ISLAMIC DEVELOPMENT BANK
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HUMAN RESOURCES MOBILIZATION THROUGH THE PROFIT-LOSS SHARING BASED FINANCIAL SYSTEM

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

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FOREWORD

Human resources mobilization is one of the key economic issues facing contemporary Muslim economies. Labour force participation in most of the Muslim economies is extremely low which is resulting into a simple waste of the precious resources given by Almighty to the Muslim economies in abundance. Conventional economics suggest several solutions. None seems to work effectively to improve the situation in developing countries in general and in Muslim countries in particular. Does Islamic economics have any thing to offer in this respect? This paper attempts to answer this question by making a formal presentation on the employment and human resources mobilization aspects of the Islamic financial system emphasizing that the system has a more powerful built-in model of human resources mobilization than the existing models developed under conventional economics. The paper is another effort of IRTI in implementing one of the functions assigned to it by its statutes i.e. to organize and conduct basic and applied research for the application of Shari'ah in the field of economics, finance and banking. It is hoped that this paper will be useful not only for policy makers in the Muslim countries who intend to apply Shari'ah in their economies but also benefit those who are actively involved in research or teaching in the areas of Islamic economics, banking and finance.

Prof. Dr. Abdel Hamid El-Ghazali
Director, IRTI

1. INTRODUCTION

The Islamic financial system and its economics have been under discussion for about two decades. Allocative efficiency has probably been the issue that has been most widely and most rigorously discussed. Such issues as stability and growth have also received substantial attention. Employment and human resources mobilization, however, is one aspect which, though, recognized and referred to in literature as well as in seminars and conferences[1], has not yet been subjected to rigorous discussion and formal presentation as an independent and important aspect of the Islamic financial system. This paper is an attempt to make a formal presentation on the employment and human resources mobilization aspect of the Islamic financial system emphasizing that the system has a more powerful built-in model of human resources mobilization than existing models of employment and human resources mobilization discussed in conventional economics.

2. SIGNIFICANCE OF THE ISSUE

The human resources mobilization aspect of the Islamic financial system has significance from two perspectives. Firstly, the majority of Muslim countries are faced with low labour force participation, high (open and disguised) unemployment rates and extremely low wages and labour incomes. Despite more than four decades of trying different growth and employment strategies, most of these countries have failed to get out of the trap.

If the Islamic financial system offers hopes for the mobilizing of human resources and solving 'the problems of unemployment and the underutilization of human resources, then this is worth studying for the benefit of Muslim countries in order to point out to them the alternate strategies that are a part of their Islamic heritage.

Secondly, those Muslim countries which intend to Islamize their financial or economic systems are likely to face the problem of how to justify this on economic grounds. Although the theoretical discussions on the Islamic financial system have rigorously proved that in the long-run the Islamic financial system will make every-one better off, the conversion to the Islamic financial system may be a costly proposition, at least in the short run. This cost, of course, will have to be paid by the savers (by receiving lower returns) and by the investors (by paying the higher cost of capital).

The economic case for Islamizing the financial system of a Muslim economy can be made only if it can be linked to solving one of the immediate problems facing the economy. If the Islamic financial system can be shown to be conducive to human resources mobilization, then the policy of converting to the Islamic financial system can specifically be linked to the programs alleviating unemployment and poverty which even in the short-run, will make the conversion more acceptable and more fruitful. Linking the Islamic financial system with human resources mobilization will give a substantial edge to the argument for Islamizing the financial system and many Muslim countries faced with a reserve of unemployed and low paid human resources may find persuasive economic arguments for moving towards the Islamic financial system.

3. REVIEW OF EXISTING MODELS OF EMPLOYMENT

Before presenting the human resources mobilization aspect of the Islamic financial system, it may be instructive to review the existing models of employment and human resources mobilization particularly from the point of view of their relevance to existing financial systems.

Economic theory suggests various models that explain how the employment level is determined in the economy and what factors create a divergence between the supply and demand of labour, thus, creating unemployment (only major categories of models are reviewed below).

3.1 CLASSICAL (COMPETITIVE FREE MARKET) MODEL

According to this model, the marginal productivity of labour determines the demand for labour at various levels of wages and the marginal utility of leisure determines the supply of labour to work at different wage rates. Supply and demand simultaneously determine the equilibrium level of employment.

According to the model, the mobilization of involuntarily unemployed resources would require an increase in the marginal productivity of labour, which would shift the demand curve upwards. The marginal productivity can be increased either by providing education and training to build up the human capital of labour or by raising the amount of physical capital per worker.

Although the option of raising the levels of education and training for the purpose of human resources mobilization has its own merits, its effectiveness in reducing the problem of unemployment is severely constrained, particularly for the developing world, for the following reasons:

1) Education and training involve heavy initial capital investment before they can bring about any significant increase in productivity. Developing countries facing an acute shortage of resources fail to give the necessary priority to the education sector in their investment plans. The lag in the investment in education and training and the realization in productivity increase may also result in a mismatch of supply and demand. Unemployment may persist for a considerable period of time.

2) Building up the human capital of labour in the economy may shift the supply curve as well, and despite the increase in productivity, the equilibrium level of employment may not significantly change.

The other option (raising the physical capital per worker) can be exercised in two ways: (1) by raising the capital of existing entrepreneurs/ employers which in turn would generate a new demand for labour, or (2) by promoting new entrepreneurs out of labour which has no capital. The financial system of an economy plays an important role in this respect as it has to mobilize capital and distribute it in the economy in a way that not only improves the productivity of labour, but also motivates entrepreneurs to benefit from this productivity by increasing the demand for labour.

The capital and financial markets have to ensure that:

(1) the system does not create a bias towards promoting capital intensive (labour saving) technology, and

(2) the system does not discriminate against enterprises that create more employment.

The financial and capital markets in developing countries generally lack these features. These markets have developed in such a way that they concentrate on financing more capital intensive technologies in large enterprises which generally do not accelerate employment generation.

Besides, the model also fails to address itself to one very peculiar situation which generally prevails in several developing countries. This is the phenomenon of low labour force participation. The above mentioned model can suggest policies only for creating employment opportunities for those who are involuntarily unemployed, i.e., for those who are explicitly looking for work. The model makes no suggestions for those people of working age who are out of the labour force because they do not have economic opportunities of their own choice (or of the choice of their family) and at the place of their choice (or the choice of their family). Various moral and ethical considerations necessitate this behaviour in developing countries, in general, and in Muslim countries, in particular.

This stock of human resources is also required to be mobilized, firstly, because they are of working age and, secondly, because they have the willingness to contribute to their family income provided they get work that does not violate the social and ethical norms. The fact that there has been a willingness in this stock of human resources to enter into the labour market whenever suitable opportunities arise has been demonstrated, empirically, in several countries. There are countries in Asia and Africa where the open unemployment rate has either remained at a very low level or has increased during the last 30 to 40 years despite the fact that job opportunities in those societies increased at a rate much higher than the growth rate of the population of working age. This merely suggests that the population previously reported out of the labour force is entering the labour force as soon as suitable opportunities arise[(2)].

3.2 CLASSICAL (UNLIMITED SUPPLY OF LABOUR) MODEL

The phenomenon referred to above is similar to what has been reported as the unlimited or perfectly elastic supply of labour by Arthur Lewis(21).

The model suggests that the modern sector be pumped with capital so that the labour demand curve rapidly shifts upwards taking advantage of the minimum subsistence wage until the turning point is reached where further demand for labour comes with the increase in wages and the subsistence sector vanishes. Investment will continue to be needed in the modern sector until the sector absorbs all the stock of human resources.

The financial system is required to mobilize and channel necessary resources for investment into the modern sector. The modern sector has the credit worthiness to attract finances. The lure of jobs in the modern sector (accompanied by the temptations of the urban sector where the modern sector is located) mobilizes the human resources to demand these jobs even at a minimum subsistence wage. The modern sector, thus, is supposed to be a catalyst for mobilizing human resources. The success of the model greatly depends upon the investment decisions of the modern sector. The model suggests that minimum wages will generate higher profits for the modern sector to invest and this, along with other sources of finance, should accelerate investment and, hence, employment. But there is no compulsion in the system to induce the modern sector to reinvest the high profits or to allocate the finances acquired from other sources so as to accelerate employment generation. "A great deal of documentation is now available to show that many countries so distorted incentives and signals in favour of capital that employment was heavily penalized" [(4)].

The model suggests that minimum subsistence wages be maintained until the economy is developed enough so that all surplus labour is absorbed. This is bound to create class conflict. Empirical evidence from several developing countries that worked on this model shows that serious political instability due to labour unrest arose as a result of the widening differentials in the income of labour and capital owners. This phenomenon is undesirable from an Islamic point of view as well.

Furthermore, this model, initially, envisages only a simple transfer of labour from the traditional sector to the modern sector without affecting the economic conditions of the labour class. It is only after all surplus labour is absorbed at. subsistence wages -that labour incomes- start to increase (provided that the class conflicts and labour unrest do not put the model off the track before the turning point is reached). Although labour is mobilized in the sense that labour is moved from disguised unemployment to a more productive modern sector, this mobilization does not have much significance from the point of view of the economic conditions of labour itself.

Also this model does not take into account the fact that not all' labour in the traditional sector in rural areas may be willing or be allowed to move to the modern sector which is mostly in urban areas. This will particularly be true for the female population and for younger and the older males.

3.3 NEO-CLASSICAL (PRICE-INCENTIVE) MODEL

This is an extension of the classical (competitive free market) model discussed above. This model suggests that it is not absolute low wage levels that lead to employment expansion, but rather it is the reduction in the price of labour relative to the price of other factors of production, i.e., capital, that can generate more employment for unemployed human resources. According to the price theory, the reason for the low rate of utilization of labour force in developing countries, lies in a variety of structural, institutional and political factors that make the effective price of the utilization of human resources higher than the effective price of the utilization of capital, particularly that of financial capital. Some of the factors that are usually referred to in this respect include minimum wage laws, the role of trade unions, low or negative real rates of interest, protection on imported capital, etc.

The policy prescription of this model is : "set the prices right" so as to allow price incentive to work for better utilization of human resources.

Although, in principle, this policy makes sense, it fails to recognize several elements. -

Firstly, in most developing countries, income inequalities are so high that further reductions in the relative price of labour will lead to serious political costs without achieving economic results.

Secondly, even a reduction in the relative price of labour may not bring the desired results in terms of employment expansion because the response to the reduced price will depend on the elasticity of the labour-capital substitution. Empirical studies[5] relating to the elasticity of substitution in the manufacturing sector place it between 0.5 to 1.0. This means a 10 per cent reduction in relative wages will lead to a 5 to 10 per cent increase in employment. Not only is this insufficient to solve the human resources mobilization problem, but it also leads to reducing the income of the labour class as a whole. In some developing countries, these elasticities may even be lower, reflecting an almost fixed co-efficient production function.

The model poses two dilemmas. Firstly, development requires accelerated investment, which in turn requires reducing the price of capital (including the price of financial capital). A downward pressure on the price of capital with an inability to reduce wages (being already at subsistence level) puts the price-incentive against employment expansion. Hence, the model has little to offer to developing countries which want to develop along with expanding employment.

Secondly, there is the question of how to define and then correct prices so as to use the price-incentive for promoting very small self employing enterprises in the so-called informal sector which can play a significant role in mobilizing human resources. All those who fail to get or do not want to get a wage-paying job have the option of doing their own work provided that they get the opportunity to do so. The bulk of human resources reported outside the labour force (particularly the female population) in several developing countries falls into this category. This option, however, cannot be exercised without some financial support. The financial system, therefore, has a significant role to play in mobilizing human resources to exercise this option.

Human resources intending to exercise the option of self-employment may not have the collateral to obtain the needed financial capital and even if they arrange the collateral, the repayment of capital with interest may be impossible if they are unable to earn a sufficient profit/income. Risk bearing is too costly for them. What does the price-incentive model suggest for this kind of employment? What correction in factor prices is needed to promote self employment among those who fail to get a wage paid job? We need something more to add. to this model in order to achieve the desired results with respect to human resources mobilization.

3.4 NEO-CLASSICAL THEORY FOR LOW PRODUCTIVITY AND SUBSISTENCE LIVING IN AGRICULTURE AND URBAN INFORMAL SECTOR

The models discussed above deal .with determining wage-paid employment, in the modern sector. A major concern of the human resources mobilization program is the motivation of all labour employed in the rural 'sector and in the 'urban informal sector where productivity and incomes are extremely low. Efforts are required to improve their economic status and increase their productivity/income as part of any human resources mobilization program.

The rural agricultural sector provides, a typical example of such resource mobilization where almost everyone is seemingly employed but their extremely low productivity, low income and subsistence living requires them to be mobilized to look for better economic status. Despite the need for a separate theory because of the peculiar nature of this sector, not much has been written on the subject. The neo-classical theories described earlier are generally assumed to cover the rural/agriculture sector as well.

The dilemma of the neo-classical theory, however, is that a decision to increase capital per worker should be the rational-choice of the farmers/ producers in the agriculture/ rural sector, but they do not choose this option despite the availability of capital. Indeed, they show resistance to' such an option whenever' it is offered to 'them. Lately, economists have suggested that the explanation of this dilemma lies in recognizing the fact that "subsistence agriculture.. is a highly risky and uncertain 'venture, because of its heavy dependance on nature. It is made even more risky by the fact that risk puts the lives of the farmer and his family at stake. In regions where farms are 'extremely small and cultivation is dependent on the uncertainties of a highly variable rainfall, the peasant. and his family become exposed to the very real danger of starvation if they cannot get even a subsistence output from their farms. In such circumstances, the main motivating force in the peasants' life may be maximization, not of income, but rather of his family's chances of survival. Accordingly, when risks and uncertainties are very high, a small farmer may be very reluctant to shift from a traditional technology and crop pattern that over the years' he-has come to. know and understand to a new one that promises higher yields but may entail greater risks of crop failure. When sheer survival is at stake, it is more important to avoid a bad year than to maximize output in better years"[(6)].

In this entire argument, the financial system plays a key role. In fact, it is the nature of the financial system that makes the argument, as quoted above from Todaro, valid. Suppose a farmer is getting Y output from traditional methods (using his labour on fixed land). We can represent the production relation as

$$Y = F(L) = aL$$

Suppose he needs finances K to use a certain technology which will contribute an additional output

$$Z = F(K) = bK$$

and suppose the cost of capital is c per-unit of capital. The net output of the farmer, with the use of new technology, after the payment of capital cost, will be

$$Q = Y + Z - (1+c) K = aL + bK - (1+c) K = aL + (b-c) K - K$$

If the farmer does not use the new technology, his net output is

$$Q = Y = aL$$

Now we introduce uncertainties. Suppose it is 50 per cent likely that weather will be good for the yield and 50 per cent likely that it may not be good. The expected net outputs thus would be :

With new technology $EQ = 0.50 (Y+Z) - (1+c) K$

Without new technology $EQ = 0.50 Y$

It is clear that without technology, the farmer is getting something from tried methods (0.50 Y) which have at least been saving him from starving. But with technology he may not get anything at all. The amount 0.50 (Y + Z) may be less than the payments (1 + c) K, he has to make to repay capital and its cost and, hence, the farmer is risking starvation. The rational choice of the farmer, therefore, is not to use the new technology.

The financial system in which the farmer has to pay back the borrowed capital with fixed cost, irrespective of the outcome, defeats any attempt to induce the farmer to borrow money to use the new technology, improve his productivity and, hence, his income. The financial system will kill all the incentive and motivation for self-mobilization.

The same is true for the informal sector. Economic theory gives no specific model for mobilizing human resources in the urban informal sector with extremely low productivity/ income.

. The existence of the informal sector was recognized when massive additions to the labour force failed to show up in unemployment statistics. However, no need for a separate model has been considered, probably on the grounds that existing theory could explain this phenomenon., In terms of classical theory (of surplus labour), the urban informal sector contains that stock of surplus labour which makes the labour supply curve infinitely elastic at a constant subsistence wage and allows the modern sector to expand rapidly. The rapid expansion of the modern sector ultimately is supposed to absorb all the stock of human resources lying in the urban informal sector, after which there will be no informal sector and wages will start moving up from the subsistence level. However, the experience, over the last four decades, of several countries, including those which deliberately included this model in their development plans revealed that despite the accelerated growth of employment in the modern sector (much higher than the growth of the labour force), the size of the urban informal sector (as well as those seemingly employed in the rural/ agriculture sector at subsistence level) continued to increase.

In terms of the neo-classical model, those, in the urban informal sector, remain at a subsistence level, because, due to the risk of starvation, they do not want to use the new technology or improved methods of production.

The neo-classical model does not explain how to neutralize the fatal implications of risk bearing for such labour. It is this aspect that makes the profit-loss sharing based system more relevant in promoting human resource mobilization.

There are two points to be noted about the approach of the existing models to the informal sector. One point is that both models consider creating wage paid employment opportunities in the formal sector as a primary source of human resources mobilization. Those who cannot be accommodated in the formal sector are required to be comfortably absorbed in the informal sector as a second-best alternative. To assign a secondary importance to a sector, (which in some developing countries such as Pakistan, is as big as 70 per cent of the total urban labour force)[(7)], is not a justified approach.

The other point is that neither of these models pays any attention to the role of the financial system which may be the key factor in the persistence or non-persistence of the urban informal sector. It has already been mentioned that the existing financial system in most developing countries exaggerates the impact of risk bearing for human resources without capital. These people are likely to be motivated to improve their economic condition by utilizing better technology and improved means of production; if, in case they are unable to succeed in their enterprise, the following two elements are taken care of :

(a) The capital lost in the process of utilizing it to improve technology and the means of production.

(b) The subsistence of the family in order to save them from starvation, in case the new methods of production are not successful.

In other words, if some institutional arrangement can cover the loss of borrowed capital and can guarantee the subsistence survival of the family, then it may be sufficient to induce the individual to take steps to improve his productivity. Once he is made to pass through the critical situation, then it will give him a chance to build up some assets to meet any unfavourable situation later on without any external help.

3.5 KEYNESIAN MODEL

The Keynesian model, in fact, is a model that aims at human resource mobilization in a global context rather than explaining it in terms of a labour market phenomenon that is concerned only with those who report themselves to be in the market.. The Keynesian model requires measures to increase effective demand in the economy, which in turn will induce productive activities- in the economy and, hence, will mobilize human resources. As a response to increased effective demand, new large scale and small scale enterprises as well as self employed productive activities may be generated and a cycle of demand-output- employment may succeed in mobilizing the entire stock of human resources. Depending on the composition of the induced aggregate demand, those who are not willing to move may also find opportunities to have an activity of their own choice at the place of their own choice.

In this model, the financial system of an economy is simply required to inject the appropriate finances to stimulate effective demand. This can be supplemented by other fiscal and financial measures in order to synchronize the increased demand and the supply response. The efficiency of the loan market is particularly important for this model to adequately induce private investment and productive efforts to match the increased demand.

However, in our context, this approach is an indirect one in the sense that the measures suggested by it do not directly address the target population, which is the unemployed or unutilized stock of human resources. They are expected to mobilize themselves in response to the increase in the aggregate effective demand. It is quite possible that the increase in demand may come in those sectors which may leave the unutilized and unemployed human resources unmoved[8].

4. LESSONS DRAWN FROM THE ECONOMY THEORY

Conventional programs of employment had little success in mobilizing human resources in developing countries, in general, and in Muslim countries, in particular. The review of existing theories presented in the previous section suggests that there is a need to develop an entirely new approach.

4.1 A SUGGESTED APPROACH

In the light of the various issues discussed in chapter 3, the following approach towards a program of human resources mobilization is suggested. This approach is intended not only to take care of the weaknesses of the models discussed earlier but also to realize the maximum potential of the Islamic financial system towards human resources mobilization as will be discussed in the next section.

1. A program of human resources mobilization should aim at the following two specific targets:

   i) Mobilizing the idle human resources (those unemployed or those reported outside the labour force) to make them economically active; and

   ii) Mobilizing those who are already the so-called "employed" to enable them to improve their economic condition.

2. A human resources mobilization program should concentrate on creating self- employment opportunities for the target population. The creation of wage-paid job opportunities should be left to the formal sector, which should take care of itself. Alternatively, there may be a separate program for the promotion of the formal sector independent of the human resource mobilization program. This should bring at least the following outcomes.

Firstly, it directly aims at motivating and enabling the target population to create jobs for itself. Any program that aims at creating wage-paid jobs will have to motivate an employer to create job opportunities. The motivation and utility for the target population to respond to this demand will still be lacking. As has already been elaborated, several factors may not permit the target population to respond to such demands. Motivating and enabling the target population to create jobs is supposed to minimize these factors and, hence, increase the probability of success.

Secondly, the choice of a self-employment opportunity gives those human resources (who make the choice) more opportunities to improve their economic conditions compared to those who choose to be wage-paid employees. This is because:

a) a self-employed person is in a position to make decision to expand
• his 'enterprise and, hence, his income earning capacity if opportunities exist. A wage-paid employee lacks this decision making power.
a self-employed person has more motivation and incentive to save as he has an opportunity to use his savings to expand his business and further improve his economic. status. This tendency, is very likely to have a snowballing effect enabling him to accumulate more and more capital as the expansion of his business increases the capacity to save which gives him further motivation to expand his business. Such effects are lacking in a wage-paid job,' as the individual can utilize his savings only by giving them to some one else, institution or individual, who may give him only marginal returns.

c) - a self-employed person has the opportunity and the option of utilizing the maximum time available to him. This opportunity and option may not be available to the wage-paid worker because he has no control over the amount of or the wages paid for overtime work.

d) a self-employed person has the option and the opportunity to utilize two aspects of his human capital; the ability to do labour and the ability to make decisions and to bear the risks associated with these decisions. Both are productive abilities. But in a wage-paid job, the worker can benefit only from the former ability which is very limited and, hence, puts a limit on his capacity to improve his economic situation.

e) a self-employed or family operated enterprise is the only source of mobilizing most of the women of working age in Muslim countries at least for any short- or medium-term planning. purposes.

Therefore, the suggested model requires that a human resources mobilization program aim at creating self-employment opportunities in such a way that the above- mentioned advantages of such opportunities are fully exploited.

3. The urban informal sector and the rural sector are required to be accorded primary importance in the program even if this means that the support to the formal sector to create employment opportunities be given a low priority. This priority is required for the following reasons:

a) The self-employment sector is obviously a highly labour intensive and extremely low capital intensive sector: Small investments can mobilize more human resources to enter into economic activity in the rural sector and urban informal sector than it will do in a formal urban sector.

b) The formal urban sector is in a better position to take care of itself than the informal and rural sectors. It is the informal and rural sectors that are more in need of a push.

c) The promotion of the formal sector may help to mobilize only those human. resources who are willing to work in the sector. There is evidence from some Muslim countries that a large part of the rural population as well as a substantial part of the urban population (particularly females) may not be willing to do so. A program to promote self-,employment in the urban informal sector and the rural sector has 'a wider scope in view of the fact that in several developing economies about 80 per cent of the population of working age belongs to these two sectors.

d) Income raising opportunities in the rural and urban informal sectors reduce the pressure on individuals to migrate to urban areas where they remain unemployed or live on subsistence earnings in the hope of getting a wage- paid job in the formal sector. Focussing self-employment programs on the rural sector and on the urban informal sector will have a direct impact on reducing urban open unemployment, a serious issue in most contemporary developing economies.

e) The promotion of self-employment or very small enterprises in the rural and informal urban sectors will provide competition to the formal sector with respect to the hiring of labour. As soon as the average family income starts rising in the rural and urban informal sectors, the supply side reservation wage for employment in the urban formal sector will rise, because the formal sector draws labour from these two sectors. There will be pressure on the formal sector to raise wages (otherwise labour would prefer to go to the informal sector for self-employment jobs). Involvement in entrepreneurial self-employed jobs helps build up human capital which in turn will help labour to sustain the increase in the minimum reservation wage for seeking employment in. the formal sector. This competition will raise human. resources mobilization along with an increase in wages in the formal sector and family incomes in the rural and informal urban sectors.

4. As self-employment opportunities are substantially promoted in the economy, there will be a need for a simultaneous follow-up program to be supplemented by the following:

i) Identifying those successful self-employing enterprises which have potential for further growth and helping them to grow into small enterprises employing labour from outside on a wage basis.

ii) Enabling these small enterprises to, integrate into the formal sectors, if they continue to show potential for growth.

The above approach should not be taken as a strategy of perpetuating backwardness, as was the criticism of Fritz Schumascher when he suggested a similar strategy under the title *"Small is Beautiful" .* The approach in this paper is not that of. small is beautiful and, therefore, that only small should matter. The approach is to recognize that *Small is Important* because it potentially involves about 90 per cent of the population in most developing countries and, hence, the *small* should be given due attention, while promoting the large, for the purpose of industrialization and technical progress. Secondly, and more importantly, the strategy of giving more attention to the *small* emerges from the fact that the Islamic financial system (to be discussed in the next chapter) already has a built-in mechanism to motivate and support the *small .* This potential should be exploited to benefit the *small.* Thirdly, it will be discussed later. that the amount of investment required to mobilize substantial amounts of human resources under the above approach is so small that a medium-term plan adequately phased to implement the above approach should not substantially affect any existing programs for industrialization and technological progress. A proper integration of the small sector with the medium and large scale sector and adequate assistance to the small sector to adopt new technology will, in fact, accelerate the industrialization and technological progress.

The approach suggested above, in short, boils down to the following:

Motivate and enable all such human resources that are either not working and contributing anything to family income or that are earning (or are living on) an income less than that of market wage of comparable skills to take up self-employing economic activity that can ensure at least an income equal to the formal market wage. As these self-employed human resources gain experience and expertise, motivate and enable them to increase the size of their enterprise to employ more non-family members. As self-employment activities grow into small enterprises, efforts are made to enable them to integrate with the formal sector so that they ultimately are recognized as a part of the formal sector and are no longer a part of the informal sector.

In the three stages identified above, the first stage is the primary and essential step in human resources mobilization. The remaining two stages are meant simply (a) to reinforce the primary stage in order to accelerate the speed of human resources mobilization; (b) to help them move from informal sector self-employment to a formal sector production firm and, hence, be self sustaining in income and economic status and (c) to make the human resources mobilization program an engine of growth in the economy as well.

The last two stages, however, are not the direct subject of this paper. It will simply be the extension of the policies applied in the first stage. This paper concentrates only on the first stage.

The motivation and ability of the economically inactive or less active stocks of human resources to take up self-employment jobs depends essentially on the following factors:

a) Ability to produce some goods and services in demand locally.

b) Ability to market the goods.

c) Access to required capital at the right price (or the correction of the financial system as already mentioned).

The target population we are concerned with in developing countries, by definition, does not have the education or training for substantial production skills. Yet, it should also be recognized that we are not talking of a productive activity requiring any substantial skills to start with. There may be numerous activities for self-employment which do not require substantial skills. Whatever skills they require can be informally acquired locally with little time and money. We are talking about activities like vending, tailoring, shoemaking, carpentry, iron-mongery, running a small eating place, running low cost public transport (which, in rural areas, may even be animal driven) and so on. The ability to do these things can be acquired at one's own initiative with very little cost, which, in most cases, can be afforded even by people of the lowest means, provided there is sufficient motivation to do so. This will, hence, not be a major area of intervention at least as far as the first stage of the scheme concerned.

The same is true for the ability to market the goods. Again, in the first stage, we are talking about the production of goods and services in local demand. Clothing, shoes, textiles, low cost household utensils and pottery, low cost household furniture, groceries, food products and, services, etc. are only some examples. The goods, being a part of the bare minimum needs of the local population and, hence, essential are not likely to face a marketing problem. The household's income generated from the production of these locally demanded goods and services will also reinforce the demand for local products. Hence, in the first stage, as far as the model is concerned, even marketing is not assumed to be a major area of intervention. The major area of intervention would be the financial system to ensure adequate access to capital requirements at the right price.

4.2 CORRECTIONS IN THE FINANCIAL SYSTEM

This is an area requiring substantial intervention. The target population we are talking about obviously lacks any amount of capital, however small it may be, to initiate small self employing productive activities. Also, the poor possess latent skills which, when complemented by adequate capital, can be harnessed for more remunerative self- employment. It is important that financing programs for the poor should be appropriately designed, implemented and managed in a way that fits the circumstances in which the poor find themselves. There are, of course, two dimensions of intervention in this area. One relates to generating the' supply of required capital and the other to creating demand for available capital.

4.2.1 Supply of Required Capital

Supply of capital required by the target population is constrained by two factors. Firstly, the target population is devoid of any collateral to guarantee the principal amount and a return on it. Secondly, doubts about the capabilities of the target population to produce and market the goods and, hence, make substantial profits to repay the capital with return make the investment a risky proposition. This sector will, therefore, fail to attract a substantial amount of funds to ensure supply of capital for meeting the needs of the sector as long as there are opportunities for earning a risk-free and guaranteed return on capital. As long as some sectors of the economy continue to guarantee a fixed return on capital, some special fund will have to be created to ensure a substantial supply of capital to finance the productive efforts of the self-employing activities of the first stage. This fund will have two prominent features. Firstly, it will supply capital to the target population with no physical collateral. If the target population fails to offer any personal guarantee, that too may be waived, in some cases, it should suffice if the potential client can provide a trustworthy reputation of good character. Secondly, it will be willing to expect no income for some time, until the self employing activities start generating sufficient income to pay some return on the capital. The capital will also be willing to bear a partial or total loss in case the self-employing activities fail to take off in a reasonable period of time.

4.2.2 Demand for Required Capital

The existence of a need for capital requirement for financing activities to improve household incomes and productivity though self-employing activities may not be sufficient unless that need is not translated into an effective demand for capital. The constraining factor is the same as already discussed by the conventional economic theory in the context of explaining the lack of motivation to adopt new technology. As has been mentioned earlier, human resources living at the subsistence level in the rural and urban informal sector do not readily accept innovative methods of production because the risk is too great. The risk is of starvation if the new methods fail to produce results. It is this same risk that prevents idle human resources from engaging in entrepreneurial or self-employment activities.

Although idle human resources are already subsisting on someone else's income, the risk is that entrepreneurial or self employment activity will require capital that will have to be borrowed and in the event of failure, the income of the rest of the family will be at stake, which may then lead to starvation.

This bottleneck requires at least three elements to be resolved :

i) The burden of bearing a loss by human resources should be made negligible at least in the short-term.

ii) There should be a system of social security that would take care of the subsistence of the entrepreneur and his family during the lean periods of his enterprise.

iii) The (factor) price in the market should be set right so as to provide the necessary incentive to idle human resources to opt for an entrepreneurial activity rather than to wait for a fixed wage-paying job.

In short, there are two areas of intervention:

a) Guarantee of minimum needs of the population through some formal system of social security

b) Capital markets

The capital market is the major area of intervention for the proposed model. Interventions in. the capital market are required to correct the elements that create a bias against self-employing entrepreneurial activities and in favor of fixed wage-paying job opportunities. The corrections would aim at the following:

i) Eliminating the need for collateral, in general, and for physical collateral, in particular, while accommodating the capital requirements for self-employing productive activities.

ii) Linking the return on capital with the performance and outcome of the enterprise into which capital has been put.

It. is in. this context of the capital markets that the Islamic financial system and its role in human. resources mobilization is presented in the next section. .

The following section evaluates the Islamic financial system vis-a-vis the prevailing financial system in Muslim countries from the point of view ,'of its relevance for human resources mobilization programs.

Before going into a discussion of the Islamic financial system, it may be clarified at the outset that the above conclusion does not mean that the reforms of the financial system are a magic cure for the problem. The significance of education and occupational training for the mobilization of human resources cannot be overemphasized. Corrections in the financial system can help mobilize human resources to utilize their capacity to the greatest possible extent but their capacity remains constrained by their education level. With mass illiteracy in most developing countries, the productive capacity of the masses remains at extremely low levels. But the point is that even this capacity will remain unutilized because of the financial system. This paper, therefore, emphasizes the correction of the financial system at least as a source of mobilizing human resources to exploit their existing capacities, irrespective of how low they are.

5. ISLAMIC FINANCIAL SYSTEM AND ITS RELEVANCE FOR HUMAN RESOURCES MOBILIZATION

The Islamic Financial System is described in the Appendix. The following features are to be noted with specific reference to the mobilization of human resources.

1. The system has a provision for *Qard Hasan* for needy people. Under *Qard Hasan,* there is no return on capital and repayment is subject to the ability of the. borrower to pay. *Qard Hasan is* highly encouraged in Islam and state institutions and the private voluntary sector are supposed to raise funds to meet the *Qard Hasan* needs of the members of society.

2. The system entitles the capital to earn a return only by bearing some of the risk associated with the activity. There are various Islamic modes of financing. Some modes of financing may not mean risk bearing to the full extent or for the entire period of financing (as in leasing-based or trade-based modes of financing). Some modes of financing, however, imply risk bearing for the entire period of financing. Participatory forms of financing, which include *Mudaraba* and *Musharakah* participate in the risk bearing to the full extent of the invested capital and for the entire period of risk bearing. Islamic economy, in its financial and economic features will truely be distinguished from the participatory modes of financing than on the leasing or trading-based modes of financing.

3. There is a system of social insurance (in the form of Zakah and charities) that is meant to meet the subsistence needs of those whose subsistence is threatened for any reason. Although it is not directly a part of the financial system, it has significant implications for supplementing the role of the Islamic financial system in mobilizing human resources. State institutions as well as the private voluntary sector are supposed to organize Zakah and charity funds and make arrangements to meet the survival needs of the less privileged members of society.

Introduction of the participatory modes of financing *(Mudaraba* and *Musharakah)* as a core of the financial system in the economy allows, the following features also to emerge and prevail in the economy.

i) Profitability of the project becomes the primary consideration for the financial accommodation. Credit-worthiness becomes the secondary consideration, because the return on the project is not fixed but depends on the profitability of the project. (In the interest-based system which guarantees the principal with interest, credit-worthiness is the primary consideration and the profitability of the project is of secondary importance).

ii) Financial institutions may not be as inclined to finance large enterprises as they are in the interest-based system. Neutrality to the size of the enterprise is more likely to prevail. Profitability has generally been found, empirically, to be independent of the size of the enterprise. (The interest-based system has a clear bias towards large enterprises as the credit worthiness of large enterprises is generally more easily establishable than that of small enterprises).

iii) Finances have a chance to be more widely spread and distributed in the economy. Since the return on financial capital is associated with risk bearing, the diversity of the portfolio is a key to minimizing risk. The interest-based system has no compulsion to diversify because with the credit-worthiness feature, diversity will not help reduce risk and may be more likely to increase it.

iv) As a logical conclusion; when profitability and diversity are the primary considerations and there is nothing to suggest that these two elements are positively related with the size of an enterprise, smaller enterprises will get more encouragement from financial institutions. Smaller enterprises require smaller financial accommodation and, hence, diversity and the spread of risk become less by dealing with smaller enterprises.

v) There is more likelihood of the efficient utilization of capital under the Islamic financial system, which forces financial institutions to look for the most profitable and feasible projects. Under the interest-based system, there is no such compulsion as the return on capital is fixed and guaranteed by collateral.

We shall now look at how the Islamic financial system caters to the needs of a human resource mobilization program. The discussion will be confined to the needs pointed out earlier while taking into consideration the existing models of employment which were summarized in sections 3.1 to 3.5.

5.1 FACTOR-PROPORTION-BIAS

It was argued that the existing financial structure has a bias towards investment in capital-ntensive (labour saving) technology. This is because:

a) The fixed rate of interest (usually determined by the monetary authority of a country) causes the relative price of capital to go down, particularly when there is inflation in the economy. This (price incentive) creates a tendency to use more capital-intensive production processes.

b) Since credit-worthiness and collateral requirements are easily established by those who already own capital, capital becomes concentrated in fewer hands. This promotes capital intensity as it becomes easier to control a large capital intensive enterprise than to control a large labour intensive enterprise. Although credit-worthiness may still exist in some form in the Islamic system, its strength is not likely to be as great as in the interest-based system where guarantees and a fixed return are required for capital as well as ensuring credit-worthiness.

The Islamic financial system implies the following:

a) The institution of *Qard Hasan* will only provide capital to people with little means which, by definition, means the promotion of labour-intensive activities.

b) Islamic financing is on a participatory basis. *(Mudaraba* by *Musharakah* has no built-in incentive towards capital intensity). The return on capital is not fixed and it will increase with inflation and, hence, there is no unplanned decline in the relative price of capital. Also, there is no built-in mechanism to allow the concentration of capital in a few hands. Credit-worthiness and collateral needs, though they may still exist, will be of secondary significance; the primary significance being given to the profitability of the project in which the investment is being made. Furthermore, participatory finance yields a risk-bearing return and risk can be minimized by distributing capital on several projects. The concentration of capital and, hence, capital intensity is likely to decline with the introduction of participatory finance.

Although the leasing-based and trading-based modes of Islamic financing may have a tendency towards concentration and capital intensity (as compared to participatory finance), this tendency is likely to be lower than that in. the interest-based system. This is due to the fact that large entrepreneurs do not have as much advantage as they have in the interest-based system, since goods/assets involved in trading or leasing-based financing can themselves serve the purpose of collateral.

5.2 SETTING THE FACTOR PRICES RIGHT '

The Islamic financial system helps to correct factor prices in several ways. Firstly, as has already been mentioned, a fixed rate, in periods of inflation, moves the relative factor prices against labour (making labour, relatively, increasingly more expensive). The Islamic financial system does not create this distortion in participatory finance where inflation will inflate the share in the profit and, hence, the relative price of capital will not be reduced because of inflation alone.

Secondly, it corrects the price of entrepreneurship vis-a-vis capital. In the interest-based system, all productive risks go to the entrepreneur and entrepreneurship, therefore, becomes a too costly factor compared to capital which remains cheap irrespective of how risky it may be to initiate productive activities. Thus, there is no demand or very little demand in the society for entrepreneurship, although there is a lot of demand for capital. Hence, there is no (price) incentive for capital to take up the role of the entrepreneur. The relative prices have all the incentive for capital to be only a fixed income earner.

Thirdly, it also corrects the price of entrepreneurship vis--vis the price of labour. Employees on a fixed wage basis and self-employed entrepreneurs who have their own business both provide human efforts. The_ latter,. however, face the risk of losing the capital invested in their business, while the former face no, risk. In the interest-based system where capital is guaranteed with a certain fixed return, the risk is too much for the human resources to take up an entrepreneurial activity. This is particularly true for the human resources with little means. The interest-based financial system, thus, distorts the choice of human resources between taking up an entrepreneurial activity or a fixed wage-paid job. There is more demand for labour activity than for entrepreneurial activity. The Islamic financial system, particularly under participatory financing, corrects the choice, as the cost of taking up an entrepreneurial activity is reduced by forcing capital to share the risk. .

5.3 "SURVIVAL" SYNDROME

The Islamic financial system, effectively, has the ability to fight the "survival" syndrome, which was described earlier as having two elements:

1. A fear of the loss of capital
2. A fear of starvation

These two fears prevent the human resources with little means from being enterprising and innovative in improving their economic condition. Most of the Islamic modes of finance relieve the user of capital from the risk of its loss. In addition there is the institution of Zakah and charities which also have the potential for taking care of the subsistence needs of the less privileged members of society. These institutions can be organized at state or society level in such a way that they can also be used to motivate and mobilize human resources involvement in an enterprising activity, if a wage paid job is not available. By guaranteeing the subsistence of new entrepreneurs (in case they fail) and/or in guaranteeing the principal amount of the loans that the new entrepreneurs may need to borrow, these institutions can further supplement the Islamic financial system's potential for mobilizing human resources.

5.4 SYNCHRONIZATION OF AGGREGATE EFFECTIVE DEMAND WITH THE HUMAN RESOURCES MOBILIZATION PROGRAM

At the macro level, the policies creating an effective demand may not, to the same extent, simultaneously generate human resources mobilization. Fiscal policy or the injection of money supply through interest-based institutions may generate effective demand, which may be met from imports or from capital intensive production. On the other hand, no supply at all may be generated, and the end result may be the creation of inflation. The Islamic financial system provides opportunities where effective demand as well as supply through human resources mobilization can be generated simultaneously. The expansion of the finance supply through Islamic financial institutions generates a productive capacity as well as generating effective demand, because all of the finance supply will be meant for productive purposes and, as already mentioned, the Islamic financial system has a clear bias towards smaller enterprises which are more labour-intensive. Therefore, the simultaneous generation of effective demand and supply by an Islamic financial system mutually reinforces the employment and absorption of unutilized human resources in more productive activities. The magnitude of the problem that was identified in the discussion of the Keynesian model with respect to the possibility of a mismatch of demand and supply and, hence, an inability to mobilize *resources-is* considerably reduced by *the features of* the-Islamic *financial* system.

6. SOME INSTITUTIONAL PROVISIONS

Besides modifying the approach towards human resources mobilization and making corrections in the financial system, some additional institutional provisions also need to be identified in order to reinforce the strategy described earlier. Particularly in need of attention are the following.

6.1 COMPLETE ELIMINATION OF INTEREST FROM THE ECONOMY

The introduction, of the Islamic financial system based on participatory financing is a key to the successful implementation of the proposed strategy. The Islamic financial system, however, will not be able to show its full effectiveness for the human resources mobilization program described in this paper unless the option of interest-based financing is completely eliminated from the economy. If this is not done, then those who own capital are likely to favour the interest-based option and are unlikely to provide capital for participatory finance which could be used by human resources to become more productive. On the other hand, potential capital users will only bring forth projects for participatory financing in which the income is low or the risks and uncertainties are high. Capital owners, however, will not be interested in financing such projects. For higher income and less risky projects capital users are likely to opt for interest-based financing. Hence, participatory finance will be driven out of the economy, if the interest option is allowed to exist. This will be the same phenomenon as Grasham's Law of "Bad Money Driving Good Money Out". In such a case, only government financed institutions will be able *to* provide *the necessary financing along the* lines proposed by the strategy. The financial constraints faced by most of the labour in developing countries in the Muslim World will, however, not permit government financial institutions to work on a large enough scale to implement the human resources mobilization program as outlined in the paper.

6.2 DECENTRALIZATION OF. THE BANKING SYSTEM

Most developing countries have a centralized banking system. The centralization occurs at the level of the distribution of finances collected from small savers. This centralized distribution of finances has resulted in the concentration of capital in a few hands which, from the point of view of human resources mobilization, is counter-productive. The strategy described in earlier sections requires the decentralization of the investment decisions of financial institutions. This may require some groundwork in the form of giving adequate training to local bank managers for-making investment decisions, but this is essential for an effective human resources mobilization program in the framework described in this paper. The spread of the banking system. to rural areas with powers given to local managers to make investment decisions and to distribute funds accordingly will have to be an important part of the entire strategy particularly in those countries where more than 75 per cent of the population of working age is located in rural areas. The practicality and cost effectiveness of decentralization in connection with the proposed model can be seen in the experiences of the Federal Business Development Bank of Canada and of. the Grameen Bank; Bangladesh.

6.3 ESTABLISHMENT OF A DEVELOPMENT BANK FOR HUMAN RESOURCES MOBILIZATION

'- There have been several development 'banks for capital formation, but development banks for human resources mobilization are almost non-existent in the Muslim world. Development banks for the specific purpose of human resources mobilization must be established to provide risk bearing capital to mobilize low-income human resources, who may not be able to compete with the higher income groups in offering a better rate of return. These institutions will be particularly required in countries which have an abundant supply of labour, the substantial part of which is extremely poor, illiterate and unskilled.

7. COMPARISON OF THE PROPOSED MODEL

There have already been some experiences in the developing world as well as in the developed world in the field of mobilizing human resources (particularly in promoting self employment) through the development of appropriate financial arrangements.

These experiences succeeded in proving the following :

1. Human resources can be mobilized through the availability of finances by giving them opportunities for self-employment activities.
2. Even illiterate workers have the capacity to utilize financial capital to substantially improve their productivity and income through self-employment.
3. Self-employment results in a high marginal propensity to save and a propensity to invest and, hence, leads to an accelerated improvement in economic conditions.
4. The availability of finances can convert even housewives into traders or manufacturers.
5. The financial capital required for mobilizing human resources into self- employment activities is extremely low.

The existing experiences, however, suffered from the following problems. Firstly, these institutions have always been short of funds. If human resources are to be mobilized only through specialized institutions then they require exclusive funds for this purpose which can only come through the public treasury or through donations. Both these sources can only generate insignificant amounts for countries where labour is abundant. In countries such as Indonesia, Bangladesh, Pakistan and Malaysia, most of the economic resources are already committed to various development efforts which leaves very little to be assigned to such institutions.

The private sector cannot supplement public efforts in this field in an interest-based economy, because specialized institutions can only provide poor people with an easy access to cheap capital. Capital is only cheapened by reducing the rate of interest.

The private sector will not be interested in such an activity when the rest of the economy is offering a better rate of interest.

Secondly, even if these institutions are provided with enough funds, their ability to mobilize a sufficient portion of the available stock of human resources is doubtful simply because of their interest-based philosophy. These institutions provide interest-based loans, where both the principal and the interest is guaranteed and is required to be-paid irrespective of the outcome of the activity for which the loan has been taken. It has already been shown that this basis of financing kills the motivation to seek financing for an entrepreneurial activity because uncertainties are too costly. There are six types of potential borrower. They are those with projects which have .

1. Low return with no or negligible risk.
2. High return with no or negligible risk
3. Low return with low risk
4. High return with low risk
5. Low return with high risk
6. High return with high risk

Specialized development financial institutions even with very low interest rates motivate only the first two types of ,client.; Since these specialized institutions only operate on a limited scale, they can always find enough clients within the type 1 and type 2 categories. When they do have enough funds to look for clients in other categories; those in categories 4 and 6 may hesitate-to avail themselves at this facility because of factors already highlighted in earlier sections. Categories **.3** to 6 may also generally remain unmobilized even if the specialized institutions' finance is available to them.

On the other hand, the Islamic financial system motivates all six categories. The financing needs in some of the cases (such as for categories 2, 4 and 6) can be taken; care of by the market, whereas for the remaining cases (such as categories 1, **3** and 5), specialized institutions can be designed, if the funds are available.

The fundamental difference between the two approaches is that the interest-based financial system aims at providing small entrepreneurs in a particular section of the population with cheap access to capital, whereas the Islamic financial system aims at providing all sections of the population with an equal opportunity to have access to risk bearing capital in the economy. •

The existing specialized financial institutions attempting to mobilize human resources in various parts of the world seek guarantees of repayment of principle with return. Some of them, operating in very poor areas, have developed certain pressure groups to force borrowers to repay the principal with return irrespective of the outcome of their enterprise. People are put in jail for not repaying loans in order to ensure repayment. All this demobilizes even those human resources which may have productive potential but which may not have resources to repay the loan in case of the failure of an enterprise. The bulk of the human resources in labour abundant countries fall into this category.

It should also be noted that since, in the Islamic financial system, there is Zakah on wealth, wealth cannot be left unproductive, but must be invested to earn a return of at least 2.5 per cent to pay Zakah. If no interest-based option is available, people have to look for entrepreneurs to invest their resources. The private sector, therefore, mobilizes human resources to generate potential entrepreneurs who can invest their funds productively. It is only a matter of developing appropriate institutions to harness this potential of the private sector. There are examples in Muslim countries where some unscrupulous elements developed such institutions and mobilized millions of dollars of additional resources on the pretext of investing the resources on an Islamic basis of profit-sharing. However, not properly regulated and controlled by government, these institutions usurped the resources mobilized from small savers. But this experience did indicate the potential in Islamic societies to raise funds for entrepreneurs. On the other hand, what we are emphasizing is that, in the first instance, the proposed model has a built-in potential mechanism to create new entrepreneurs as new finances are mobilized and injected into the economy. This potential is to be exploited to mobilize not only idle human resources but also those who are presently working as fixed wage employees but who have the potential to be entrepreneurs, who will not only initiate new activities, but will also generate a greater demand for labour than the same amount of investment would have generated if it had been given to already established entrepreneurs. We only propose that this potential of the Islamic financial system be exploited through appropriate polices to accelerate and upgrade the employment of human resources in the economy (without affecting the rest of the growth and development targets of the economy) at a rate higher than what can be achieved by an interest-based system. In addition to this, we are proposing that special development financial institutions be established to reinforce the system by catering to the needs of the very poor through special arrangements. It will be shown below that with the Islamic financial system, these institutions are likely to be more effective than their counterparts in the interest-based economy. The strength of the argument for-the model, however, is not in the success of such specialized institutions, but rather in the unique nature and potential of the entire financial system for human resources mobilization.

8. CONCLUSION

The Islamic financial system is more conducive to the mobilization of human resources in society. It is not being claimed that the Islamic financial system can automatically and miraculously mobilize all human resources. It is only being claimed that the system has the potential to support a carefully designed program to mobilize human resources. This claim is based on the following features of the system.

1. It has no built-in bias towards capital-intensive (labour saving) technology.
2. It sets the prices right to create more price incentive for human resource utilization.
3. Human resources are not intimidated by the fear of the loss of capital or by the fear of starvation for undertaking an enterprising activity, if they do not or cannot find a wage-paying job for themselves.
4. Public policies for growth and employment can be more effective because financial expansion comes mainly through generating productive activities.

In the presence of the Islamic financial system, a carefully designed human resources mobilization program can be more successfully launched by ensuring the following:

i) Tilting the financial system, as far as possible, towards using the participatory mode of financing.

ii) Adopting an approach towards human resources mobilization consistent with the features of the participating financing aspects of the Islamic financial system. This requires that human resources mobilization should not simply aim at creating (wage-paying) employment opportunities in the formal sector, but should rather pay more attention to the creation of activities in the self-employing/informal sector. The system not only attempts to create new opportunities in the formal sector, but is also conducive to upgrading existing activities in the informal sector to facilitate entry into the formal sector.

iii) Developing the institutions to support the financial system and the desired approach towards human resources mobilization. These institutions will aim at :

a) identifying small projects that can be taken up by people with little means;

b) motivating individuals/families to take up projects in order to best utilize their human capital;

c) arranging *finances (on an* Islamic *basis) to* support *the* acquisition and operation of projects;

d) developing financial instruments with specific aim of mobilizing human resources[9];

e) monitoring and guiding the performance of the projects.

In conclusion, it should also be mentioned that it may not be necessary to wait until the entire financial system is Islamized before the proposed program of human resources mobilization could be implemented. What can be done is to earmark substantial amounts of the financial resources of the country for investment on a' participating basis with the unutilized human resources. But this can only be done in the public sector. The private sector, having the option of interest-based financing, will be unwilling to engage in participatory financing with people with little means. The advantage of Islamizing the entire financial system in society would be that even the private sector would contribute to human resources mobilization *as the* elimination *of* interest-based *financing* would *remove* all the incentive to finance large, capital-intensive enterprises.

APPENDIX

ISLAMIC FINANCIAL SYSTEM

Briefly speaking, we are talking of a system with the following features :

(1) There is no interest in the economy. Financial capital can earn income only by bearing and sharing the risk of losses. All banks, commercial financial institutions and development financial institutions will seek and provide finances which will always have some risk bearing element. Although there can be several different ways (to be discussed in more detail later in this section), all of them must have some form of risk bearing by the finance supplier.

(2) If financial capital is not willing to bear and share risk, it can then be advanced on *a Qard Hasan* basis. In this case, financial capital neither earns any income nor bears or shares any risk of loss. Commercial financial institutions, of course, will not indulge in such transactions on a large scale. The system will develop special institutions for this type of financing, either on a cooperative basis or in the public sector.

(3) There are Zakah and charities in the system (the minimum obligatory levy being 2.5 per cent on the ownership of financial capital). Besides serving as a deterrent to keep financial capital idle, it also serves as obligation-free financial support to the low income section of population.

(4) Public borrowing is constrained by the absence of interest in the economy. Public borrowing will either come in the form of risk bearing capital for commercially productive projects or it will come in the form of *Qard Hasan* to the government. Government securities, which bear a return, can be issued only for such borrowing that is linked to commercially productive activities.

(5) In principle, it is possible for the government to print money, if its benefits outweigh its costs.

Within the above-mentioned outline, it will be instructive to go into more detail about the modes of financial accommodation in the above-mentioned system where interest is absent and financial capital can earn income only by bearing the risk of loss.

MODES OF FINANCIAL ACCOMMODATION

From Islamic teachings, we can identify two categories of permissible forms of financial accommodation. One can be called Direct Financial Accommodation and the other can be called Indirect Financial Accommodation.

DIRECT FINANCIAL ACCOMMODATION

. Financial. needs are allowed to be met by the finance owner in one of the following two ways: the *Qard-Hasan* System (QHS) and the Profit-Loss Sharing System (PLS). Under QHS, a finance owner may provide a loan to someone who needs it. He will have a claim only on the principal amount. He, cannot claim any return on it, small or large, nominal or real, directly or indirectly. The finance owner, in this case, is also obliged to reschedule or. postpone the repayment of the principal amount, if the borrower's conditions are such that he does not have the ability to pay. The postponement is required to be given until he is able to pay.

• If a finance owner intends to benefit from his financial accommodation, then he will have to enter a PLS arrangement with a finance user in the context of a specific productive/commercial enterprise only. The PLS arrangement is not allowed if the financial accommodation is for consumption purpose or for general purpose (in which case the QHS is the only option).

The principle of PLS arrangement is the following. The finances will be provided for a specific project or productive activity. The finance provider and the finance user will agree to share the profit earned from the project according to a pre-agreed ratio. The profit- sharing ratio may be different from the ratio of the investments of the two parties in the project. In case of a loss, both parties will share the loss in the exact proportion of their investment in the project. The loss cannot be shared in a ratio different from that of their investment.

There is no other option for Direct Financial Accommodation.

INDIRECT FINANCIAL ACCOMMODATION

There are and can be several permissible Islamic ways of indirectly providing financial accommodation. Some of these are or have been in practice and others may be discovered or identified in the future. Before explaining some major forms of Indirect Financial Accommodation, let us first clarify the fundamental principle underlying these forms: The underlying principle which will always have to be adhered to in both Direct

Financial Accommodation, and Indirect Financial Accommodation is that there can be no return earned on one's finances without subjecting these finances to bearing some part of the risk associated with the activity in which finances are being used. The only difference between Direct Financial Accommodation and Indirect Financial Accommodation from the point of view of risk bearing (if return is to be earned on financing) is that under Direct Financial Accommodation, risk bearing is in exact proportion to the investment of two parties and is for the entire period of the use of finances, whereas under Indirect Financial Accommodation, the risk bearing can be different from the proportion of the investments. Sometimes it may be possible for the finance provider to substantially reduce his part of the risk bearing (but he is not allowed to totally eliminate it) and it may also be possible to substantially reduce the period of risk bearing (though he cannot reduce it totally).

Let us briefly describe some major forms of Indirect Financial Accommodation. These forms can be described' under three major categories, namely:

(i) Trading-based modes,
(ii) Leasing-based modes, and
(iii) Service-based modes.

TRADING-BASED MODES

There are two major forms of trading based modes: the Deferred Payment Form and the Deferred Delivery Form. To understand this concept, let us call the party needing the finance, A, and the party providing the finance, B.

Under the Deferred Payment Form, the permissible financing would be as below:

A needs financing to purchase certain goods. B is not interested in a PLS arrangement. B can offer to purchase the goods needed by A from the market. A will then repurchase them from B at a predetermined profit (mark-up on cost plus basis), and B will agree to receive the payment at some pre-agreed date. In this way, the financing needs of A have been met and B also ends up making a profit on his financing. The risk that B is bearing is that during the period he is marketing the goods for A and all the goods are delivered to A, the entire loss will be his. Furthermore, it is also possible that after B has made all the purchases for A, A may change his mind or may not like. the goods marketed by B and, hence, B will end up with the responsibility of disposing of the goods purchased by him. This risk can, however, be further reduced if B appoints A, himself, as his (B's) agent to purchase the needed goods. In this case, of course, A will purchase the goods that he needs and the risk of rejection of goods is, thus, removed. The risk of loss or damage of these goods, however, will remain with B until A finally makes a contract to re-purchase them from B. Until A makes this contract, A also has the option to change his mind. Hence, some risk will still be there. Any attempt to eliminate the entire risk, for example, binding A to repurchase the goods from the beginning of entering into the deal will be against the spirit and fundamental principle of financial accommodation in Islam.

Under the Deferred Delivery Scheme, A approaches B to provide finances and B agrees to do so only by purchasing at a specific predetermined price certain specific goods that B will produce and/or deliver at specific date in the future. A's financing needs are met and B, expects to earn a profit, because he contracted the price with some expected margin of profit. The risk bearing for B in this case is that he may not be able to realize the expected margin of profit that he had in mind while agreeing upon the price of the goods. The actual price at the time of the delivery of goods may turn out to be lower than what B paid in advance. Also B, after delivery of the goods, has to store and market them and in this process he bears several risks.

LEASING-BASED FINANCING

Leasing in itself is an alternative to financing. A needs equipment or real estate, but he does not have financing to purchase it. B uses his finances to purchase the equipment and leases it to A and charges rent on it. The needs of A are met. B makes a profit out of the rent.

It may seem that B is earning a fixed income without bearing any risk and, hence, that this is similar to interest. However, it should be noted that rent does not reflect a return on finance, at least in an Islamic sense. Under Islamic arrangements, B will be bearing the following risks while leasing the equipment to A:

(i) During the entire lease period, the maintenance of the leased item remains the responsibility of B. The total cost of maintenance during the entire life of the item will always be uncertain.

(ii) The leased item may be damaged or go out of order (due to no fault of the lessee) before repaying the total investment made on it and without realizing any return. Even if insured, the uncertainty of the working life of an item will make the gains from insurance uncertain. Under Islamic arrangements, passing on the insurance cost to the lessee will be against the principles of Islam. Finance leasing is, also, not permissible in Islam.

(iii) The lessor is not certain if the item will remain on lease at the expected rent long enough to repay him the investment and a certain return on it.

All of this keeps the profit of the lessor on his investment on the leased item uncertain until the item completes its working life.

Leasing, however, is not financing and is only an alternative to financing.

As mentioned above, leasing only met for A the need for using the equipment or real estate. But if A wanted to own the equipment or real estate and needed financing for this purpose, then leasing did not meet the financing need.

We have leasing-based financing modes which are modes of Indirect Financial Accommodation to meet financing needs in Islamic ways. The leasing-based modes work in the following way. A approaches B to finance a certain purchase. If the purchase is of a rentable good, then he may prefer to use the leasing-based mode. B makes the needed purchase and hands it over to A on lease. B also agrees to receive (in addition to rent) the payment of the price of the equipment, etc. in installments. As the installments of the price are paid, the rent of the equipment also declines proportionately. When all installments are paid, the rent to be received by B becomes zero, and the equipment is thereafter owned by A. The financing needs of A has been met as he ends up owning the equipment due to the financing from B. Also, B ends up receiving his investment, along with some return on it, in the form of the rent that he has received during the period.

SERVICE-BASED FINANCING

A is a skillful person and he can earn substantial income from his skill by producing certain goods. But he needs financing to purchase raw materials. The trade-based mode which allows for Deferred Payment is not suitable, because A is not a trader and does not know how to market his goods. The service- based financing mode can help meet financing needs of such a person. B offers A all the necessary materials to produce a certain amount of goods for B, and B offers to pay A on the basis of the completed output. A's financing needs have been met (and he is also relieved of marketing problems). B expects to make a profit by selling the goods, produced by A, in the market with some margin of profit. In a strict sense, this may not be called financing, but since it relieves the needy from seeking the financing to meet his needs, it can at least be treated as quasi-financing.

NOTES

1. The topic was specifically discussed in the Second International Conference on Islamic Economics held in Islamabad in 1986 and also in the Seminar on the Development of Financial Instruments held in Kuala Lumpur in the same year. Some writings that touch upon the subject include; M. A. Mannan [22], M. N. Siddiqi [25] and M. Fahim Khan [18].
2. For further discussion of this phenomenon, see Henry Bruton [6, 5] and Fahim Khan [17].
3. For further discussion of this point, see: M. P. Todaro [27].
4. See: H. J. Bruton [5] p.54.
5. See: David Morawetz [23].
6. See: Todaro [27] pp. 314-315.
7. See S. U. Sethuraman, *The Urban Informal Sector in Developing Countries,* ILO, Geneva, 1981.
8. For more discussion, see: Todaro [27] pp. 251-253.
9. Mannan, in Ariff and Mannan [32] referred to such instruments as Human Capital Certificates. Although the concept, as presented by Mannan, involves some *Shari'ah* reservations, it does point to an area for consideration and research. Further details on this can be seen in the proceedings of the Seminar on "Developing a System of Financial Instruments" held in Kuala Lumpur in 1986, edited by M. Ariff and M. A. Mannan and published by IRTI (see p.97).

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