



Visiting Scholar Research Series

No. 2

ECONOMICS OF SMALL BUSINESS IN ISLAM

**ISLAMIC RESEARCH AND TRAINING INSTITUTE
ISLAMIC DEVELOPMENT BANK
JEDDAH, SAUDI ARABIA**

ISLAMIC RESEARCH AND TRAINING INSTITUTE (IRTI)

Establishment of IRTI

The Islamic Research and Training Institute was established by the Board of Executive Directors of the Islamic Development Bank (IDS) in 1401H (1981). The Executive Directors thus implemented Resolution No.BG/14-99 which the Board of Governors of IDS adopted at its Third Annual Meeting held on 10 Rabi Thani 1399H (14 March 1979). The Institute became operational in 1403H (1983).

Purpose

The purpose of the Institute is to undertake research for enabling the economic, financial and banking activities in Muslim countries to conform to shari'ah, and to extend training facilities to personnel engaged in economic development activities in the Bank's member countries..

Functions

The functions of the Institute are:

- (A) To organize and coordinate basic and applied research with a view to developing models and methods for the application of *Shari'ah* in the field of economics, finance and banking;
- (B) To provide for the training and development of professional personnel in Islamic Economics to meet the needs of research and shari'ah-observing agencies;
- (C) To train personnel engaged in development activities in the Bank's member countries;
- (D) To establish an information center to collect, systematize and disseminate information in fields related to its activities; and
- (E) To undertake any other activities which may advance its purpose.

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The President of the IDS is also the President of the Institute. The IDB's Board of Executive Directors acts as its supreme policy- making body.

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Location

The Institute is located in Jeddah, Saudi Arabia.

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MOHAMMAD MOHSIN
Visiting Scholar

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In the name of Allah, the Most Merciful, Most Beneficent

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FOREWORD

The Islamic Research and Training Institute (IRTI) was established by the Islamic Development Bank (IDB) in 1401H [1981] and started operating in 1403H [1983]. Main objectives of the IRTI are to carry out research in the area of Islamic economics, banking and finance; to develop capabilities of professional personnel in Islamic economics to meet the needs of research and shari'ah observing agencies; to train personnel engaged in development activities in the IDB member countries and to develop databases in fields related to its activities to help foster the development of the IDB member countries.

This research on "Economics of Small Business in Islam" has been contributed by a visiting scholar who visited IRTI under the "Visiting Scholar Scheme" adopted within the framework of activities undertaken by IRTI to achieve its objectives.

Effective mobilization of savings through the Islamic financing instruments implies effective investments for the purpose of capital formation and growth. Islamic savings should flow in areas of relative scarcity. How can this be achieved in the Islamic perspective? A possible outlet for Islamic savings is the small business sector, as this study assumes. Therefore, the study concentrates upon the possible uses of Islamic financial techniques in the small business sector.

The main objective of the study is to investigate and elaborate the role of Islamic ethics and institutions in exploiting the economics of small-scale business sector for the benefit of Muslim societies.

The study does not, however, elaborate the nature and characteristics of Islamic financial instruments. It focusses on the application of these methods and instruments approved by Fuqaha. It identifies the institutional framework and makes policy recommendations that could help the development of small-scale business.

It is hoped that this study gives readers a reasonably clear understanding of economics of small-scale business in Islamic framework.



M. F m Khan Officer -
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ABBREVIATIONS

CTS	Countries
HDI	Human Development Investment
ICB	Islamic Commercial Bank
ISSBDC Corporation	Islamic Small-Scale Business Development
SSB(s)	Small-Scale Business(es)
SSBS	Small-Scale Business Sector

INTRODUCTION

In a secular economic environment, both legislative mandates and the investment management of savings institutions emphasize investment in the fixed interest-bearing obligations of established concerns. Consequently, with the institutionalization of savings, a barrier has been created which is difficult to scale by venture enterprises particularly for relatively small business. This is counterproductive because economic development is impeded if resources do not flow into areas of relative scarcity and growth. Moreover, the effective mobilization of savings through the Islamic financing instruments implies effective investment for the purpose of capital formation and growth. It is essential that Islamic savings should flow in areas of relative scarcity ensuring that the economic growth they generate is distributed widely and fairly. How can this be achieved in the Islamic perspective?

A possible outlet for Islamic savings is the small business sector. Investment in small-scale business is considered important because it addresses both humanitarian and development objectives: humanitarian because economic development should enrich human life; and development because progress largely springs from the innovative efforts of new enterprises and small business units which are not at present integrated with the current stream of development in many developing Islamic countries.

OBJECTIVE OF THE STUDY

Of the several investment alternatives available, the present study concentrates upon the possible uses of Islamic financial techniques in the small business sector. The main objective of the study is to investigate and **elaborate** in detail the role of Islamic ethics and institutions in exploiting the economies of the small-scale business sector for the benefit of Muslim societies.

THE SCOPE OF THE STUDY

Being a study on the uses of savings in small-scale business, the 11

analysis does not elaborate the nature and characteristic features of Islamic financial instruments. It demonstrates the application of those methods and instruments which have gained the approval of the *Fuqaha*. It identifies the institutional framework and makes policy recommendations that could help the development of small-scale business as a viable feature of the Islamic system in actual practice in the contemporary setup of Muslim economies.

DEFINITION OF SMALL-SCALE BUSINESS

There is no universally accepted definition of small-scale business. Definitions differ from country to country and also according to purpose. The size of an enterprise is usually measured in terms of the number of people employed; the amount of capital employed; the size - of fixed assets; the sales turnover or the annual output. In line with the objective of the study, it was considered consistent to use the number of people employed as a criterion. Since the 'labor-intensive' feature of small-scale business has been emphasized as a means of providing better employment opportunities in Islamic countries, it was considered appropriate to keep the number on, higher side. Small-scale businesses are, thus, defined as those employing 50 persons or less at any one time. Another attribute identified in this" study of small-scale business is that the owner is supposed to be the manager. 'Business' in this study means any legal, commercial, trading or industrial activity.

In short, 'small-scale business' means a business owned and managed by the same person and employing fifty or less persons at a time.

MAIN ASSUMPTIONS

The study is focussed on creating the necessary social and physical infrastructure based on Islamic principles. It assumes that small-scale businesses and supporting institutions operating in the Islamic perspective will compete with secular enterprises and institutions in a mixed market. Consumers and capital markets are supposed to be highly imperfect - as indeed they are - where the products, output and services of small

businesses and that of financial institutions based upon Islamic principles shall be differentiated on the basis of quality and performance. Islamic enterprises and institutions shall have their own code of conduct based on the Shari'ah without seeking any amendment to the existing secular legal framework of the country. In other words, in addition to the Islamic Shari'ah, Islamic business, financial and specialized institutions shall abide by the law of the land.

We have also assumed that a country's propensity for the small-scale business and its willingness to apply Islamic principles will be determined by the attitude of society. Cultural differences between different countries and regions will, therefore, strongly affect the direction of the activities of the government. In general, the most explicit policy formulation indicating the role and organization of government will be to foster, counsel, assist and protect, in so far as possible, the interests of small-scale business. Since the level of participation in small-scale business and the success of policy reforms will depend upon the willingness and resources of the government of a country, our recommendations for developing the necessary social and physical infrastructure for the operation of small-scale business in the Islamic perspective will remain tentative and suggestive.

PLAN AND LAYOUT

The study is divided into seven sections. Section I describes the economic structure of Islamic countries. It observes that poverty, low productivity and chronic unemployment are the chief features of low-income developing Islamic countries. Section II, while explaining the rationale of small-scale business, stresses the importance of its labor-intensive character as an effective means for providing better employment opportunities in developing Islamic countries. However, Section III shows that government support and action have failed to exploit in full the economies of small-scale business in the formal sector in developing countries.

The factors inhibiting the growth of small-scale business are analyzed in Section IV. Relevant issues with policy implications for

Islamic enterprises are carefully examined. Against this background, a suitable infrastructure to foster viable small-scale businesses in the Islamic perspective is suggested in Section V. The modus operandi of the proposed system is explained in Section VI. The main conclusions are summarized in Section VII.

I

ECONOMIC STRUCTURE OF ISLAMIC COUNTRIES

Almost all Islamic countries at different stages of economic growth are categorized as 'less developed'. About 80 percent of the Muslim population lives in low income countries and a vast majority live in the most depressed regions of the world. Apart from other characteristic features of developing countries, Muslims in Islamic countries and also those living as cultural minorities in other countries, share a relatively higher incidence of poverty, low productivity and unemployment.

According to various estimates, the unemployment problem is likely to become more acute in the near future. Economic forecasts suggest that the total requirement for the next decade is around one billion jobs. This would imply increasing the total employment rate in the developing countries by more than 4 percent a year in the 1990s, compared with less than 3 percent in the 1980s. The ILO projection for the next decade holds no comfort. On present trends the growth of employment will continue to lag far behind that of both output and the labor force. In recent years the problem of unemployment has assumed the dimension of jobless growth which is regarded as a new and disturbing phenomenon.

While initiating the process of growth in developing countries, it was assumed that pursuing economic growth by increasing output would generate employment. However, this has not happened. Developing countries on an average experienced 4.5 percent growth in GDP during 1960-73, but employment grew by only half as much. The situation is worse in the depressed sub-Saharan region where a good number of Islamic states are located. Almost all countries in the region have an unemployment rate exceeding single digits. In Asia as well, countries like Pakistan, despite a respectable growth rate of more than 6 percent, have experienced unemployment rates above 15 percent. This can be attributable to the use of 'capital-intensive' methods of growth under

which less than one-third of the increase in output in developing countries between 1960 and 1987 was associated with labor, and more than two-thirds from an increase in capital investment.' Developing countries are now confronted with the serious problem of 'jobless growth'. Policymakers the world over are searching for development strategies that combine economic growth with more job opportunities.

¹ UNDP: Human Development Report 1993, Oxford University Press, New York, 1993, p.35.

II

RATIONALE OF SMALL-SCALE BUSINESS

One of the best ways to ensure employment is to promote small businesses which are labor-intensive and provide more jobs per unit of capital invested. The establishment of such businesses generates employment and income and also helps check rural-urban migration.

The ability of the SSB to generate greater employment opportunities at a low cost particularly suits the developing countries that are confronted with a rapidly growing population.' Since development in the case of the SSB is woven around people (not people around development), it contributes immensely to preventing large shifts in the movement of population associated with industrialization. The location of small-scale industries in rural areas encourages the use of new, renewable and alternative sources of energy, which are invariably cheaper to produce, thereby reducing the use of imported energy and conserving foreign exchange.

The people centered feature of the SSB also helps in the deconcentration of economic resources. In most developing countries, poverty is often caused less by an absolute shortage of resources than by their skewed distribution. The decentralization of development through small-scale business can be one of the most important methods of action in preventing the urban 'pyramiding' of industrial enterprises. In medium term and large scale industry, two kinds of activities have to be eliminated to reduce the drain on national resources: unviable 'white elephants', and activities that surpass the limits to operate competitively. These considerations imply a trimmer industrial sector and specialization in resource-based activities and in industries where low technological

Farooque, Q.H.: Small Scale and Cottage Industries as a Means of Providing Better Opportunities for Labor in India, Aligarh Muslim University, Aligarh, 1958, p.16.

requirements give local processing a comparative advantage. Small-scale businesses possess these attributes as they have low technical requirements which can be developed locally. The SSB is often regarded as a center for the development of semi-skilled manpower and indigenous entrepreneurial capabilities badly needed for industrialization.

A particularly important feature of the SSB is its ability to facilitate vertical and horizontal linkages with medium and large size business. Vertical linkages have great significance in developing countries as their establishment also encourages the development of integrated and interlinked industrial development by subcontracting. Small-scale business geared towards the production of components or spare part also stimulates the growth of other sectors, such as, food, agro-based industries, building industries, transport and communications, and energy. The promotion and expansion of small-scale industrial activities in rural areas could help meet the goals and objectives for rapid and integrated development, with emphasis being placed on the satisfaction of basic needs and the use of local resources.'

Because of the key role that small-scale business could play in the diversification of economic activity and in the creation of better employment opportunities, some governments in developing countries have pursued active policies in the development of the SSB. Expanded government action in support of the SSB includes: the establishment of specialized financial institutions and the development of infrastructure, which consists of the establishment of industrial estates in urban and rural areas, marketing services including export market facilities, technical development, extensive training and concessions in power supply. In addition to infrastructure facilities, financial incentives provided include exemption from excise duty, quantitative restrictions on the output of

³ Mohsin, Mohammad: Tax Incentive to Small Companies in India, Journal of Commerce, Aligarh, October, 1972, p.102.v

large scale firms which is an implicit subsidy to the SSB and reservation in product lines.'

State patronage and subsidies, however, have failed to bring about the required level of development activity in small-scale business in the formal sector. The informal sector, which received no state support, continued to grow mainly through the activities of small-scale business. In Latin America, for example, 31 percent of all nonagriculture employment was in the informal sector at the end of the 1980s as against 25 percent at the beginning of that decade.

In the sub-Saharan region, the informal sector expanded by 6.7 percent a year between 1980 and 1989, substantially faster than the formal sector. Between 1980 and 1985, while the modern sector added only 500,000 jobs to the urban labor market, the informal sector created some six million new jobs. By 1990, the informal sector employed more than 60 percent of the urban work force - more than twice the share employed by the modern sector. The same trend was noted in the South-East Asian region where the urban informal sector has been growing faster than the formal sector.'

Small-scale industries in the informal sector are characterized by three features:

- (a) The units of operations are very small, much smaller than their counterparts in the formal sector.
- (b) The sector is very active, but shows little evidence of the upgrading of size, technology, products, etc., which would

Little, M.D. Ian and Mazumdar, Dipak and Page (Jr), John M. Small Manufacturing Enterprises, Oxford University Press, Washington, 1987, p.88.

UNDP: Human Development Report 1993, Oxford University Press, New York, 1993, p.41.

denote structural transformation for linking with the mainstream of development.

- (c) The sector as a whole has not contributed to the entrepreneurial and technical skills needed for healthy industrial growth. However, the informal sector has survived economic vicissitudes much better than the modern sector. It is essential that this attribute of the informal sector be fully exploited in the national economic interests of the country.⁶ But at the same time, there must be a smooth transition from the informal to the formal sector in a country's economy.

Khan, Fahim M. Human Resources Mobilization Through the Profit-Loss Sharing Based Financing System, IRTI Research Paper No. 17, Islamic Development Bank, Jeddah 1992, p.9.

III

CONSTRAINTS TO THE DEVELOPMENT OF SMALL-SCALE BUSINESS

The failure of government support programs to achieve the desired level of growth in small-scale business in the formal sector is due to a number of interrelated factors. The factors responsible for this failure, which has a bearing on defining the role of the SSB in Islamic perspective, can be divided into those related to policy and administrative actions and those inherent in the nature of interest rate finance.

POLICY OPTIONS AND PERFORMANCE OF SSB

The relatively slow growth of SSB is largely attributed to the fact that many developing countries have not incorporated specific policies on small-scale business into their national development plans. Industrialization policies have mainly focussed on the public sector. Investment incentives have discriminated, both de jure and de facto, against the SSB. Credit controls and interest rate ceilings encouraged banks to favor large firms even more than their natural disposition to do so. Where financial incentives have been given, they have been improperly administrated. Other constraints include inadequate infrastructural and institutional arrangements, as well as shortcomings in the areas of marketing and distribution.

Some developing countries have drawn up integrated program for the development of small business. However, the wrong priorities were established. Emphasis was laid on the provision of easy credit which encouraged the use of capital-intensive methods and accelerated the output rate faster than the employment rate. Although this had some economic advantage, it failed to achieve the basic objective of creating jobs for which institutions were established. Moreover, it is expensive and risky to give credit without imparting managerial and technical training. The missing element in the absorption of aid in small-scale business in developing countries was the development of industrial capabilities. It is

this fact that is critical in explaining why growth in the formal sector lagged behind growth in the informal sector.

The consequences of the inadequate small base of industrial entrepreneurship have great implications for the uses of funds as well as for the continuity and survival of SSB. It is estimated that 80 percent of SSB units failed because of inefficient management, more than for any other specific reason.' Among the management related pitfalls were (i) overinvestment in fixed assets, (ii) large . buildup of inventories, and (iii) expansion of manufacturing and sales activities beyond the limits of financial resources. Further studies in developing countries have also indicated that because of an inadequate skill base for industrial entrepreneurship in the small-scale sector, the projects chosen in most cases were uneconomical, were 'packaged' incorrectly or expensively and were poorly managed and organized. The technical inadequacies of these projects prevented them from reaching at operational level. However, even 'ill conceived' and 'ill designed' projects attracted finance from specialized institutions.'

Similarly, the administration of the policy of the reservation of products for the SSB and restrictions imposed on the output of large scale firms with a view to providing safe 'havens' for the SSB have been found to be counterproductive in many developing countries.' The artificial measures adopted to 'nurse' infant 'industries' in 'industrial enclaves' have encouraged the founders to prolong the 'incubation' period, in order to continue to enjoy state patronage.¹⁰ Consequently small-scale

Sen, A.R.: Appraisal and Administration of Small Industries Loans, Allied Publishers Ltd., New Delhi, 1992, p.2.

⁸ Griffen, Keith and Knight, John: Human Development in the 1980s and Beyond, United Nations, New York, 1989, p.149.

⁹ Little, M.D. Ian and Mazumdar, Dipak and Page (Jr.), John M.: Small Manufacturing Enterprise, Oxford University Press, New York, 1987, p.312.

¹⁰ Mohsin, Mohammad: Tax Incentive to Small Companies in India, Journal of Commerce, Aligarh, October 1972.

businesses remained enclave operations for long periods. Vertical and horizontal linkages were minimal. In many developing countries, SSBs were divorced from formal manufacturing, retaining the original dualistic structure of industry - few servicing and consultancy enterprises are found and gaps between efficient and inefficient enterprise remain large.

The Nature of Interest-Rate Finance

Interest rates are a market mechanism whereby limited funds are allocated among those that are willing and able to pay for them. The capital market is highly imperfect: It discriminates sharply among borrowers. Apart from other factors, the basis of differentiation is 'size' and the 'collateral' offered as security for funds. The market rule is: Other things being equal, the higher the risk, the higher shall be the rate of interest (cost of capital). The smaller the borrower, the more risky it is to lend to him. In order to minimize risks, lenders exact physical collateral guarantees which small enterprises cannot provide. The SSB is, therefore, ranked as a 'high risk' and 'high cost' borrower. In this process the small entrepreneur is often eliminated from the market, if sufficient collateral is not provided.

With a view to overcoming these problems, governments in many developing countries have established specialized institutions to give loans on soft terms and at subsidized rates to the SSB. But these institutions continue to rely on 'collateral' which does not serve the interests of the **SSB**. Recent studies have shown that institutions restrict their lending to the larger and less risky clients, effectively excluding small enterprises from the market. In particular, entrepreneurs who are starting businesses for the first time, constituting the highest risk, are the least funded. One of the principal conditions laid down by the specialized financial institution is that the total amount loaned can only finance 70 percent or 80 percent of the project cost, the rest of the money being invested by the entrepreneur in the form of equity from his own resources. This is indeed a high debt-equity ratio for those starting out in business for the first time.

The use of 'collateral' as a basis of lending in interest rate financing poses the greatest deterrent to the development of the SSB. It is this factor that has made lending from specialized institutions 'ineffective' and has often diverted resources towards unproductive uses. Another self-defeating consequence of such discriminating subsidized interest rates is that the borrower whom the government is trying to help is excluded and, in fact, ends up paying higher interest-rates in informal credit markets.

Finally, there is increasing evidence to show that 'collateral' as a basis of lending can never serve the best interests of the small business. To coverage requires considerable formalities. In collateral finance, specialized financial institutions have evolved an appraisal system that requires documentation and data which is far beyond the capacity of small enterprises resulting in the slow processing of loan requests which works against the interests of small borrowers. The small businessman, for whom the availability of funds is much more important than the cost of capital, prefers to deal with a single lender who can meet all his financial requirements. He turns to the money lender in the informal sector not only for money but also for the quality of service and the speed and care with which he is served, albeit at a high cost. Specialized financial institutions have failed to develop that edge in service in the formal sector.

IV

POLICY IMPLICATIONS FOR SMALL-SCALE BUSINESS IN THE ISLAMIC PERSPECTIVE

The foregoing analysis of the constraints of the development of small-scale business in the formal sector tends to suggest that 'collateral' encourages lending for unproductive uses and causes shortage of equity *which* is a chronic and critical problem for SSB financing. In many cases the equity of the entrepreneur is financed by loans from relatives and friends, or from moneylenders. Equity financing is undoubtedly a high risk area requiring careful appraisal and follow-up. In some developing countries, efforts have been made to provide finance to the SSB with sound projects but with inadequate collateral, through risk-sharing arrangements which are usually in the form of equity." This indicates a major shift in policy. It is widely recognized that for the conducting of efficient business and for the proper use of public money, financial aid from specialized financial institutions should not be made available unless the small-scale business shares ownership and control with the lending authorities. The view that financial institutions should not bear the administrative responsibilities of enterprise is also changing.¹² The emerging shift from debt to business partnership is also accompanied by a greater degree of control and coordination among various agencies serving the SSB. Some countries have established multipurpose corporations to bring under unified control the functioning of various institutions distributing finance, raw materials, tools and machinery and assisting in the selling of products. Such a unified pattern has already emerged in the United States where small business investment companies work in collaboration with the Small Business Administration. The lending authority of the Small Business Administration commences as

" Mohsin, Mohammad: Financial Management in Small Companies, Indian^s Journal of Commerce, All India Commerce Association Conference 1973, p.536.

¹² Ibid., p.537.

soon as the procedures regarding the lending of the funds are completed.

The shift in emphasis from 'collateral' to the viability of the project as a basis of lending puts 'risk evaluation' in its proper perspective. In business finance, 'safety' is not permanently attached to any specific form. Lending on the basis of collateral can be hazardous because in case of business failure, it is difficult for a normal asset to be disposed of for a price equal to the value of the loan for which it was created. On the other hand, an economically viable project judged along with the integrity and ability of the management ensures the repayment of the loan.

The development of small-scale business in the Islamic perspective, apart from changing the basis of assessment, should lay more emphasis on establishing a sound industrial base, with special emphasis on the development of the capacities and capabilities which can contribute to the promotion of resource-based industries. The costly error of establishing financial institutions before building industrial capabilities should be avoided. In most Islamic developing countries, adequate indigenous technical skills and managerial skills already exist which could be easily modernized with a minimum infusion of capital and know-how.

Policy biases against small enterprises should be removed. Incentives should be provided to attract people with means and modern skills. Small-scale enterprises should not be isolated in industrial enclaves as a result of the erroneous notion that they are "infant industry". They should be encouraged to establish links with large manufacturing enterprises. In well-planned industrial programs, small-scale and large scale business enterprises should play a complementary and supplementary role.

The most crucial need of the small-scale business is the provision of equity capital, and the Islamic modes of finance based on risk bearing and profit sharing fully ensures this. The broad parameters of an integrated policy program within an Islamic framework are explained in the following section.

INFRASTRUCTURE FOR THE DEVELOPMENT OF SMALL-SCALE BUSINESS IN THE ISLAMIC PERSPECTIVE

The scope of small-scale business in the Islamic perspective can be looked at in a more dynamic way. In OECD countries the role of small-scale business is seen as that of a 'seed-bed'. This image may be appropriate also for developing Islamic countries.

The concept needs a pragmatic approach in the creation of institutions and organizations that may help the development of self-sustained small-scale businesses. An obvious objective is to ensure that the economic growth they generate is spread more fairly and widely. The appropriate infrastructural arrangement for self-regenerating small enterprise support will vary from country to country depending on their resourcefulness and the prevailing financial and economic conditions and institutional framework. However, irrespective of the socioeconomic structure of a country, the multiinstitutional approach of channelling resources through both commercial and multipurpose development institutions seems to be the most effective arrangement. Aid to small enterprises must be made after ensuring that they have built up the requisite 'capacity' and 'capability' to 'absorb' it. The assistance must be administered in such a form as to make it possible for lending institutions to develop viable programs which are ultimately self-financing.

This requires the development of three types of capabilities:

1. Institutionalization of household savings
2. Institutional framework
3. Industrial capabilities

1. Institutionalization of Household Savings

The institutionalization of household savings is one of the most important conditions for capital formation and growth. Scattered individual savings are too small to meet the needs of enterprises. Household savings, which have a greater share in the national component of savings in less developed countries, are generally in a passive form and do not contribute directly to economic development.¹³ The mobilization of scattered individual savings and their channelling into productive uses is the main function of savings institutions. The intermediating operation of these institutions also helps in the transmission of resources from the informal to the formal sector.

Besides rendering immense service to enterprises, savings institutions help families by providing safety, security and profitability for their savings. Generally, individuals who save with a variety of motives are not familiar with the techniques and availability of investment opportunities. It is, for example, very difficult for individuals to assess investment risk in small enterprises. In Islamic countries, a religiously motivated class exists that is keen to invest its small savings in strict accordance to the Islamic Shari'ah but it is not conversant with any available outlets. These people do not "have the expertise or know-how to find a leasing or trade business that may yield them a risk-return package on the average, better or at least equal to the profit-sharing-based risk-return package offered by banks".¹⁴ It is necessary to mobilize such savings to meet the aspirations and saving motive of individuals. The transmission of these savings will also help capital formation in the small-scale business sector established in the Islamic perspective.

¹³ Mohsin, Mohammad: Investment of Life Insurance Corporation Fund, Aligarh Muslim University, Aligarh, 1966, p.16.

¹⁰ Khan, Fahim M.: Comparative Economics of Some Islamic Financing Techniques, IRTI Research Paper No.12, Islamic Development Bank, Jeddah, 1991, p.20.

Islamic savings can be mobilized by establishing new savings institutions or the scope of Islamic commercial banks can be expanded to encompass the functions of development banks. This departure from traditional banking practices will not be a novelty. In recent years conventional commercial banks have begun performing more nonbanking functions. Operations of mutual funds and unit trust schemes to attract term deposits from the household sector are some examples of departures from traditional banking practices.'

Similarly, Islamic commercial banks (ICBs) can mobilize Islamic motivated savings by introducing variable savings schemes patterned after 'unit trusts' or 'mutual funds'. Such a unit trust based upon Islamic principles can be created in the bank to exclusively serve small-scale businesses and can be designated the 'Islamic Small-Scale Business Unit Investment Trust'. The designation of unit trusts according to currency, financial instruments, trade or region is quite common. The proposed Islamic Small-Scale Business Investment Unit Trust shall be a Trust within the Bank with the specific objective of financing small-scale businesses operating upon Islamic principles. The Trust shall be based upon the principle of *Mudarabah* and the Bank shall manage the Fund as *a Mudarib*. It will assume powers of Manager and trustee subject to the responsibilities of a Mudarib as interpreted in the *Shari'ah*.

The aim of the Trust Fund will be to provide the individual investor an adequate return from carefully selected small-scale businesses which are based and operated on the principles of the Islamic *Shari'ah*. This point is important as it emphasizes that the Bank as *Mudarib* shall invest in those small-scale business unit which undertake to follow Islamic techniques and methods in trading and financing, and in subsequent transactions and dealings with third parties (customers or suppliers). It is also important because the Trust is formed to meet the aspirations of

⁵ Mohsin, Mohammad: A Profile of Riba Free Bank - Studies in Islamic Economics, (Ed.) Khurshid Ahmad, International Center for Research in Islamic Economics, King Abdulaziz University, Jeddah and the Islamic Foundation, U.K., 1980, p.388.

individuals and families whose main motive in purchasing units is to invoke the Islamic *Shari'ah* in all modes of financial and trading transactions.

In order to maximize return, and minimize loss, the bank as *Mudarib* of the SSB Trust Fund will follow a fully diversified investment policy which may involve using different Islamic financial instruments such as leases, installment sales, and other variables modes of trade financing arrangements, as well as other methods of finance which conform to the principles of the *Shari'ah*. The Fund may also attempt to spread investment across a wide range of industry or trade in different small business units, localities, regions, and even geographical areas. The principles of the diversification of investment are not only important for the safety of funds, but also serve the important purpose of spreading resources over different areas of growth, thereby avoiding concentration in a few small-scale business units. In the beginning the Bank might not have a wide range of options for diversification. However, with the expansion of Islamic enterprises the opportunities and avenues of investment both in terms of instruments and trade are expected to increase.

As is the usual practice with unit trusts, profits shall be distributed according to a fixed periodicity or interval on a prorata basis, and the bank will be entitled to charge a fee as a 'service charge'. The charges will not be deducted from the initial investment, but rather recovered from the fund's income over several years.

The institutionalization of Islamic savings through small-scale unit trusts will reflect the willingness of the people to subscribe to a particular business objective created on Islamic principles. It will also indicate the ability of the Bank to motivate people by its performance and quality of service. In an imperfect capital market, ICBs have to demonstrate their ability to mobilize savings by differentiating their 'products', which is very well 'branded'. This is a unit trust with a difference - a strict adherence to the Islamic *Shari'ah*.

Generally, savings institutions invest according to their legal framework and nature and the characteristics of the liabilities that they assumed at the time of the mobilization of savings. ICBs also have a mandate. Their legal framework is prescribed by the Islamic *Shari'ah* and their liability features are based upon the conditions of the contract assumed at the time of assembling the savings of individuals. In this manner the chief characteristics of product are singled out. They can preach, for example, the virtues of 'trading' and the vices of 'Riba', and this will form the basis of product differentiation. Islamic banks will have a clientage just like other banks; firms are paired with particular types of customers with definite tastes and preferences.

In order to expand their area of operation, ICBs have to demonstrate the quality of product with a record of efficiency, fair dealing, honesty and financial performance. In short, by demonstrating all the qualities of the 'Ameen' prescribed in Islam.

Mobilization and assembling Islamic savings is the first, albeit an important, act in the process of capital formation, which will be partly performed by Islamic Commercial Banks. However, the transmission of savings for effective use in small-scale business is very complicated. Investing in small-scale business units scattered over wide areas, entering into contracts with manufacturers and dealing with the suppliers of raw materials may not be the type of work for which ICBs are well equipped. They will require the services of a secondary and specialized institution.

2. The Institutional Framework

In a number of developing countries, governments have established specialized institutions that provide credit primarily to those business units which do not obtain finance directly from commercial banks. The major reasons for the reluctance of commercial banks to finance directly are: (a) SSBs are more risk prone by nature; (b) the cost of loan servicing is too high to bear; and (c) there is comparatively less security coverage.

Individual specialized financial institutions differ in their practices and performances. But all of them have adopted 'collateral' as a basis of security on account of which they remain ineffective. In the Islamic framework where the mode of operation is different, the services of these institutions will be required for the promotion of a 'trading' infrastructure, to coordinate commercial bank activities and that of other institutions established for the purpose. What is needed is a more comprehensive program entrusted to a multipurpose institution where all the funding and support activities required for small industries can be centralized. As observed before, in some industrialized countries multipurpose institutions have already emerged to help the growth of small business. In the United States, for example, the Small Business Administration (SBA) formed under Federal legislation assists small businesses in a number of ways the provision of competent management and technical and production counselling. This prepares the way for a small business to avail itself of capital and credit.

In the an Islamic framework, a similar type of multipurpose institution is required for the promotion of a 'trading' infrastructure. This institution will be called the Islamic Small-Scale Business Development Corporation (ISSBDC).

The proposed institution will be multipurpose and will be entrusted with the following functions:

- a. Formulating policies, strategies and a coherent and integrated program for the development of small-scale business based upon the Islamic *Shari 'ah* within the framework of the industrial development and rural development plan of the country. This may involve direct and indirect promotion of small-scale business.
- b. Assessing manpower, managerial and technical capabilities and establishing institutions to design training programs for upgrading and fostering capabilities (including technical and religious) for the development of small-scale business.

c. Establishing appropriate institutions and mechanisms to promote self-reliance activities on the part of small-scale business units and mobilizing funds based upon the Islamic *Shari'ah* facilitating a mechanism of trading in respect of the procurement of fixed asset, raw materials and intermediate inputs and marketing of the final products through specially designed networks which may involve ICBs, large companies and a chain of dealers.

d. Formulating arrangements for subcontracting between small and large scale enterprises and establishing businesses for the transfer of technology. Arranging for that purpose vertical and horizontal links with local engineering design and production capacities, including standardization and quality control as well as advising and providing institutional support.

e. Ensuring the supply of physical facilities for small-scale units, such as, water, power, electricity and buildings.

These are some of the main functions. In fact, the proposed corporation will be the focus of activity for the development of small-scale business in the Islamic perspective. For the 'seed bed' role assigned to small-scale industries in the Islamic *Shari'ah*, the proposed corporation has to undertake action oriented research aimed at broadening the scope, nature, feasibility and implementation of small- scale business projects. The concept of 'seedbed' also involves small- scale businesses established according to the Islamic *Shari'ah* being connected with national development stream. The proposed corporation will be an effective link in that direction.

3. Industrial Capabilities

Institutional interaction will depend upon acquiring the requisite industrial capabilities. Thus, the first requirement for the promotion of the SSB in the Islamic perspectives is the development of industrial capabilities which is related to the investment in human capabilities, such as, education, health and skills, so that work can be productively and

creatively. In the Islamic framework, 'capabilities' also include the inculcation of the moral, spiritual and ethical values of Islam.¹⁶

The development of human capabilities has a special significance because the organization of the SSB in the Islamic framework needs a complete re-orientation to the approach. The 'security of enterprise' in the Islamic framework shall be based and interpreted on the 'personal quality' and chartered of the individual and not on the traditional security of land and buildings.

The conventional definition of 'capital' in the Islamic sense shall be expanded beyond the concept of 'physical capital' to include 'human capital'. Emphasis in the Islamic perspective will be placed on the enhancement of 'human capabilities'. so that human creativity can be unlocked. Again, the investment in human capital for developing industrial capabilities in the Islamic perspective will include both 'moral' and 'technical' aspects. In other words, the improvement in character and morality will be given the same importance as the development of enterprise skill and technical know-how. The strategic role of developing industrial capabilities will be identified in this context.

It is widely acknowledged that small businesses in Islamic countries suffer from a 'technical gap'. However, the precise nature of this capability gap and its causes have not been adequately analyzed. Although the achievement in human development has been significant during the past decade, the reality is that developing Islamic countries have paid very little attention to education, relevant skills and worker retraining. Barring a few Gulf states, which have made much faster progress in Human Development Investment (HDI)," several Islamic developing countries have a very low level of investment. The 31 Islamic

¹⁶ Chapra, M. Umar: Islam and the Economic Challenge, The Islamic Foundation and the International Institute of Islamic Thought, Leicester, 1993, p.259.

⁷ Saudi Arabia had the greatest change in its HDI value - from 0.386 in 1970 to 0.688 in 1990, UNDP: Human Development Report, 1993, Oxford University Press, New York, 1993, p.16.

countries for which data is available have an average 0.346 HDI value as against an average of 0.485 for all developing countries. It should be pointed out that there is no automatic link between the income level of countries and their investment in human development. Some least developed countries have a higher HDI than higher income Islamic countries. The investment in HDI is related to attitude and government policy.

Investment in human capital is necessary in Islamic countries as it raises the productivity of labour - and if matched by the kind of technology best suited to the skill of the work-force, it can have a multiplier effect throughout the economy - a necessary condition implied in the 'seed-bed' role for small-scale business. Moreover, the utilization of aid is also related to industrial capability. Clearly any government organization with the necessary financial resources can always buy a physical plant and set up an industrial facility. However, without the relevant skill and experience, there is grave danger that the aid may remain unutilized or the enterprise may not reach the break-even point.

Three types of industrial capabilities have to be developed in the Islamic perspective, viz., managerial, technical and religious. The imparting of managerial skill will remain confined to 'one man' who is supposed to identify suitable investment opportunity and muster the financial, technical and other resources in order to mount, implement and, ultimately, manage the project at an appropriate scale and with an appropriate market orientation. The managerial skill in small businesses overlaps with the skill in routine enterprises as well as with other business functions.

The acquisition of technical capabilities is essentially a product of two forces on which various factors impinge: formal training and learning for a particular job. Formal training occurs in the educational system as well as in in-service training programs. In the case of small-scale business, the 'forward' and 'backward' linkages that are normally established with 'big' enterprise determine to what extent and how efficiently knowledge can be infused into small enterprises in the economy. Vertical or horizontal linkages are important as the small

enterprises receive up-to-date technology at the lowest possible cost. This also helps them to upgrade productivity, reduce cost and improve products.

Apart from technical know-how, the operation of business in the Islamic perspective also requires that the entrepreneur be acquainted with the moral of business with a view to serving the society. As a God-fearing entrepreneur, he is expected to be social-minded and sympathetic towards the cause of the community.¹⁸ This will considerably enlarge his outlook in utilizing national resources and in maximizing social benefits. With the background of Islamic education and training, he will be trusted by the lenders of financial assistance as well as by those to whom he subsequently supplies goods and services.

To attain this objective, training institutes and vocational schools have to be established. They will impart not just vocational training but an integrated program of managerial skills and religious education. The training -institute established for the purpose of imparting integrated courses should not give certificates to trainees after the completion of the program. A better reward is in the form of tools and equipment given to successful participants. This will encourage them to start a business instead of searching for employment. An illustrative example is from the Malawian Enterprise Development Institute, which trains the educated unemployed. In addition to vocational training, their program offers training in human management and entrepreneurship. At the end of the course, the graduates are not awarded a certificate. They are given a set of tools and loans to start actual businesses.

¹⁸ Siddiqi, M.N.: The Economic Enterprise in Islam, Islamic Publications Ltd., Lahore, 1972, p.65.

VI

MODUS OPERANDI OF THE SYSTEM

The center of small-scale business activity in the Islamic perspective will be the Islamic Small-Scale Business Development Corporation (ISSBDC) which will play a leading role in promoting the formation of a self-reliant small-scale business sector in the Islamic perspective. The role of the Corporation can be described with reference to three important functions:

1. Direct promotion of small-scale business.
2. Indirect promotion of small-scale business.
3. Institutional interaction.

1. Direct Promotion of Small-Scale Business

In conventional financial practices, specialized financial institutions help entrepreneurs prepare feasibility studies for their project, provide concessionary funding and/or guarantee the SSB enterprise creditworthiness in order to gain access to commercial sources. In the Islamic perspective at the initial stages where the principles of finance are not in vogue, the specific characteristic features of the 'entrepreneurship' required for the operation of an enterprise cannot be developed quickly. The particular expertise and knowledge will be accumulated over the years while actually working in the field. It is, therefore, functionally necessary that the ISSBDC initiate action related to the formation of enterprise according to Islamic principles. This may involve the identification, implementation and actual management of the project until it reaches an appropriate level of operation. The ISSBDC may associate the prospective owner as a partner. The enterprise will be entrusted to him after he acquires the necessary training and the enterprise becomes operational. To facilitate such a transfer of ownership, there is a built-in mechanism in the Islamic financial system (i.e., diminishing *Musharakah*) under which the ISSBDC can withdraw its capital and management gradually according to a scheduled timetable. In this arrangement the

ISSBDC, the ICB and the individual who is a prospective partner will contribute capital in an agreed proportion. Under the agreement the **ISSBDC** and the ICB, who are meant at some future date to retire from the partnership, will get back a part of the net income of the business as a repayment of the principal amount which they contributed. The individual (the prospective sole owner) will be entitled to retain the remaining part of the income. With gradual yearly repayments, the ISSBDC share and that of the ICB equity capital shall be amortized and the individual will become the sole owner of the business.¹⁹

The system has the merit of enabling the ISSBDC to promote the enterprise on sound business principles involving Islamic canons of transactions and dealings; training the individual to assume the owner/manager responsibilities. The system also enables the ISSBDC to keep its freed resources - managerial, technical and financial - in circulation. The financial forecast related to income flows will enable the ISSBDC and the ICB to anticipate the possible time of their complete withdrawal from the business.

It may be that persons of acceptable calibre and character who could be associated with the enterprise may not be readily available at the time of its promotion. In such cases the Corporation should itself take the initiative. It can float the enterprise with the association of the ICB under an agreed plan. As soon as the business reaches the break-even point, the Corporation can dispose it off as a going concern. Three methods of disposal are available according to the Islamic *Shari'ah*: (A) outright negotiated sale, (B) sale by installments, and (C) leasing.

A. Outright Negotiated Sale

The method of outright negotiated sale of a going concern is in use in some developing countries where the Industrial Development Corporation, which is the public sector undertaking established by the

¹⁹ Ahmad, Ausaf: Contemporary Practices of Islamic Financing Techniques, IRTI Research Paper No. 20, Islamic Development Bank, Jeddah, 1993, p.41.

government, promotes and floats the enterprise. As soon as the concern reaches a definite scale of operation, it is auctioned. This method has been found to be suitable in those developing countries that have a shortage of 'promoters' and 'entrepreneurs'. Investors in some developing countries are 'shy' of handling promotional problems.²⁰ The same practice can be adopted by the ISSBDC in floating small-scale business. As long as the right types of talents and persons are not available, the Corporation shall retain the ownership and control of the enterprise. The established enterprise will not be auctioned because the sale of Islamic small-scale businesses will be restricted to those persons who have acquired industrial capabilities and character to the satisfaction of the ISSBDC. The individual has to give an undertaking that he will himself own and operate the concern. The cost of the going concern and the margin of profit charged over the original cost incurred on the promotion of enterprise will all be made clear. The sale of a going concern will thus be a transfer of property in the ordinary sense in consideration of a price in money.²¹

B. Sale by Installment

Under installments or hire purchase the sale price of the SSB units shall be recovered in installments spread over a period of time. The price of the going concern shall be fixed as in an outright sale. The installments payable by the prospective owner of the business will have two distinct components: the agreed rental as in *Ijarah Wa Iqitina* and a part of the amount of profit. The full ownership rights of the SSB units shall be passed on when all the installments are paid. Like the outright sale, the operating unit shall be sold on installments to those persons who have acquired the necessary training and have proven their character to the satisfaction of the ISSBDC.

20 Hanson, A.H.: Public Enterprise and Economic Development, Routledge and Kegan Paul Ltd., London, 1985, p.208.

21 Mannan, M.A.: Understanding Islamic Finance: A Study of the Securities Market in an Islamic Framework, IRTI Research Paper No. 18, Islamic Development Bank, Jeddah, 1993, p.9.

C. Leasing

Under the lease transaction, the SSB unit will be given to an approved individual on lease at an agreed rental price. The lessee may be given the opinion to purchase the business at an agreed price in the future., In that event the rental paid by the lessee shall be treated as an installment paid towards the cost of the concern.

2. Indirect Promotion of Small-Scale Business

In order to qualify for ISSBDC support, there are three eligibility conditions for enterprises promoted by individuals: (a) the person should have the acquired capability according to the ISSBDC standard; (b) the person himself should own and manage the enterprise (this condition rules out absentee owners) and (c) the project should be viable.

If the ISSBDC is satisfied that the above conditions are fulfilled, it may provide any or all of the 'package' of services which will include a range of consultancy, financial and technical aid and a supply of fixed assets, raw materials, marketing assistance and linkage arrangements. Generally, ISSBDC cash accommodation will be provided only for the payment of wages and salaries. Most financial assistance and accommodation will be in 'kind' (for example, machinery at the time of expansion or replacement and raw materials to meet operational needs).

3. Institutional Interaction

The institutional financing of capital formation, the ISSBDC will lead the operation. It will initiate and coordinate the participation of other institutional investors for promoting small-scale business. Its role can be seen in two of the most important activities of the small business; (A) financing fixed asset formation and (B) financing business operation.

A. Financing Fixed-Asset Formation

Fixed assets are those that provide service over a period of time. They are deferred expense and determine the production capacity of a firm. A cash outlay is made at one 'point of time, but benefits accrue over a period of time. Fixed asset formation have two distinct characteristic features. First, the expenses planned are generally of a considerable size. Second, capital expenditure decisions are often irreversible within a short period of time. In order to accommodate these aspects of fixed assets formation, contemporary Islamic financing techniques have developed large varieties of debt and equity forms with varieties of return and control.

The debt-based modes of financing are *Bay'al Salam* and *Murabahah*. Under these terms the owner of a small business is obliged to pay back the entire amount at agreed terms. The debt-form may be without any charge (*Qard Hasan*) or it may carry some nominal administrative charges known as 'service charges'. *Murabahah-based* transactions may include cost-plus or they may be a markup-based. The nondebt modes of financing are *Mudarabah* and *Musharakah*. The debt-creating modes impose a burden on the borrower irrespective of the profitability of the enterprise; and in equity financing (*Mudarabah* and *Musharakah*), the payment is based upon the earnings.

The duration of the debt is a known. All debt will be returned and repaid at a specific date. Debt maturity is based upon the needs of the enterprise as well as the liquidity requirements of the suppliers of capital. The terms of debt related modes can be made flexible as variable terms of installment and under *Ijarah* can be tailored to suit the circumstances of the borrower.

Equity financing (*Musharakah*) terms can also be made flexible. It may be permanent or diminishing. In Islam a return on capital is justified only if the capital is exposed to a business risk. The degree of/ this type of risk and the level of participation in management also diff. in different financing techniques. In *Mudarabah*, *Musharakah*, *Ijara* and *Bay'al Salam*, the ISSBDC and other associated investors stake the

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entire amount of their capital as well as any expected return for the entire period until the capital is returned. In *Murabahah* (mark-up based) the rate is relatively less than other methods.²²

In *Bay'al Salam*, the ISSBDC has no role in the management of the SSB unit which it is promoting. Both in *Mudarabah* and *Bay'al Salam*, once the funds have been handed over, the SSB enterprise is free to use them according to its discretion. The ISSBDC has no participation in the management. *Musharakah* provides an opportunity under which the ISSBDC has a role in the management of funds. Similarly, in *Murabahah* (markup-based) financing and *Ijarah* (leased-based) financing, the ISSBDC has full control over the use of funds.

The cost of capital, in the Islamic perspective is defined as the "amount that the finance user ends up paying to the finance owner over and above the original finance obtained". It is related to the nature of finance. The cost remains uncertain until the completion of the contract under *Mudarabah*, *Musharakah* and *Bay'al Salam*. In *Ijarah* (leasing) and *Murabahah* (mark-up based), financing is predetermined and fixed.²⁴

Various features of financial instruments and types of finance can be used to suit the circumstances of both borrowers and lenders. Various options and combinations of financial instruments to meet the nature of fixed asset formation are available. In the initial stages of the formation of the SSB when the ISSBDC and the ICB play a leading role, temporary *Musharakah* will be the obvious choice. In subsequent operations, a

22 Khan, Fahim. M.: Comparative Economics of Small Islamic Financing Techniques, IRTI Research Paper No. 12, Islamic Development Bank, Jeddah, 1991, p.13.

²³ Ibid., p.17.

²⁴ For a complete explanation of the relation of cost of capital to different methods of finance refer to: Ibid., p.17.

combination of various methods can be adopted to suit the needs of the enterprise and the circumstances of institutional investors.

In the procurement of fixed assets for the small-scale business enterprise, the Corporation has the option to use different financing methods. If the ISSBDC is itself establishing the business unit, it will buy the required fixed assets with the close association of the ICB and debit the Enterprise Capital Account, which will be added to its capital cost since the transaction is in the nature of capital expenditure. If the Corporation is supporting an already existing unit, it will act as an intermediary, buying the asset for the user firm and with the participation of the ICB, paying the supplier or the manufacturer of the asset. In these transactions involving the procurement of assets, various financial options are available which vary in range from outright purchase in cash to payment through a letter of credit drawn with strict accordance to Islamic principles. Similarly, the SSB units receiving the assistance of the ISSBDC/ICB may choose a method of finance suited to their convenience.²⁵

In intermediation, the ISSBDC and its associated investors have the scope for making profit through trading. The opportunity lies in the actual buying and selling of assets. Through regular and bulk purchases, the ISSBDC will earn regular 'commission' and a 'discount' in prices, while supplying the SSB at market prices. Under *Murabahab* or *Musharakah* terms, the difference in purchase price and sale price will constitute a profit which will be shared between the ICB and the ISSBDC and other participating investors.

The participation of the ISSBDC with the collaboration of the ICB and other institutions in each enterprise shall be a temporary nature. The terms, conditions and share contributions in each joint venture will be separately tailored according to the nature of the transaction. This consideration is important because the demand for fixed assets does not

²⁵ Ahmad, Ausaf: Contemporary Practices of Islamic Financing Techniques, IRTI Research Paper No. 20, Islamic Development Bank, Jeddah, 1993, p.93.

end with the formation of the enterprise. It arises again for replacement, expansion and product improvement. Whatever the use or purpose, the installation of machinery or any other facility of a fixed nature will be treated as a separate venture. Such an approach will enable the enterprise to enforce strict standards of profit planning and control. It will also help the ISSBDC to evaluate closely prospective earnings, income flows and employment generating capacity. Such an objective analysis will enable the other external suppliers of funds to keep a watch over the use of separate assets supplied with their assistance.

B. Financing Business Operation

Fixed-asset formation and subsequent expansion comprise is only one aspect of the enterprise operation. A manufacturing activity starts with raw material and ends with finished goods. Operational issues are day-to-day problem which have to be carefully managed. It has been pointed out that many conventional small-scale enterprises fail due to the improper management of inventory. Overinvestment causes a considerable erosion of profits and capital.

Inventory accumulation in any form - raw material, stores and spares, works-in-progress and finished products - involves carrying costs which are often unbearable for small enterprises. For businesses conducted by Islamic principles, there are reasons to believe that the need for funds for inventory accumulation will not be so great. Islam discourages 'hoarding' and 'speculation', so inventory building with these objectives is completely ruled out. Moreover, ISSBDC intermediation in the process of supplying raw material and stocking finished products will also reduce the need for demand for inventory accumulation. Generally, firms build up stocks of raw material in order to ensure the continuity of production and the availability of quantity discounts. ISSBDC bulk buying from the supplier and selling to the SSB will ensure continuous supplies. Similarly, buying finished goods from the SSB and selling them in the market will relieve producers from marketing problems and will allow flexibility in production scheduling.

There are two aspects to ISSBDC intermediation in the inventory operation. One is 'financing' and the other is 'trading' and both are interlinked. SSBs need raw material for which they require short-term credit accommodation. The ISSBDC will supply the raw material but not the cash. It will purchase the raw material with the collaboration of the **ICB** and other financial investors. In this manner the purchasing of raw material will be a joint-venture among financial institutions. This may be undertaken on a "*Murabahah*" or "*Musharakah*" basis. The sale of raw material to the users (SSBs) can be on the basis of "*Bay Muajjal*" or "*Bay Bithaman*" (deferred sale). Under the system of transaction, the raw material will be delivered to the SSB units immediately, while payment for the raw material will be postponed to a later date. This arrangement allows the ISSBDC and its other associates to charge a higher price than the prevailing market price. The difference between the purchase price, with discount and trade rebate, and the sale price, will yield a margin of profit for the ISSBDC and its partners.

In the case of finished products, the ISSBDC will make purchases from the SSB units and with the financial participation of the ICB and others, the cash price will be paid immediately to the SSB. This will provide liquidity to the SSB, while assumes the market risk. The goods will be sold in the open market and the profit will be shared among the partners.

Financing of fixed asset formation and meeting the requirements of current operations will impose considerable strain on ISSBDC resources. It will be desirable for the ISSBDC to start its operation with a selected number of units especially in the selected trades. It may, for instance, select SSBs that can feed the major industries by production of spare parts and other components while gradually expanding operation in the consumer goods industries.

The advantage in beginning with ancillary industries is that it offers immediate opportunities for forward and backward linkages with medium and large enterprises. Such linkages are in the mutual interest of the SSB and the manufacturers or suppliers of the machinery and equipment. Whereas the latter receives spare parts and components

strictly according to their own specification, the SSB is ensured of its market.

Vertical as well as horizontal integration with major industries is the key to many of the problems faced by small-scale business in developing countries. As pointed out earlier, vertical linkage leads to a deepening of the industrial structure, the spread of technology and the diffusion of skills. Horizontal linkage will help the growth of SSBs in formal sectors where large firms can license their technology to small ones. Moreover; horizontal linkage between small-scale business firms under the umbrella of the ISSBDC will help them in the realization of economies of scale in certain industrial functions. It will also enable SSB units to move towards common norms of efficiency and best trade practices based on Islamic principles.

VII SUMMARY

Small is not only 'beautiful' but also 'useful' in the context of the social and economic advancement of developing countries. The most serious problems of developing countries are poverty, low productivity and unemployment. In recent years unemployment has assumed a new dimension and form in the 'vicious circle of poverty'. Developing countries are experiencing growth without creating job opportunities. During the last decade GDP has increased at an average rate of 4.5 percent, but employment grew only half as much. This is attributable to the use of 'capital-intensive' methods of growth under which less than one third of the increase in output is associated with labor and more than two-thirds increase with an increase in capital investment. Consequently, most developing countries are now confronted with the disturbing phenomenon of 'jobless growth'. Policymakers the world over are searching for developing strategies that combine economic growth with more job opportunities.

One of the best ways to ensure employment is to promote small businesses which are labor-intensive and provide more jobs per unit of capital invested. The establishment of such businesses generates employment and income and also helps check rural-urban migration as they are people centered businesses.

Because of the key role that small-scale business can play in the diversification of economic activity and in the creation of better employment opportunities, some governments in developing countries have pursued active policies in the promotion of small-scale business. State patronage and subsidies, however, have failed to bring about the desired level of activity in small-scale business in the formal sector. Employment opportunities for small-scale business have continued to

increase in the informal sector which has received no state patronage while employment has remained subdued in the formal sector.

The failure of government support to achieve the expected growth in small-scale business in the formal sector is due to a number of interrelated factors. These factors can be divided into those related to policy and administrative actions and those inherent in the nature of interest rate finance. Among the administrative weaknesses, the most profound is that of providing credit facilities without creating the 'industrial capabilities' to absorb them. The consequences of the inadequate small-scale base of industrial entrepreneurship have grave implications for the use of funds as well as for the continuity and survival of business. The high mortality rates of small-scale business are attributable to management related pitfalls.

However, the problem with small-scale business is not merely the volume of credit. It is also a question of form, the way it is administered and the manner and the terms and conditions on which credit facilities are provided. With a view to facilitating credit flows, governments in many developing countries have established specialized institutions to give loans on soft terms and at subsidized rates to small-scale businesses. However, studies have shown that institutions restricted their lending to larger and less risky clients effectively excluding small enterprises from the market. In particular, entrepreneurs who are starting business for the first time, constituting the highest risk, were the least funded.

There is also increasing evidence to show that subsidized lending with collateral as a basis often benefits the wealthier, politically influential and well-connected people of society as they can afford to provide what is acceptable to the lender. Such loans on short terms have led to investments in equipment which have encouraged capital rather than labor-intensive technology. This works against the main objective of small-scale business lending, which is to create employment.

In some developing countries, assistance to small-scale business is provided on the basis of the economic viability of the projects. Efforts are made to provide finance to small enterprises with sound projects but

inadequate collateral; through risk-sharing arrangements which are usually in the form of equity. This move is in the right direction, for in business finance, safety is not attached permanently to any specific form. Lending on the basis of collateral can be hazardous as it is difficult for a normal asset to be disposed of for a price equal to the value of the loan for which it was created. On the other hand, an economically viable project judged along with the integrity and ability of the management ensures the repayment of the loan.

Risk in business is not only inevitable but it appears in a wide and unpredictable diversity of forms. Islamic methods of finance recognize this basic truth of finance and, therefore, encourage risk sharing. This is also important in the macrosense. The supposed choice between 'risk' and 'sustained economic growth' is fatal and dangerous. Risk is imperative if growth is to be achieved. This recognition of 'risk' means that the scope of small-scale business in the Islamic perspective can be looked at in a more dynamic way. In OECD countries the role of small-scale business is seen as that of a 'seed bed'. The image may be appropriate also for developing Islamic countries. It implies that the economic growth which small-scale business generates must be distributed widely and fairly.'

The concept needs a pragmatic approach in the development of an infrastructure that may help small-scale business become self-sufficient in generating resources in the Islamic framework. Three types of infrastructural facilities will be required to propagate small-scale business in the Islamic perspective. They are the institutionalization of household savings, and an institutional framework mainly comprising multipurpose development institutions. However, institutional interaction of any sort will not be effective unless the requisite 'capacity' and 'capability' are sufficiently built up. This will require the ' establishment of training institutes and vocational guidance centers.

The institutionalization of household savings' is' the" primary condition for capital formation and growth; , The passive ' form of household savings must be channelized to the small-scale. sector. At present no link exists between individual savings and The small business

sector. Studies have shown that in every Islamic country a middle class exists that is anxious, to save- according to the Islamic *Shari'ah*: However, these people are not familiar with any outlet. It is proposed to establish within Islamic Commercial Banks on Islamic Small-Scale Business Unit Investment Trust. for the mobilization of household savings. Designated unit trusts, in terms of currency, industries, trade or regions - are being, operated by conventional commercial banks. The 'proposed designated Trust shall be based upon the principle of *Mudarabah* and the Islamic Commercial Bank shall manage the Fund as *Mudarib* - .

The aim of the Trust will be to provide the individual investor an adequate return from carefully selected units of small-scale business which are based and operated on the principles of the Islamic *Shari'ah*. The Bank as *Mudarib*, shall invest in those small-scale business units that will provide an undertaking to follow Islamic techniques and methods in trading and finance. The Islamic Commercial Bank will be competing for the mobilization of household savings in the imperfect capital market. The basis of their product differentiation shall be the strict adherence to Islamic principles.

The mobilization and assembling of Islamic savings is the first act in the process of capital formation. However, the transmission of savings for effective use in, small-scale business is very complicated and may require the establishment of a sophisticated multipurpose institution to which all the funding and support activities required for small-scale business can be entrusted. In the Islamic framework a multipurpose institution based along the lines of the Small Business Administration in the United States has been suggested, to be called the Islamic Small-Scale Business Development Corporation. It should be clear from its very name that the proposed Corporation shall be performing all the conceivable functions involved in the promotion and execution of projects related to small-scale business.

The actual institutional interaction will not be possible without the development of industrial capabilities which are related to human capabilities, such as education, health and skill so that the persons involved in the formation and development of small-scale business can

work productively, and creatively. In the Islamic framework, capabilities also include the inculcation of the moral, spiritual and ethical values of Islam.

The development of human capabilities has 'special significance because the organization of small-scale business in the Islamic framework requires a completely different orientation from the **conventional approach**. The "security of enterprise" in the Islamic perspective shall be based and interpreted on the personal quality and character of the individual and not on the traditional security of land and building.

The proposed Islamic Small-Scale Business Development Corporation shall be the center of gravity around which all small-scale enterprises shall cluster. Its modus operandi can be seen in three broad functions: direct promotion of small-scale business, indirect promotion of small-scale business and pioneering institutional interaction.

The direct promotion of small-scale enterprise in the Islamic perspective is important. At the initial stages where the Islamic principles of finance are not in vogue, the specific characteristic features of the "entrepreneurship" required for the operation of an enterprise cannot be developed quickly. The particular expertise and capability will have to be built over the years while actually working in an enterprise based on Islamic principles. It is, therefore, necessary that the proposed Corporation initiate action related to the promotion and management of enterprise according to Islamic principles.

The Corporation may associate the prospective owner as a partner. The ownership and management will be entrusted to him after he acquires the required level of "industrial capability" and the enterprise has also reached a break-even point. The Islamic financial system has evolved an effective device of diminishing *Musharakah* under which the ISSBDC can gradually withdraw its capital and management according to a scheduled timetable.

It may be that persons of acceptable calibre and character who could be associated with the enterprise may not be readily available at

the time of its promotion. In such cases the ISSBDC will itself initiate the small-scale enterprise with the collaboration of the ICB. After the business reaches the break-even point, the Corporation may decide to sell it as a going concern. Three identified methods of disposal in Islam will be available: (i) outright negotiated sale, (ii) sale by installments, and (iii) leasing.

Unlike the "auction sale" practiced' by Industrial development banks for the sale of enterprises in some developing countries, the ISSBDC sale shall be negotiated with only those individuals who have undergone training for "industrial capabilities" according to the ISSBDC standard and have given an undertaking that they will themselves manage the business.

The modus operandi is based upon two types of institutional interactions: 'financing' and 'trading' Financing is involved when the enterprise needs fixed assets and raw materials. However, the assistance will be in kind. The ISSBDC will supply fixed assets and raw materials to the SSBs as and when the demand arises. The payments will be deferred: 'Trading' is involved in the procurement of fixed assets and raw materials. The buying and selling of assets and raw materials will yield a margin of profit/loss which the ISSBDC will share with the ICB and other participants in the trade.

The institutional interaction will occur in performing the financing and 'trading functions'. Contemporary practices of Islamic financing techniques have developed large varieties of debt and equity forms which can be 'applied in the procurement and financing of fixed assets and in inventory operations (raw materials and finished goods). In all methods of transactions, the "trading" aspect shall be kept in view.

The participation of the ISSBDC and that of the ICB and other institutions shall be of a temporary nature at the time of formulation and also in other subsequent operations. The promotion of each unit and the subsequent procurement of fixed assets for replacement, expansion and development 'in the existing units shall be 'a separate "joint venture". New financial- agreements shall be tailored to suit the nature of

requirements. The installation of fixed assets, whether for replacement or expansion, will be treated as a separate venture within the enterprise. Such an approach will enable the enterprise to apply the strict standards of profit planning and control. Each proposal for fixed assets installation shall be evaluated by the ISSBDC not only from the point of view of profitability, but also from its ability to employ the requisite number of people. Such an approach by the ISSBDC will clear the ground for the participation of other institutions.

Similarly, the ISSBDC will keep a watch on inventory financing. It will not encourage hoarding or speculation. No cash accommodation shall be granted. Raw material will be provided according to the requirements of each unit, and the price for the finished inventory will be paid in cash immediately so that the enterprise can meet its other requirements of liquidity.

Financing of fixed assets formation and meeting the requirements of current operations will impose considerable strain on ISSBDC resources. It will be desirable for the ISSBDC to start its operation with a limited number of units in selected trades. It may, for instance, select an SSB that can feed the major industries by the production of spare parts and other components for these industries, while gradually expanding operation in the consumer goods industries.

The advantage in beginning with ancillary industries is that it offers immediate opportunities for forward and backward linkages with medium and large enterprises. Such linkages are in the mutual interest of the SSB and the manufacturers or suppliers of the machinery and equipment. Whereas the latter receive spare parts and components strictly according to their own specification, the SSB is assured of its market.

Vertical as well as horizontal *integration* with major industries is the key to many of the problems faced by small-scale business in developing countries. Vertical linkage leads to a deepening of the industrial structure, the spread of technology and the diffusion of skills. Horizontal linkages will help the growth of SSBs in formal sectors where

large firms can license their technology to small ones. Moreover, horizontal linkage between small-scale business firms under the umbrella of the ISSBDC will help them in the realization of economies of scale in certain industrial functions. It will also help all SSB units to move towards common norms of efficiency and best trade practices based on Islamic principles.

CONCLUSION

The broad contours of an infrastructure to support the viable operation of small-scale business have been drawn in this study. The institutional interaction, while supporting the self-sustained growth of small-scale enterprises, will ensure that the economic development generated is distributed widely and fairly among all sectors of the economy. This is in line with the dynamic approach of the "seed bed" role assigned to the small-scale business sector.

Cultural differences and the diversity in political and economic conditions in different Islamic developing countries do not allow for the suggestion of a specific viable structure. In fact, there is need for an in-depth study to examine the possibility of building an infrastructure along the lines suggested in this study and of applying Islamic financial techniques in the small-scale sector with reference to a particular country.

A pilot project of small-scale business based upon Islamic principles will demonstrate the practical application of Islamic techniques. The operation of Islamic enterprises which seek no changes in the existing regulations will be acceptable to the governments in any country. Islamic enterprises will function within the legal framework of the country and adopt at the same time the Islamic code of conduct. This is unlikely to disturb the existing social and economic structure in any Islamic country.

NOTES

1. Islamic countries means member countries of the Organization of the Islamic Conference (OIC).
2. Income classification of country is based upon the OECD definition of country category:
 - A) Low income countries (LICs) comprise least developed countries and all other countries with per capita income in 1990 of \$1195 or below.
 - B) Lower Middle Income Countries (LMICs) comprise recipients with per capita income in 1990 between \$1190 and \$2465.
 - C) Upper Middle Income Countries (UMICs) comprise recipients with a per capita income in 1990 between \$2465 and \$4300.
 - D) Higher income countries (HICs) comprise recipients with per capita income above \$4300.
3. Least Developed Countries (LDCs) account for 47 of the countries on the current United Nations list.

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ISLAMIC DEVELOPMENT BANK (IDB)

Establishment of the Bank

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent by a Conference of Finance Ministers of Muslim countries held in Jeddah in Dhul Oa'da 1393H (December 1973). The Inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the Bank formally opened on 15 Shawwal 1395H (20 October 1975).

Purpose

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *Shari'ah*.

Functions

The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms of economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially in capital goods among member countries, providing technical assistance to member countries, extending training facilities for **personnel engaged in development** activities and undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to the *Shari'ah*.

Membership

The present membership of the Bank consists of 48 countries. The basic condition for membership is that the **prospective member** country should be a **member** of the Organization of the Islamic Conference and be willing to accept such terms and conditions as may be decided upon by the **Board of Governors**.

Capital

The **authorized** capital of the Bank is six billion Islamic Dinars. The value of the Islamic Dinar, which is a unit of account in the Bank, is **equivalent** to one Special Drawing Right (SDR) of the **International Monetary Fund**. The subscribed capital of the Bank is **3,654.78** million Islamic Dinars payable in freely convertible currency **acceptable** to the Bank.

Head Office

The Bank's head office is located in Jeddah in the Kingdom of Saudi Arabia and the Bank is authorized to establish agencies or branch offices elsewhere.

Financial Year

The Bank's financial year is the Lunar Hijra year.

Language

The official language of the Bank is Arabic, but English and French are additionally used as working languages.



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