by God, but merely an expression of (revisable) legislation which depended upon particular circumstances, a particular period, and a particular place. Such pragmatic legislation did not seek to establish universally applicable and timeless principles; rather, it aimed to solve particular problems. The pragmatic legislation of the Prophet and the early caliphs did not produce universal principles; rather it provided analogies based on previous cases to assist in new, individual instances.

The Prophet listed the following assets (and sources of income), which were to be subject to *zakat* payments (basis of assessment):

1. camels, sheep, and cows,
2. gold, silver, and coins,
3. wheat, barley, dates, and grapes,
4. buried treasure.

It is unclear whether he also levied *zakat* on honey and trade goods. When one of the early caliphs had to decide whether *zakat* was also payable for horses, for example, he only reached a decision for that specific instance and left open the question of whether other animals, such as goats or donkeys, should also be subject to *zakat*. Later judges widened group 3 to include rice in the list of produce subject to *zakat*. In so doing, they based their decision on an observation that all objects in this group originally covered foodstuffs; thus, rice – as a foodstuff – should also be included. Yet, it is peculiar to the pragmatic legislative development that a decision is reached only for a specific case (rice), but no generalization or postulation of the principle used in reaching that decision is made – e.g. that all foodstuffs should become subject to *zakat*. Thus, there continue to be food items for which producers do not have to pay *zakat*. Economists view this lack of consistency as problematic from the point of view of non-discrimination or fairness.

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From this perspective, deciding on a case-by-case basis by way of analogies also causes further problems of justice: There are small rice producers in Asia, for example, who are required to pay *zakat*, while owners of rubber plantations remain exempt. If this inequality is to be avoided, all agricultural, forestry, and plantation produce, as well as revenues or profits derived from the respective businesses should be subject to *zakat* levies. In that instance, however, the question must be asked why *zakat* is only levied on revenues or profits from the primary sector, while profits from the secondary and tertiary sectors remain *zakat*-free. Such considerations, though, would require a complete abandonment of the established methods of pragmatic legislative development and a move towards a type of

“constructivism in the spirit of the Quran.” Clearly, then, there is great scope for discussion and conflict between Islamic economists and Islamic lawyers. The latter group may point out that even the Prophet was aware that goods in the third group could be subsumed under the heading of “foodstuffs” when he stipulated them. Nevertheless, he did not levy *zakat* on all food items known at his time, but only on certain ones. This fact must not be ignored.

There is also a need to interpret the original stipulations for entitled recipients (see Fig. 3). Islamic economists consistently point to the poor and the needy as a group that is of particular importance. However, without a definition of

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need specific to a particular country and a particular period, and the establishment of the nature and level of help based on *zakat* income, it is impossible to evaluate the viability and the allocative and distributive effectiveness of the system, let alone its moral or ethical qualities. This is not the place to discuss the hugely diverse concepts of Islamic economists in detail. We can, however, draw attention to a particular problem, which arises if we seek to understand *zakat* as the nucleus of a social security system: in times of economic downturn, the number of people requiring support will rise while *zakat* receipts will decline. This divergent relationship between expenditure and income, which is highly adverse for a social security system, must be covered by reserves and, perhaps, by additional sources of income. This requires the technical knowledge of Islamic economists. Shariah scholars probably have less to offer in this regard.

Fig. 3

**Zakat as a social security contribution**

Funding		Application	
Historical Basis of Assessment	Modern Analogies		Entitled Recipients
<ul style="list-style-type: none"> <li>• Gold and silver</li> <li>• Livestock</li> <li>• Trade goods</li> </ul>	General capital levy?	Social Security	<ul style="list-style-type: none"> <li>• Poor</li> <li>• Needy</li> </ul>
<ul style="list-style-type: none"> <li>• Agricultural produce</li> </ul>	General income levy?	Extensive interpretation: for nearly all government duties	<ul style="list-style-type: none"> <li>• Debtors</li> <li>• Travellers</li> <li>• Redemption of Slaves</li> <li>• For converts to Islam</li> <li>• For warriors of Islam</li> </ul>
<ul style="list-style-type: none"> <li>• One of the highest duties of a Muslim</li> <li>• Basis in the Quran and Sunnah, details from Caliphs</li> <li>• Social security system independent of the family</li> <li>• Elements of solidarity and subsidiarity</li> </ul>		No Tax (Self-Governance)	<ul style="list-style-type: none"> <li>• Administration of <i>zakat</i></li> </ul>
<ul style="list-style-type: none"> <li>• Numerous open issues about details of adaptation/new interpretation</li> <li>• Social security system with developable core</li> </ul>			

**PROHIBITION OF INTEREST AND THE FINANCIAL SYSTEM**

Conversely, contributions made by Shariah scholars on topics of the financial system outweigh those of Islamic economists (for the moment, at least). Shariah commercial law is most developed and sophisticated with respect to contract law (purchase, leasing, and rental agreements) while it is only rudimentary with respect to labour law. Wherever Shariah provides sufficiently detailed contents, this has to be considered when designing economic sub-systems. This implies that the literature on interest-free finance now relies more heavily on legal texts than it used to. Up until about the mid-1980s, scholars tended to draw less on legal sources for the Islamic content and instead depended much more on principles they took directly from the Quran, or rules based on the Sunnah.<sup>6</sup>

6 | For literature up to the 1980s cf. M.A. Mannan, *Islamic Economics: Theory and Practice (A Comparative Study)* (Lahore: Sh. Muhammad Ashraf, 1970); Muhammad Nejatullah Siddiqi, *Banking without Interest* (Lahore: Islamic Publications, 1973); Mohammad Ariff (ed.), *Monetary and Fiscal Economics of Islam* (Jeddah: Kind Abdulaziz University, 1982); Ziauddin Ahmed, Munawar Iqbal and M. Fahim Khan (eds.), *Money and Banking in Islam* (Islamabad: Institute of Policy Studies, 1983).

As a result of more intensive interaction with Islamic legal scholars, it became clear, however, that personal interpretations of Islam's primary sources – the Quran and Sunnah – by economists did not satisfy the methodical requirements of Islamic scholarship. In order to legitimize something convincingly as Islamic, particular criteria developed by Islamic theology and jurisprudence and procedures for interpreting and applying the Quran and the Sunnah (the tradition of the Prophet) must be taken into account.<sup>7</sup> However, the less the primary sources yield and the less developed an area is within Islamic legal studies, the more freedom Islamic economists have with respect to the design of economic (sub-)systems.

**For the financial sector there are particularly high levels of codification and extensive legal writings.** The financial sector (financial institutions, financial markets) is one sub-system for which there are particularly high levels of codification and extensive legal writings, which must be taken into account when drafting rules and contracts.<sup>8</sup>

- 7 | Cf. Imran Ahsan Khan Nyazee, *Theories of Islamic Law – The Methodology of Ijtihad* (Kuala Lumpur: Islamic Book Trust, 2002); Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Cambridge: Islamic Texts Society, 2003); Wael B. Hallaq, *An Introduction to Islamic Law* (Cambridge: Cambridge University Press, 2009).
- 8 | Cf. Muhammad Ayub, *Understanding Islamic Finance* (Chichester: Wiley, 2007); Brian Kettell, *Introduction to Islamic Banking and Finance* (London: Brian Kettell, Islamic Banking Training, 2008); Sudin Haron and Wan Nursofiza Wan Azmi, *Islamic Finance and Banking System – Philosophies, Principles and Practices* (Shah Alam: McGraw-Hill (Malaysia), 2009); Humayon A. Dar and Umar F. Moghul (eds.), *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance* (London: Chancellor Publications, 2009); Humayon Dar and Talha Ahmad Azami (eds.), *Global Islamic Finance Report 2010* (London: BMB Islamic, 2010); Madzlan Mohamad Hussain, *Demystifying Islamic Finance: Correcting Misconceptions, Advancing Value Propositions* (Kuala Lumpur: Zaid Ibrahim & Co, 2010), <https://www.zaidibrahim.com/wp-content/uploads/2010/05/Demystifying-Islamic-Finance-soft-copy.pdf> (accessed October 17, 2010); Volker Nienhaus, "Islamic Economics in Practice: Interest-Free Financial Management," in: Werner Ende and Udo Steinbach (eds.), *Islam in the World Today: A Handbook of Politics, Religion, Culture, and Society* (Ithaca and London: Cornell University Press, 2010), 141-92 and 862-70; Zaharuddin Abdul Rahman, *Contracts and Products of Islamic Banking* (Kuala Lumpur: CERT, 2010); Ibrahim Warde, *Islamic Finance in the Global Economy*, 2<sup>nd</sup> edition (Edinburgh: Edinburgh University Press, 2010).

Within this sector, there are three prohibitions that must be observed, namely those of:

- *riba*, i.e. interest on loans,
- *gharar*, i.e. avoidable uncertainty in transactions,
- *maysir*, i.e. gambling.

The Islamic prohibition of interest could provide cause for questioning the compatibility of the Islamic economic system with that of the social market economy since financial markets perform essential functions for a decentralized, competitive economy, in particular providing savings for productive investments and managing risks.

It is difficult to conceive of capital markets without interest; and without a capital market, the market economy cannot function. However, we must be wary of a misinterpretation at this point: although Islam does indeed ban interest on loans, it does not deny the scarcity and potential productivity of capital, provided that it is combined with labour (entrepreneurial efforts). Thus, Islam does not forbid capital markets; it merely requires certain modifications to the conventional system.

**Although Islam does ban interest on loans, it does not deny the scarcity and potential productivity of capital, provided that it is combined with labour.**

- Loan interest rates – strictly speaking, monetary interest that is determined by transactions in the inter-bank market and modified by the monetary policy of the central bank – is not the only conceivable indicator for the scarcity of capital. It is possible to structure investment and financing decisions around average returns of stock portfolios, for example, in order to determine a scarcity price for (venture) capital. This was the case for early models of the Islamic economy (between the 1970s and 1980s), which only recognized equity-like forms of savings and financings and no debt relationships. The basic idea was that, on the one hand, savers would not receive fixed interest on their savings accounts, but shared in the bank's profits or losses, and that, on the other, banks financed enterprises and projects on the basis of profit and loss sharing (known as *mudaraba*, when only one partner – the bank – provides the capital, and *musharaka*, when both partners contribute the capital). Profit-sharing ratios may be freely negotiated (as percentages of profit)

but they must be specified at the beginning of the transaction and cannot be altered afterwards (to take account of business developments, for example). Losses must be borne proportionately to the capital shares of the investors (in the case of *mudaraba*, by the bank alone; in the case of *musharaka*, by both partners). Such a financial system faces the problem that returns on participation finance and equities, such as stocks, are not certain and instead are subject to a degree of fluctuation, i.e. risk. This makes direct comparisons of alternatives difficult.

- Nowadays, Islamic financial market models are, by contrast, based on a broader spectrum of investment and financing instruments that includes broadly risk-free forms of finance and debt instruments that are allowed under Shariah law (see below). Actual models use such returns as scarcity indicators.

What had initially been neglected in theoretical models became an important foundation of financial transactions in the practice of Islamic banks since the end of the 1970s: although the Quran does prohibit interest on loans, it explicitly encourages trade and trade profits.

**It is possible to replace a bank loan with a system whereby the bank acts as an intermediary and acquires the objects needed on the client's behalf.**

Since borrowers in the majority of cases do not require liquidity for and of itself, rather require it to acquire merchandise, raw materials, machines, and other objects, or to pay for services, it is possible to replace a bank loan with a system whereby the bank acts as an intermediary and acquires the objects needed on the client's behalf, pays the supplier directly, and sells these objects on to the client for a fixed markup on the purchase price (or, by analogy, commissions services). The client then pays the purchase price and the profit markup at a later date either as a lump sum or in installments to the bank. The bank's profit markup is analogous to economic interest; however, legally-speaking it is a trade profit and is thus not affected by the prohibition of *riba*. Trading operations (known as *murabaha*) also differ in other respects (particularly with regards to liability and transfer of risk) from loan transactions, meaning that the boundaries between permissible trade profits and prohibited interest are quite clear.



It must be emphasized, that Shariah concerns Islamic law and, thus, any judgments about the legitimacy of transactions is based on legal and not on economic criteria. Since Islamic economists were searching for an economic (material) rather than a legal (formal) alternative to interest, they neglected (quite rightly so from their point of view) the (debt) financing techniques

based on intermediary trading since they were legally permissible but did not get the system any further economically compared to the status quo of interest-based finance. For the practical operations of Islamic banks, however, this situation is considerably different:

**In countries with a lack of regulatory provisions, low levels of transparency, poor business ethics, and a legal system with deficient enforcement powers, financing based on profit and loss sharing harbors a great risk for the bank.**

in countries with a lack of regulatory provisions, low levels of transparency, poor business ethics, close links between the political and economic elites, and a legal system with deficient enforcement powers, financing based on profit and loss sharing harbors a great risk for the bank: For entrepreneurs who are more interested in the bottom line of their balance sheet than in Islamic values, finding a partner who will share losses of a risky business (if the actual risks are cleverly concealed) is an attractive proposition, while sharing expected profits is less appealing. There is much to indicate that participation financing systematically attracts above-average levels of risk without guaranteeing above-average profits. Therefore, in practice, Islamic banks tend to focus on (debt) financing on the basis of trade agreements (*murabaha*) and other permissible rental or leasing transactions (known as *ijara*).

Islamic financial practice has, though, not just limited itself to these rudimentary financing instruments; rather, it has expanded its tool set in two important directions. To date, Islamic economists have rarely integrated these adequately into their macroeconomic models and are, therefore, more inclined to an overly optimistic assessment of the stability and allocative qualities of an Islamic financial system:

- The first direction is the provision of liquidity at fixed costs/returns by a combination of trade transactions. In the original model, Islamic banks could only provide liquidity on the basis of profit and loss sharing, which presented two problems: on the one hand, the risks associated with this, and, on the other, the exact costs/

returns, which could only be known retrospectively. A classic and prohibited method for evading this would involve just two parties in a trade transaction, where the bank's client and the supplier of the commodity were one and the same: the client would sell the bank an object for immediate payment and then repurchase it for later payment at a markup. The legal verdict is, however, different if three or four parties are involved in the same business. If the bank's client is primarily interested in liquidity and not in the commodity purchased by the bank, the client can then sell the commodity acquired from the bank to another party for

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immediate payment. As a result, (1) the bank has made a payment today and has received a claim for a higher payment in the future, and (2) the client has received payment today and has a liability for a higher payment in the future. Neither the bank nor the client possesses the commodity. In extreme instances, the customer could sell the object back to the supplier. If that were considered unacceptable, the client (with or without the bank's help) would have to find another buyer. This is not particularly difficult if the commodity is one that can be traded on the stock exchange – such as platinum, which is traded by many brokers on the London Metal Exchange. Such combined trading (known as *commodity murabaha* or *tawarruq*) is now commonplace among Islamic banks both for finance transactions with non-banks and in interbank transactions (as part of their liquidity management). It should come as no surprise that this practice is heavily criticized by some Islamic economists, as the banks have developed an instrument that is compatible with Shariah law, but can completely replicate, from an economic perspective, interest-bearing loans (with the exception of the marginally higher transaction costs as a result of broker commissions). In spite of this criticism, Islamic banks along with Shariah scholars have made great efforts over the past few years to emulate conventional financing methods – from simple options through complex derivatives to hedging and total return swaps – in a form that complies with Shariah law. Many of the results of this special form of "contract engineering" are highly controversial in terms of their structure, but have the blessing of prominent Shariah scholars and are used

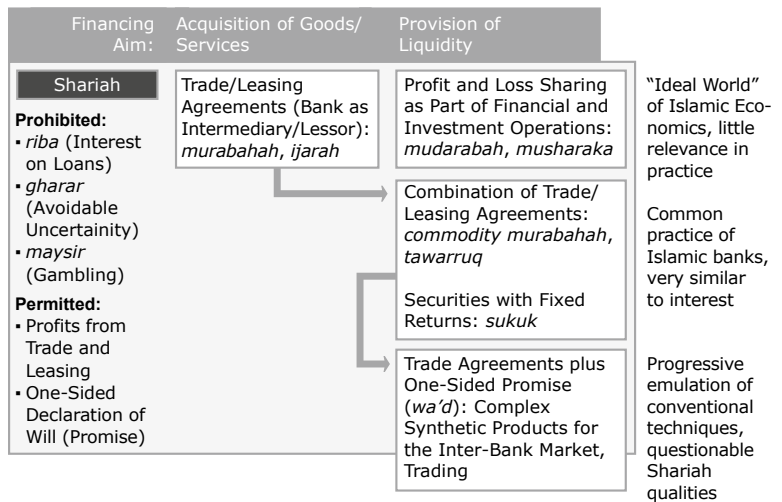
by parts of the Islamic finance industry. This has led to a broad debate about “form over substance” within the Islamic financial sector, which has failed to yield any solid results as yet (aside from increased public awareness of the problem).

- The second direction of expansion for Shariah-compatible instruments is the creation of tradeable securities that resemble fixed-interest securities in their economic character but are equity-based as they incorporate ownership rights: so-called *sukuk* (Islamic bonds) are created when companies, who are looking for finance for a fixed period of time, transfer ownership of such assets which generate a stable income stream (by long-term rental, for example) to a special purpose vehicle (SPV). The SPV then issues certificates on the capital markets equal to the value of the object transferred; these certificates give the holders the right to a share in the securitized income stream. This income stream mostly comes from the original owner of the object who leases the object back from the SPV (similar to conventional sale-lease back methods). Based on a strict application of Shariah criteria, the right to an income stream is derived from the fact that the certificates constitute (partial) ownership of the SPV's assets from which the income stream is generated. In this instance, the certificates may be traded without restrictions as Shariah-compliant equities. In reality, however, many *sukuk* do not involve an actual transfer of ownership. Only the usufruct (the right to utilize, i.e. the title to the rental income) is transferred and not the asset itself (i.e. the leased real-estate). The difference becomes clear in instances where the *sukuk* issuer (the SPV) goes into insolvency or files for bankruptcy: in the case of “real” title deeds, the holders may hope to recover part of their capital through the sale of the asset, while the capital is lost completely in the case of certificates which only securitize the income stream that has now dried up. Seen from the perspective of Shariah law, many *sukuk* are not just criticized for these diluted or very restricted ownership rights, but also because of a buy-back guarantee of the issuer for the certificates at their issue price when the term ends. By this the on-going returns and capital expenditure are known, **In reality, many sukuk do not involve an actual transfer of ownership. Only the usufruct is transferred and not the asset itself.**

meaning that a de facto interest-bearing instrument has been created. While buy-back guarantees as such are permissible, prices must equate to the actual market value of the asset at the time the buy-back is effected (and not be fixed at the issue price or market value at the time of the issue). If the buy-back were transacted at actual market prices, this implies considerable risks for the returns of a *sukuk* compared to an interest-bearing bond, since this market value is not known at the time of issue and may decrease over time.

Fig. 4

**Prohibition of Riba and Islamic Finance**



**SHARIAH, ISLAMIC ECONOMICS, AND THE SOCIAL MARKET ECONOMY**

Without going into further complexities of an Islamic financial system, what has been discussed thus far is sufficient to corroborate two important theses.

- The first thesis is that the formal restrictions, which stem from the requirements for Shariah-conformity, do not prevent the construction of a sophisticated and efficient financial system and capital market – without which the social market economy could not function. In view of the current global financial crisis, such a strong link between the financial sector and the real economy, and a limit to the development and application of synthetic

financial products for speculative and high-risk purposes is, perhaps, more beneficial than detrimental for a social market economy. Against the backdrop of replications of problematic, conventional techniques and products that conform to Shariah law, the calls by Islamic economists – which perhaps go a little too far – for every financial transaction to be based on a real economy transaction can also be understood in some respects as self-criticism, or at least a warning to Islamic financial engineers.

**Islamic economic systems are indeed compatible with the concept of the social market economy, and Islamic economics can act as an advocate of such a concept transfer. Nevertheless, this alone would not bring much benefit.**

- The second thesis is that Islamic economic systems are indeed compatible with the concept of the social market economy, and that Islamic economics can act as an advocate of such a concept transfer. Nevertheless, this alone would not bring much benefit as the political effectiveness and the practical relevance of Islamic economics as an academic discipline is relatively weak at a systems level, and this influence has tended to wane rather than wax over the past twenty years. On the one hand, following the collapse of Communism, major questions about economic systems – and hence the search for a third way – have rather lost their political importance. At the same time, though, a devaluation of the prescriptive parts of Islamic economics is taking place, which give general recommendations for the structure of an Islamic economic system. Ever since market-based concepts have started to find broad political acceptance, the specific legitimization of economic sub-systems by Islamic teachings and methods of reasoning has lost some of its appeal because many people are able to agree relatively quickly about system issues irrespective of their ideological background.

This poses a particular problem for an academic discipline such as Islamic economics which continues to be more prescriptive and to create models that are mainly focused on abstract systems rather than offering theories with explanatory power concerning the behavior of actual Muslims. This is particularly clear in the continued attention given to unrealistic profitand-loss sharing models of a Shariah-compliant financial sector while the business models of real Islamic financial institutions are

moving in a different direction (replicating interest-based instruments and structured products). The level of self-critical reflection is still relatively low. Nevertheless, an increasing number of empirical studies are being carried out, which illuminate at least some excerpts of Muslim economic realities (such as savings or consumer behavior of particular groups of Muslims, their attitude towards Islamic banks, the causes of low *zakat* receipts, labour migration issues, the effects of Islamic microfinance initiatives, etc.).

Even if the times of great controversies for economic systems have passed, it is still prudent to extend the dialog to specific issues relating to economic sub-systems outside the financial sector. Academic insight is likely to be much greater in this area and collaboration could lead to improvements in the standards of living in the Muslim world. There are promising starting points in several fields, where explicit reference to Islamic teachings and collaboration with recognized Islamic authorities has already proved very helpful. For example, these include local environmental protection and water conservation, the development and popularization of corporate governance standards, the proliferation of microinsurance, and social security systems for disadvantaged groups within the population.