

Religion and Ethics-Based Economic and Financial Systems: A Survey of Insights into Islamic Economics and Finance

Ehsan Ahmed

Abstract

This article examines the foundations of Islamic economic thought and its implications for a financial system as developed by its key proponent, Sayyid Abul Ala Mawdūdī, and his disciples. A critical analysis of the ideology follows this examination. We explore the reasons for it not finding general support in the mainstream academic circles, and for not leading to meaningful and innovative financial products or economic programs. Our analysis and the extant empirical evidence support the idea that the Islamic economics' framework needs major revisions. It appears from our survey and analysis of the recent literature that Islamic economics and finance is still a work in progress and has a long way to go before it can offer a viable market-consistent alternative to the modern banking and financial system.

Introduction

This article examines the foundations of Islamic economic thought as developed by its key proponent, Sayyid Abul Ala Mawdūdī, and his disciples. A critical analysis of the ideology follows this examination. We explore the reasons for it not finding general support in the mainstream academic circles, and for not leading to meaningful and innovative financial products or economic programs. Our analysis and the extant empirical evidence supports the idea that Islamic economics and finance's framework needs major revisions.

I. The Idea of Islamic Economics and Finance

The idea of the Islamic economics and finance is generally credited to the efforts of Mawdūdī (1903-1979), an Islamist thinker and activist who dedicated his life to the revival of Islam in India. He was involved with the struggle to reverse the decline of the Muslim community in pre-partition India even before the establishment of the movement of Pakistan (see Nasr, 2009), and founded the Jamaat-i-Islami (Islamic Party) in Lahore in 1941 to strive for his revivalist goals.

Mawdūdī, whose literary works included the translation and interpretation of Quran, was also instrumental in the development of the idea of an Islamic economic system. He strongly believed that Islam is a comprehensive system or the way of life, which included one's economic pursuits. This was strongly conveyed in his 1941 address at the Aligarh Muslim University of India (1941, 1992), in which he states that "The real economic problem of man does not consist in finding out how to prevent the development of civilized social life or to interfere with natural cause of its advance and eliminate its essential aspects; the real problem is how, while keeping intact the natural evolution of social forces to prevent social tyranny and injustice, to fulfill nature's demand that every creature should receive its portion and to remove those obstacles which cause the faculties and powers of large number of persons to be wasted away merely on

account of lack of necessary means;” (Mawdūdī, 1941 p. 16). He argues that the “real causes of evil” in the economic system are linked to the innate nature of man as the economic creature. “Evil in the economic system begins when the natural selfishness of man exceeds the limit of moderation³.” And, “If, therefore, by sheer good luck one finds himself possessing more of these means than his requirements justify, it only implies that the surplus which was really the portion of others has reached him. Why should he (the rich) hold it for himself? ...He (the rich) should look around for people who are not fit to secure their portion of the means of living....it behoove him to transfer it to them,” (ibid., p. 20)⁴. According to Mawdūdī (ibid, p.21) there are two methods of utilizing the surplus to secure means:

1. It should be lent on interest, and,
2. It should be invested in commercial and industrial undertakings.

This system creates a dual society, a small class (of rich) which controls most of the means of production and uses various techniques to grab further and further share of means of production (ibid, p. 21). Concentration of wealth among a few hands means that the poor increase in number, and a struggle ensues between these two classes. The rich who are in control of the resources want to produce more but majority of people are poor so they cannot buy the goods produced. Here, his critique on the inequality between classes resonate the ideals of a Marxian system that he himself heavily criticizes. Mawdūdī then interlinks the economic decisions of the rich to its spillover impact on international trade (ibid., p. 14)⁵. In particular, international trade is needed to sell unconsumed products to other countries. The rich class has to sell goods abroad to escape bankruptcy and hence their bankruptcy is transferred to other nations. International trade meant that:

1. Every country maximizes the production of exportable goods at the lowest possible cost, so labor is paid the minimum in wages.
2. Countries try to impose import restrictions, so they create production monopolies within the country.
3. Surplus goods are sold and receipts invested in production of more goods.

If surplus goods are not available, investments are made by borrowing money and many of the entities become insolvent if goods they produce are not sold due to insufficient demand. To ensure solvency, these entities need more markets, which lead to colonization of foreign lands. For example, the colonization of India was a consequence of the business ventures of the East India Company⁶.

Mawdūdī then moves on to the possible solutions to address the problems caused by the unrestricted capitalistic system (ibid, p. 28). Communism provides a possible solution, but it

³ Here it is clear misinterpretation of the Adam Smith type of self-interest motivation which leads to successful business ventures, which leads to economic growth and rest of the society can benefit from this self-interest motivation.

⁴ Mawdūdī sounds more Marxian here, although he later condemns communism as well. He also considers successful capitalist ventures as mere good luck instead of the success of innovative and entrepreneurial ideas.

⁵ Many market oriented capitalistic economies have adopted progressive tax systems where wealthier or higher income persons pay higher taxes, which can be used to provide basic services for lower income segments of the society.

⁶ Mawdūdī’s criticism of capitalism and the need for international trade does not have strong empirical evidence, especially from the second half of the 20th century. Economic growth has been tremendous in most market oriented capitalistic countries. International trade has played a significant role in promoting economic growth and raising standards of living in many countries including South Korea, Hong Kong, Malaysia, Singapore and even large population countries like China and India.

fails to protect individual property rights and emphasizes communal control over individual incentives. Resource allocation decision-making is left to a small group of people who control everything, which leads to disastrous consequences. A corrupt collective replaces industrialists and capitalists, and this control of resources by a corrupt few leads to an abuse of power and workers who are left without any recourse. They have no choice but to work under the control of few corrupt people. At the time of his writings, the global economy was in a tumultuous state caused by the WWII. Influenced by the socio-political circumstances of the time, Mawdūdī also provided a harsh commentary on the disastrous consequences of the fascist regimes.

What then is the alternative? According to Mawdūdī, the solution lies in the institutionalization of an economic system based on Islamic ideas that is drawn on natural laws and principles of life inherent in human nature. Introduction of few external regulations to the existing man-made system is not sufficient to cleanse the system. He espouses an Islamic economic system based on three principles (ibid, p. 33).

1. Natural laws and principles of life inherent in natural laws should not be tempered with.
2. Introduction of a few external regulations into the current systems is not sufficient.
3. The authority and pressure of law and coercive power of the government should not be used except when it becomes inevitable to do so.

To Mawdūdī, the Islamic economic and financial system is based on the principle of private property ownership subject to the qualification that the property is not acquired by unjust means (ibid, p. 35). Man is only entitled to acquire wealth using his talent in Islamically permissible (Halal) ways. While Islam recognizes the right of the individual to the ownership of all that he may acquire by lawful means, it does not give him freedom to spend his wealth frivolously; “All methods of spending which cause moral or social injury are forbidden,” (ibid, p.36). Once his “reasonable” needs are fulfilled, any surplus wealth should be distributed to others, thereby the poor and needy may then satisfy their needs. He thus takes the egalitarian nature of the Islamic beliefs to the highest level, where substantial wealth will be foregone by capitalists and other highly wealthy individuals. Mawdūdī seems to be disillusioned with an economic system where individuals are pursuing their “self-interest” blindly and the corporate sector is purely following the “profit maximizing” goals⁷. Obviously, this hinges on a system where individuals are “pious” and know that sacrificing additional wealth will earn them more rewards in the “hereafter”. In this context, Mawdūdī’s Muslim individuals and corporations are the egalitarians of the highest degree⁸.

This leads to the Mawdūdī’s discussion of the prohibition of interest. Surplus wealth saved by individuals must not be lent to others on interest basis. “This breaks the very backbone of the aggressive capitalism and blunts the edge of the greatest instrument by means of which the capitalist tries to concentrate in his hands the economic resources of the community by relying

⁷ The experience of economic growth in the 20th century has shown that pursuit of self-interest leads to healthier competition in the market place, and rewards innovation and the entrepreneurial spirit, which results in greater production of goods and services.

⁸ As discussed later in this paper, Islamic economics depends heavily on the “piousness” of economic agents who are willing to give up excess saving and any unconsumed wealth.

on the money power,” (ibid, p. 38). The Islamic system does not allow hoarding of surplus wealth or excessive savings⁹.

One way to re-distribute the wealth under the Islamic economic system is the institution of the Zakat¹⁰, an obligatory tax for charitable purposes. Under the capitalist system, wealth can be concentrated in the hand of few, whilst millions can be deprived of their basic needs. Workers are forced to work for subsistence wages and do not have access to safety nets. For example, millions have no health coverage or insurance and it exposes their dependents to further economic deprivation should the family breadwinner depart. In this situation, Zakat can provide the requisite resources or function as the social safety net to the poor during their dire needs. This form of obligatory contribution to the poor and needy can be used as an aggregate demand stimulus to expand the economy as well (ibid, p.40)¹¹.

After Zakat, Mawdūdī acclaims the re-distributive and egalitarian objectives of the Islamic inheritance laws which divide the wealth among all of the children and relatives of the deceased¹². Thus, wealth is not concentrated among a few. However, based on the evidence from the long human history, one may conclude that Mawdūdī’s proposed system will produce low savings, lack of investment, and low economic growth in Muslim economies who may adopt this system¹³.

Mawdūdī’s work in the mid-20th century set off a tidal wave of research on Islamic economics and finance in subsequent decades. Two names stand out in terms of their contributions to the Islamic economics. The first is Umer Chapra, who prior to his retirement had been involved with the Saudi Arabian Monetary Agency for over three decades. He also served as a senior advisor to the Islamic Development Bank.

Expanding further the ideas put forth by Mawdudi, Chapra (1994, 2000) endorses government regulation and intervention for the greater good of the people. Whilst it is clearly evident that a government which succeeds in maintaining strong law and order can create more productive economic environment, his prescription for economic growth follows a very strict and traditional path where partnerships (Mudarabah or Musharakah)¹⁴ are expected to replace the traditional credit system. Chapra’s economic alternative is based on five key steps that societies must take:

⁹ Empirical evidence shows that high savings are necessary for domestic capital accumulation which stimulates economics growth.

¹⁰ Zakat is considered one of the pillars of Islamic faith, where every qualified (who has sufficient minimum positive net worth) has to pay 2.5% of its net worth (not current income but net savings on an annual basis) in charity for the needy citizens of society. These minimum requirements vary for agricultural income or income from other sources. Zakat may also be required if wealth is kept in terms of gold, silver or other precious metals. However, Zakat is not required on the house one lives in or other means of production or tools required for one’s work. Zakat can be collected by the government but must be spent on helping people with needs including providing education or health services. Zakat is not meant for public sector capital projects.

¹¹ We see later in Timur Kuran’s critique that this argument for Zakat being a simulative tool in the economy does not have strong empirical support.

¹² Islamic inheritance system requires that bequeathed assets of a person must be divided among all deserving descendants in a specific way. The system has pre-specified shares for one’s widow, children and other members of the family.

¹³ In a recent study, Sait and Tempira (2015) point out that “severe land fragmentation in many Muslim countries has been well documented. Though ‘Muslim’ countries exhibit uneven and diverse socio-economic, political and religious trajectories, they often share additional common causes for land fragmentation”.

¹⁴ Mudarabah is similar to a capital venture project, where an entrepreneur has a business idea and a capitalist provides capital. Profits are divided on a pre-determined basis and losses are borne by the investor. Musharaka is a joint venture where parties invest their respective share and profit-losses are borne by each according to their share. For details of various instruments based on Islamic Law see Irfan (2015).

1. Invigorate the human factor.
2. Reduce concentration of wealth
3. Undertake economic restructuring in the developing Muslim countries.
4. Restructure financial systems.
5. Adopt strategic planning.

In one of his books on economic development, Chapra (1994) explores the underlying causes of poverty in the developing countries, especially the Muslim countries. Chapra contended that capitalistic institutions have failed to mitigate poverty in the developing countries, and countries which had strictly followed the Western capitalist advice have failed “miserably”¹⁵. According to him, most of the problems experienced by these countries can be attributed to the contrarian views held by the Western economists and policy makers as to the benefits of more egalitarian income re-distribution policies, who also incidentally dominate international agencies and influence economic policies. Chapra’s enumeration of problems with capitalism is closely linked to Mawdūdī and other proponents of Islamic economics (and finance more recently) who have been actively writing since the 1950’s.

According to Chapra, Western economists’ emphasis on self-interest as a vehicle for economic growth, and their emphasis on the market system and neoclassical economics have failed to explain acute and widespread poverty in developing nations. He also criticizes theoretical models like the Big Push which were quite popular in the 1960’s. However, Chapra’s argument against export-based economic policies is not supported by the more recent empirical evidence. Chapra (if writing today) would not have ignored the success stories of the last couple of decades from South Korea, Hong Kong, Taiwan, and even Muslim countries like Malaysia which have achieved major successes in their economies due to market-oriented approach taken by their policy makers as well as open economy path they chose to promote their service and manufacturing sectors. It is doubtful whether the egalitarian system proposed by Mawdūdī, Chapra and other Islamic economists would have been able to produce these “growth miracles”.

The second Mawdūdī disciple is Mohammad Nejatullah Siddiqi, a prolific writer in the field of Islamic economics and finance. Unfortunately, his conception of an Islamic economy is not implementable in the current global economic and financial system. This is despite his proclaimed open mindedness when he states that, "Islamic finance is open to any innovations that are in congruence with its fundamentals," (Siddiqi, 2002). And, "We should never lose sight of the reality that the divine part of modern Islamic finance, though crucial, is very small. The rest is man-made resulting from Ijtihad (efforts in understanding and applications)," (Siddiqi, 2001).

In his most recent lecture on “Elements of Islamic Economics” at the Department of Business Administration, Aligarh Muslim University, Siddiqi (2011) asserts that all freedom, including the freedom of enterprise are to be seen from an Islamic perspective. There is always a God-given purpose which comes with a set of responsibilities and accountability. Islam teaches about human accountability in the “hereafter” which determines the set of responsibilities during earthly life. Due to this accountability, regulations are needed everywhere. He acknowledges the

¹⁵ Chapra’s statement lacks empirical support from most market-oriented capitalistic societies including welfare oriented Scandinavian countries.

significance of individual property rights but asserts the great need for regulation based on parameters set by the “Divine” guidance.

According to Siddiqi, “A framework is provided by the rules laid down in the Islamic Law¹⁶. With reference to the economy, prohibition of Interest is an important rule. Money now exchanged for more money later involves the prohibited interest. The rationale for this prohibition is that the lender does not share the risks that the borrower bears in using the money borrowed. Modern Islamic financial institutions have sought to develop alternatives to interest-based lending. These are based on profit-sharing, rent or sale with a markup on purchase price (Murabaha)¹⁷. Islam has also prohibited gambling. Transactions involving excessive ambiguity (gharar) also fall in this category (Siddiqi 2011). Siddiqi asserts “the essence of gambling is taking a risk of one’s own creation with a view to making a profit thereby. It is a non-productive zero-sum game” ... some activities on a modern stock exchange fall in this category... While risk shifting is discouraged, risk sharing is encouraged” (ibid, Lecture 2). Mudaraba-based partnerships are obvious examples of risk sharing investments.

Referring to the 2008-09 global financial crises, Siddiqi points to three things “role of interest based debt, speculative and exploitative approach towards risk and an incentive structure focused on maximization of private gain... All of this has to be changed if we want to avoid future crises”. However, Siddiqi and others with similar ideals have failed to present a viable alternative to the current prevalent economic system and financial practices. Significant amount of the literature on Islamic economics and finance keeps promulgating profit/loss based partnerships in lieu of existing credit system. However, this prescription has yet to be widely accepted by the global or even Muslim investors and economic policy makers. Certainly, there are fundamental economic and policy issues that are hindering the adoption of these ideals. In the meantime, the economic ills of the Muslim countries remain unaddressed.

I. Critical Views of Islamic Economics and Finance

Whilst the objectives of the work of the Islamists are lofty and should be respected, it is the underlying theoretical paradigm and postulates that have led to it being rejected by the mainstream economists. The rigorousness of new theories or research contribution is to a certain extent measured by its acceptance into mainstream peer-reviewed journals. This serves as the initial ‘litmus test’ of the academic fraternity. There are a number of reasons for this state of affairs.

1. A Lack of Academic Rigor and Scientific Environment

By opting to publish in mainly party-run journals (or those run by the broad based global affiliates), non-refereed books or proceedings of conferences, the leading proponents have not encouraged other researchers to publish in highly ranked peer-reviewed journals. This understandably, has led to the erosion in the quality of intellectual work in the field.

¹⁶ Shariah is a term used for Islamic Law which guides various aspects of day to day human life. Shariah however, only covers a small portion of economic life.

¹⁷ Murabaha is cost plus arrangement where buyer and seller make a transaction on an agreed upon price. Buyer normally charges a higher price for a product when a buyer pays the price on installment basis. This additional price is normally not considered interest (or Riba) but profit. Irfan, Qazi, Murabaha Financing vs. Lending on Interest (July 22, 2008). Available at SSRN: <http://ssrn.com/abstract=1803651>. For further reading see Irfan (2015).

The Islamic economics proponents, in their zeal to reform the existing financial system, seem to have populated the institutions (and academic journals) in Islamic economics (and finance) with likeminded scholars to bolster their case. The resources of these institutions have been diverted to sponsor conferences where the key disciples of Mawdūdī and party cadres are invited to respectively present key note addresses and papers with little academic rigor. Likewise, the journals edited by the Islamists are focused on promoting their ideologies even at the expense of research for the economic betterment of the Muslim world. Nonetheless, all this mental jostling has been in vain as it has failed to lay the theoretical foundations or the intellectual base of the field. For instance, economic interpretations of the key injunctions regarding interest, gambling, speculation and enforcement of debt contracts (*riba*, *gharar* / *maysir* and *bai' al-dayn* or *bi al dayn*)¹⁸ are still relatively untouched. The failure to do so has been a stumbling block for the financial industry in the Muslim world and has been heavily criticized by many.

2. Overemphasizing the Normative but Ignoring the Positive

It should be noted that the failure to propose viable and practical alternatives to the existing conventional (modern) financial system and instruments is not just limited to Mawdūdī and his disciples. Most of the literature on Islamic economics and finance produced during the last two to three decades assumes virtuous individuals and societies and ignores basic understanding of the human behavior gained from social sciences which responds to economic incentives and not to religious injunctions and penalties. The end result is that Muslim nations are living in a delusion as they claim to have Islamic financial systems in place. In reality these so called Islamic systems may be delivering worse than the mainstream economic systems. For example, it is well established that property rights are a key to economic development and form the very essence of a progressive economic system. These rights are also upheld by the Islamic Law (Shariah) but are not discussed in the Islamic economics literature and in practice are disregarded by the Islamic elites. Some scholars believe this to be an important reason why the Muslim world has been underdeveloped for centuries (see Makhdoomī, forthcoming, and Salleh et al., 2011).

3. Over-emphasis on Altruistic Behavior

A principle ingredient in all Islamic-compatible economic activities is altruism. Islamic economists believe that Muslim societies can solve their problems if they consider societal interests above individual interests. Kuran (1986, 2004, 2011) asserts that following these Islamic norms is not always possible for individuals. Historically, selfish individuals have taken and modified those norms to increase their personal economic benefits. Furthermore, most of those norms followed by early Muslim societies (including one founded in Medina by Prophet Muhammad and continued by the first four Caliphs, also known as the rightly-guided ones) were meant for small agrarian communities. Their relevance and effectiveness is greatly diminished in

¹⁸ *Gharar* is a transaction which is ambiguous and has a certain degree of uncertainty. Due to this speculative element, these types of transactions are generally prohibited according to Islamic Law. However, there are many new financial instruments in the global market which might mitigate this uncertainty by combining different types of assets in a financial instrument. *Maysir* is Gambling as well. *Bai al-dayn bi al dayn* is a formal documentation of issued debt. See Ali Alshamrani (2014). Also, see Irfan (2015).

bigger urban and industrial societies. Norms like altruism are extremely difficult to achieve in large population urban societies.

Proponents of Islamic economics and finance believe that the economic system observed during the days of Prophet Muhammad and the first four caliphs performed exceptionally well. Kuran (1983, 1986, 2004, 2011) finds this to be questionable based on historical evidence. For instance, the principle of “Zakat” had to be implemented by force during the reign of the first Caliph Abu-Bakr after the death of Prophet Muhammad.

4. Fixated in Antiquity

Kuran (1986, 2011) points out that the Islamic economic system was very dynamic in the early days of Islam. It was not a fixed or static system as portrayed by many Islamic economists and scholars. He asserts that many Muslims continue to subscribe to the idea that economic practices were uniform across all Muslims in the early periods of Islam. Nonetheless, history clearly shows evidence of diversity in economic practices and laws among Muslim nations and cultures in Asia, Africa and Europe. An example of this is the principle of “Zakat”. Despite the assertions of Muslim scholars; Zakat has never been based on a fixed rule. The Zakat requirements underwent dynamic interpretations over the Muslim history including the days of the four rightly-guided caliphs (Kuran 1986, 2011).

5. Romanticization of the Golden Period of Islam

Muslim scholars over the centuries have emphasized the effectiveness of Zakat as a major redistribution tool during the golden period of Islamic caliphates. However, the reality has been much different. Muslim governments have always used various other tools than Zakat to enhance their revenues. Furthermore, there is limited evidence that the marginal propensity to consume among the Zakat recipients is sufficiently high to stimulate aggregate demand in the modern economies. According to Kuran some of the impact of Zakat is actually very regressive falling on lower income people in the Islamic society.

Aside from the above, there is also an additional problem with “Zakatability” of various assets. Unless the definition of “Zakatable” assets is expanded, it is highly probable that big urban industrialists can completely avoid paying Zakat. This is affirmed by Salama (1982) who reported that the overall Zakat contribution to GDP is negligible. In countries like Saudi Arabia Zakat distribution authorities have observed widespread evasion of Zakat by its residents. Kuran concludes that in the early Islamic societies, Zakat was not conceived as a “perfect and unchangeable” system of redistribution. It was regarded as a scheme that is changeable with time. Zakat collection rules which was previously commodity driven has become relatively obsolete as the modern industrial economic structure becomes more financially advanced and efficient.

6. Over-emphasis on the Form and not the Spirit

The Islamic economists tend to stick to the literal meaning of the various Quranic injunctions but ignore their spirit and historical context. A major aspect of the Islamic economics

(and finance) is the prohibition of “Riba” which many scholars equate with modern interest rate. To Kuran “what the Quran bans is the ancient practice of riba, which entails the doubling and redoubling of debt when the borrower failed to make the restitution on time. In pre-Islamic Arabia, the high interest rate was responsible for effective enslavement of substantial number of people, whose debts mounted exponentially following a single default,” (see Kuran 1986, p. 149). He further continues that, “The purpose of banning high interest rate (Riba) was elimination of potent source of inequality and communal friction,” (ibid, p. 149). Nonetheless, the whole Islamic finance industry seems to be focused on eliminating all forms of interest.

What comes across from some of the more recent literature on Islamic economics and finance is that modern interest rate is not a viable representative of riba. Modern interest rate paid to the depositors has (1) service cost; (2) overhead cost; (3) risk premium; (4) profit; and (5) compensation paid for the value erosion of capital due to inflation (see Gafoor, 1999).

7. Under-emphasis on the Role of Institutions and Law

Kuran (2004 and 2011) offers reasons why the Middle East is underdeveloped and focuses on the role of certain Middle Eastern institutions, including those influenced by Islamic traditions. He states “that the institutions that generated evolutionary bottlenecks include: 1) the Islamic law of inheritance (see footnote earlier), which inhibited capital accumulation; 2) the strict individualism of Islamic law and its lack of a concept of corporation, which hindered organizational development and contributed to keeping civil society weak; and 3) the waqf, Islam’s distinct form of trust, which locked vast resources into organizations likely to become dysfunctional over time,” (Kuran 2004, p.72). These institutions did not cause major disadvantages during the early years and they were not responsible for “an absolute decline in economic activity,” (ibid, p.72). However, these institutions started to perpetuate stagnancy in the economy. While Europeans were innovating and reforming their economic and financial institutions, Muslim Middle East countries failed to adapt their institutional structure in tandem with these developments.

Another factor that led to the divergence in the economic trajectory of Muslim economies was an outdated legal system. Kuran points out that beginning in the eighteenth century, Christians and Jews in the Middle East started to become dominant in the core sectors of the economy. Since the early days of Islam, non-Muslims living within the Ottoman Empire were allowed to have a separate court system to resolve their financial disputes. This provided them with the opportunities to take advantage of the more effective legal system, and the new corporate form of business and contractual arrangements in the commercial and financial sectors of the economy. The same was not the case for the legal system of the Muslim economies. Unfortunately, a lack of institutional and legal strength continues to persist in many Muslim countries and thus, further perpetuating the economic underdevelopment of the Muslim world.

8. Failure to Develop Risk Sharing Products

Ebrahim and Safadi (1995) criticize Kuran’s earlier publication (1983) and several ideas mentioned above. According to the authors, Kuran has missed the main idea of Islamic

economics, which is based on the premise of equity participating contracts. They review some of the literature which shows the equity participating contracts are more efficient than those based on fixed interest. They believe that there is ample evidence supporting equity based contracts. However, most of the contracts issued by Islamic banks cannot be characterized as truly equity based contracts. As Saleem (2005) points out, only a small fraction (1-3%) of the “Sharia Compliant” Islamic banks use “Mudaraba” contracts. Mudaraba contracts require that fund lenders assume equal risk in starting a new venture but most Islamic banks do not engage in Mudaraba type contracts. Another type of contract is Musharaka, in which an entrepreneur puts some capital as well. A great majority of Islamic Banks also do not engage in these types of contracts. According to Saleem these two types of contracts come very close to venture capital type investments. Venture capital type investments have played a significant role in developing new technologies in United States. Some of the major information technology companies like Google and large online retail businesses like Amazon and others were originally started by monies put forward by venture capitalists.

Most of the lending by the Islamic banks is based on ‘mark-up’ or cost-plus practices in sale and buy-back type of contracts (Saleem 2005). The Islamic banks in determining and calculating their mark-ups or profits on Murabaha transactions operate within the framework of the conventional banking using benchmarks such as LIBOR. A great majority of Islamic banks are engaged in Ijara¹⁹ (Islamic lease financing) where they finance up to 90% of the cost of the equipment, with guaranteed collateral.

Other concerns with the Islamic financial products relate to their higher transaction costs and underperformance. Hoepner et al. (2011), conducted an empirical study of 265 Islamic mutual funds from 20 countries. Their study is based on “unexplored, survivorship biased-adjusted” data set. They develop a three-level Carhart model to simultaneously control for exposure to different national, regional and global equity markets and investment styles. While Islamic funds from these markets are competitive in terms of international equity market standards, they underperform in more developed Western financial markets. Reason might be the smaller amount of total assets relative to the overall market capitalization and availability of huge volume of traditional funds and assets. According to their findings, Islamic funds show a clear preference for small caps.

Uppal and Mangla (2010) provides empirical evidence that the view that Islamic banks are inherently safe is not sustainable in the light of their experience during the Great Financial Crisis (GFC). Additionally, Uppal and Mangla (2010) shows that the actual lending practices of Islamic banks are predominantly based on mark-ups, thus implicitly carry interest. The study finds that the Islamic banking industry seems to have fallen short of the Islamic ideals, and their practices have moved away in substance from their brand-image towards a convergence to the conventional banking.

Conclusion

As an introduction to a recent book on Islamic Finance and Law, Balala (2015) points out that “Islamic commercial and financial practice has not experienced the trial-and-error style

¹⁹ Ijara products are very similar to products provided on lease or rent.

development that has characterized common law in English speaking world. Many of the principles, rules and practices prevalent in the Islamic law of contract, commerce, finance and property remain the same as those outlined by the Quran and the Prophet Muhammad, and expounded by scholars of jurisprudence as far back as the thirteenth century, despite the advancement in time and sophistication of commercial interaction”.

It appears from our survey and analysis of the recent literature that Islamic economics and finance is still a work in progress and has a long way to go before it can offer a viable market-consistent alternative to the modern banking and financial system. Unless there is a general willingness by the Muslim scholars and proponents of Islamic economics and finance to modernize their overall framework and put it through the rigorous scientific method of inquiry currently applied in the field of social sciences and in particular in the fields of economics and finance, Islamic economics is likely to remain a small player in the rapidly developing global economic system.

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