MARKETS AND THE ROLE OF GOVERNMENT IN AN ECONOMY FROM ISLAMIC PERSPECTIVE

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Abstract

This paper explains the notion of market in historical perspective and the role markets play in free enterprise economies. It lists the major market failures and the role governments are expected to play in regulating and supplementing markets including the promotion of CSR from Islamic perspective. The discussion is limited to product and factor markets.

Key words: Market; Invisible hand; Market failures; Islam and markets; Role of government; CSR

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1. INTRODUCTION

The concept of market has been in existence since the dawn of human civilization. In common parlance it was and remains associated with a place or location where goods and services were freely exchanged. The location usually referred to an open space earmarked for traders to set up stalls and buyers flocked there to browse the merchandise for purchase. The marketplace had no permanent structures of any sort; any site there could be occupied on a first come first occupy basis. Countless markets of this sort still operate in many countries of Asia and Africa, more so in rural areas. Many of them spring to life on specified week days. They often trade in a single type of commodity: grains like wheat, vegetables, fruits, food or cattle, to name a few.

With the passage of time, it was felt that there was need to supervise and regulate trading practices in local markets. Traditions developed and established the first rules of the game, but societal control did not take much time to emerge; market committees composed of influential people in thearea laid down the regulations and supervised their observance in practice. The regulations in the first instance related mainly to the standardization of weights and measures and their correct use. Market charges and fees for stalls and display, resting places, drinking water and provision of other facilities came next. With the growth of population, spread of education, progress in science and technology, advancement of inventions and innovations, rapid expansion of means of transportation and communication and the rise of corporate form of enterprise, market concepts, volume and variety of goods traded as also the need for and modes of regulation underwent a sea change. Legal frameworks developed and Acts proliferated.

With the rise of economics as a discipline, the term market no longer remained restricted to a location or place. Instead, market is seen as a social institution that allows exchange of any goods, services and information between buyers and sellers who are in such communication with one another that the price instantly tends to equality throughout an area, local, regional or international. Hhuman interaction in markets formalizes the transference of *ownership rights* in goods and services.

For commodities like gold and currencies that combined high value with small bulk the markets tended to be vast. However, such distinction for goods to command wide, even international, markets has fast been eroded with increasing improvements in transportation, communication, cold storage facilities, and payment systems. Today thousands of commodities including grains, fruits, vegetables, fish, machinery, aircrafts, arms, crude, coal and the like have international markets. However, most of the markets that we speak of are national or local in character. And these can broadly be divided into those dealing in real goods and services and those that facilitate trade in currencies or monetary instruments like stocks, bonds, bills and derivatives.

We shall exclude financial markets from discussion for a variety of reasons, the main ones being that transactions involving *gharar* (indeterminacy) and the use of interest lie outside the ambit of Islam and raise many ticklish issues which we cannot cover here because of time and space constraints. Suffice to find Greenspan admit that “the use of exotic financial instruments called derivatives had gotten out of control and had added to the havoc of today’s crisis”. [International Herald Tribune 25 October 2008]

Islam allows private ownership of property including the means of production and grants freedom of enterprise. It is neither opposed to competitive effort nor is averse to the free operation of the market forces. It only wants to see markets operate for promoting social good in conformity with the Shari'ah norms. An early proof that markets are prone to deviate from the right path was the establishment of a market for Muslims at Medina as the Prophet (SAW) did not consider fair and equitable the practices prevalent in a Jewish market already in existence.

We start in the following Section 2 with a brief evaluation of the merits of markets and their failures from a societal viewpoint. Section 3 deals with the Islamic approach to business and the norms markets are required to meet in an economy. In section 4 we consider the role of government in an Islamic system including the regulation of markets. Finally, Section 5 contains a few concluding remarks.

2. MARKET AND SOCIETY

Markets facilitate trade and make smooth the distribution of goods and services in a society. They indicate the evaluation of any tradable item in money terms known as its price. Free markets are considered necessary for having civil society and political freedom. In free markets decision-making moves upwards from the grass roots; consumers convey information to producers through prices signals leading to efficient allocation of scarce resources and at minimal social cost: profits are only *normal* and, therefore, legitimate. The fruits of productive effort are claimed as equitably distributed; each factor of production gets what it contributes to total output. All forms of state intervention like taxes, tariffs and subsidies are believed to create costly distortions: they tempt people for wastage and misuse of scarce producing goods society may not value as much as those produced without such restrictions. The *invisible hand* of self-interest is believed to be the best regulator of markets keeping individual and social interests in harmony.

Most of the virtues claimed for free markets including those mentioned above rest on the assumption that competition is and remains perfect. In brief, the model assumes homogenous product, the number of buyers and sellers so large that none of them can influence the market by his own individual action, factors of production are instantly mobile between alternative uses and each one has perfect knowledge of the market. Resting on such heroic assumptions, perfect competition could be no more than a heuristic notion. Even if one could magically put the model into operation, it must in the first place kill all romance of enterprise: perfect knowledge must eliminate risk and uncertainty, making innovation insignificant. More than that, perfect competition must tend to destroy itself because if firms could sell at market price without any limit, some of them would sooner than later acquire monopoly power making competition imperfect.

Firms operate as a go-between two sets of prices: one at which they buy their inputs and the other at which they sell their output. The gap between the two is seen as a legitimate gain (profit) accruing exclusively to their owners. Should firms not have the temptation to tear the two price sets as far apart as possible to maximize profit for the owners? It is in the logic of things that firms must attack competition the force of discipline allowing only normal profit which is just enough to keep their heads above water. They take action to mitigate competition to acquire pricing power and attempt to block trade gains from flowing to rivals. Brand names, trademarks and advertising are weapons they use to kill competition. The effort gives rise to various forms of imperfections including the emergence of monopolies, cartels and monopsonies. Indeed, we have been left in markets only with as much of competition as the firms have not been able to annihilate.

Major Failures

In the absence of perfect competition markets fail on a number of fronts. The pursuit of self-interest often drives a wedge between the individual and social interest; it causes market failures on many fronts. Indeed, there is no dearth of literature in mainstream economics itself expressing dismay on the performance of free markets and on enumerating their weaknesses. From these we refer here to those especially relevant for the present work. Most of the writings on Islamic economics dealing with the subject also refer to them.

- Market produces and distributes goods and services not in accordance with the hierarchy of human needs but proportionate to the purchasing power individuals command. The distribution of income and wealth being much unequal within and among nations there is insufficient production of goods to meet for all the basic necessities of life – food, clothing and shelter - for the poor masses while luxury for the much smaller clusters of the rich are made in abundance. In other words, allocation of resources is distorted. The economic notion of the efficiency requires a relook.

- The celebrated marginal productivity theory does not distribute incomes according to the contribution each factor makes to total output even if competition in the factor market were perfect. For, the demonstration that a factor is paid equal to the value of its marginal product to revenue does not by itself prove that marginal product *determines* that payment because it is not the contribution of a factor to output but its scarcity relative to other factors that determines both its marginal product and reward. Remember also Marshall's dictum that marginal uses and marginal costs do not determine value but are themselves determined together with value by the general forces of demand and supply.

- Markets provide only *private* goods. Such a good has two distinct characteristics: First, if a unit of it is purchased by A, the *same* unit cannot be purchased by B. This we call the principle of *exclusion.* Second, if C is using a commodity, D cannot use it simultaneously; For example, if I am eating an apple you cannot eat it too. This we call the principle of *rivalry* However, many goods do not have the characteristics of exclusion or rivalry but society may need them. Non-excludability and non-rivalry may cause problems for the production of such goods. It is argued that they may lead to instances of market failures, as self-interest, the driving force of the system, may not allow their production in desired quantities. Such goods are provided by the government and are called public goods, provision of civil administration or defense is the leading examples.

- Market includes in production costs only the payments made for goods and services in which law recognizes the property rights of individuals or institutions. Many natural resources like fresh air, water, forests and atmosphere that remain free gifts of nature are also used in the production process for releasing or depositing wastes that are injurious to all forms of life. Their ever increasing volume has long crossed the absorption and self cleansing capacity of natural agents and environmental damage has brought the planet Earth to the brink of disaster. Environmental goods possess also the properties of non-exclusion and non-rivalry but cannot mostly be treated as public goods. The balance and proportions God had created in the natural phenomena (Qur'an refers to such balance and proportions time and again) man has tampered with impunity only to face disaster. It is now widely recognized that environmental goods must pass through the market so that the payment for their use becomes part of production costs. This implies an extension of the concept of scarcity But how to do so remains a question without workable answer.

3. ISLAMIC NORMS

Islam places legitimate business, in its widest sense, among the most beneficial and the noblest of vocation for earning a living and acquiring of wealth. Markets and their performance have always been a focal point in Islamic writings. For instance, in his letter appointing al-Ashtar as the governor of Egypt Caliph Hazrat Ali wrote:

> *...And all of these (soldiers, taxpayers, judges, administrators and secretaries) have no support but the merchants and the craftsmen through the goods which they bring together and the markets which they set up. These provide for the needs of (these) classes by acquiring with their own hands goods to which the resources of do not attain ... then make merchants and craftsmen your own concern and urge others to do so, for they are the basis of benefits and the means of attaining convenience.*
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> Tabatabai (1982, 10. 14)

Business in Islamic system has added esteem for two reasons. First, Islam sees business as *fard Kafaya* i.e. a duty whose performance is obligatory on all Muslims in general but when performed by some of them absolves others from their responsibility in the matter. The requirements of the community as for the soldiers, doctors, teachers, jurists, and administrators are some of the examples of this category of obligations. The application of the principle to business implies the achieving of a self-reliant economy. Thus, those joining business fulfill a religious obligation in a significant and risky sector.

Second, Islam accords respect only to *honest* traders; for there is presumably the greatest temptation to ignore demands of honesty for increased earnings in business. The Qur'an refers time and again to greed and love for worldly gains among the weaknesses of humans. Thus, Ghazali pertinently remarks:

> *Profit cannot but be fair if business follows the (religious) instructions. But the trouble is that people do not remain content with relatively small (profit) and they cannot earn more without violating the injunctions.*
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> (Ghazali 1955; 92)

The mundane being in man tends to overpower his moral self, more so in business than elsewhere.

The moral code of Islam for market behavior focuses mainly on protecting the consumer. Modern economies are of course not oblivious to consumer protection, but there are significant differences in approach and attitude. Broadly speaking, moral conduct of Islamic vintage is part of developing *human personality*; piety has to grow *within* believers, rather than enforced from outside. In fact, moral norms are no part of mainstream economic theory. However, if Islamic norms of behavior are not imbibed by the believers, their markets would rarely have features productive of distinctive results. The main elements of an Islamic market conduct are as under.

1. Islam imposes a number of obligations on the sellers with regard to measurements, quality of goods, their prices and provision of information to the buyer. (Ghazali 1955, 75). Scales are the symbol of justice (Qur'an 27:25). The traders are required to keep standard weights and measures, and use them scrupulously. It is better to error on the side of giving more while selling and prefer to accept a little less when purchasing to avoid harming the other party, even unknowingly. Ghazali (1955; 93). derived this rule presumably from the verses of the scripture: *Woe to those who deal in fraud, those who when they have to receive by measure from me take full measure but when they have to give by measure or weight to men give less than that* (Qur'an, 83: 1-3). Goods sold must conform to declared quality or description; they must be suitable for meeting the purpose stated by the buyer if he relies on the seller in that matter.

2. The price a seller charges for a commodity should not be more than what rules the market Ghazali (1955, 94-95). The Shari'ah condemns any attempt at raising prices by creating artificial scarcities e.g. through hoarding or cornering the supplies. If mark ups were to be used, the addition over costs, some jurists hold, should be within one-third of spot price. Others prefer to leave the margin to the sellers' discretion presumably because compulsion may not always be the best course to make sellers charge reasonable prices. It is better, they feel, to invoke in traders an urge for compassion.

3. As a distinct departure from the mainstream, Islam insists that not only should the seller desist from undue praise of his wares, he is under obligation to reveal to the prospective buyer defects, latent or patent, if any, in the goods offered for sale. From Ghazali's explanation (1955, 82, 90) of this norm, two implications of major import follow in my opinion.

First, the provision requires the producers to implement strict quality control norms for their products and urges the sellers to accept from the suppliers only such of the goods as are free from defects. Despite adequate care, if any of them – manufacturer or distributor – fails his responsibility, he alone must bear the consequences in the form of, say, reduced price or even loss.

Second, the provision sets some norms for 'sales management' which today tends to become over glamorous, diversionary, wasteful of resources, manipulative of consumer preferences, aggressive and even deceitful (Hasan 1975, 87-93). The Islamic norm seeks to keep the sales management sublime, purposeful, informative and socially beneficial.

4 ROLE OF STATE

As the assumption of harmony between the individual and social interest is unreal, markets tend, as we noted, to falter and fail society on many fronts. And, the evidence that markets can fail to ensure efficient and equitable outcomes is a common justification advanced for government intervention in free markets Economists use models and theorems to analyze the causes of market failures, and possible means to correct them as and when they occur. Such analyses play an important role in many types of public policy decisions. However, some types of government policy interventions, such as taxes, subsidies, takeovers, bailouts, wage and price controls including regulations to correct market failure may also lead to inefficiencies in the allocation of resources or in distribution of incomes. Thus, it is argued that there is often a choice between imperfect outcomes, i.e. imperfect market outcomes and imperfect government outcomes. Islamic economics can use mainstream analyses concerning market failure and remedial action with advantage albeit on a selective basis and with modification, if needed. However, Islam departs from mainstream positions in a crucial way on many issues, there is, therefore, need to have a broader look at the role of government.

In principle, Islam stands for free markets requiring the government to merely oversee if the tenets of the Shari'ah are being observed in letter and spirit. A leading Islamic jurist writes:

> *If people are selling their goods according to commonly accepted manner without any injustice on their part and the price rises due to the decrease of the commodity (qillat-al-shay) or due to increase in population(kathrat-al-khalq) then this is due to Allah[no intervention is required].*

Ibn Taymiyyah 1976, 24 (parenthesis content is interpretive, non- textual)

Similar opinions are expressed in the writings of Abu Yusuf, and Ibn Khaldun (Islahi, 1992, 161-162). However, non-intervention in the market in case the fluctuations in the demand and supply of a commodity are the result of natural factors is a tiny, though important, part of the story. *If we assume that an Islamic economy is in operation*, the involvement of the government in the market would not be occasional or temporary. The fuller picture of an Islamic system shows the government co-existing in the market with the private sector on a permanent and stable basis. It can be seen as a planner, supervisor, producer and consumer (Kahf, 1992, 150-152). What follows is based on this sort of perception but much of it, if not all, may be found relevant to mainstream economics as well.

Some economists reject as irrelevant to Islamic economics the notion of an *invisible hand* i.e. self-interest guiding the market in performing the resource allocation and income distribution functions. I venture the opinion that such rejection is ill-conceived. Self-love and desire to improve one's lot in humans is imbedded by creation albeit counted among their weaknesses. Pursuit of self-interest may lead to undesirable consequences which could call for pre-emptive or corrective action. But rejection of self-interest as a regulatory tool will only lead us to rely on central planning with a minimal role for private property and freedom of enterprise so dear to Islam. Market operations in the system would become meaningless. Need we throw away the baby with the bath water?

In an Islamic system, one may look at the role of government with reference to (i) performance of markets (ii) provision for public goods and (iii) environmental care. We have listed above some of the main limitations of the market. In Islam freedom of the market is desirable but is not a sacred cow. The government may take action to modify or supplement the market results. Market distributes goods according to income size of individuals. As income distributions are much skewed in favor of the rich, even the basic needs of the poor go unsatisfied. Public policy may help divert resources to the production of such goods, especially provision of food, clothing and shelter, through appropriate policies.

There is no blanket rejection of monopolistic structures in Islam; what is unmistakably condemned are the hoarding of goods, especially food stuffs, and the cornering of supplies. Monopolies of the sort we have today in production never existed in the early era of Islam. Let one not stretch Shari'ah to see concepts that were no part of it. In any case, big size per se is no threat to public good. In the production of many goods the minimal cost effective size of A plant may sometimes be even larger than needed to fully meet the local demand. Also, bigger corporate size is at times a better shock absorber. Thus, if there is no threat to public good discretion might favor a monopolistic structure.

Banks may be directed to devote a proportion of credit to flow into priority uses. Fixation of minimum wages and promotion of profit sharing schemes may ameliorate the condition of workers. Governmental intervention in resource allocation and enforcement of standards may help in pollution reduction.

Planning may divert funds for development of areas that private enterprise may leave unattended. Public sector may provide merit goods like education and health care for the masses in addition to utilities like water, electricity, transportation and communication.

4. CONCLUSION

We have explained above the role markets play in an economy including Islamic. Markets have many weaknesses and fail the society on many fronts. Still, they are great social institutions of value and benefit since times immemorial. Preventive and corrective measures may mitigate their failures and increase their advantages. Islamic view of markets requires their regulation based on its ethical norms focusing on consumer protection. Public intervention in market operations for keeping them on the *right path* is an Islamic imperative.

Apart from regulating market Islam assigns government to look after societal interest through provision of merit goods, fulfillment of basic needs, caring of the environment, improving income distribution and mitigating poverty.

An essential Islamic requirement in the context of market performance is to make business, especially large sized corporations and banks, realize their social responsibilities. In fact corporate social responsibility (CSR) is fast emerging an important subject for study and research in mainstream economics. Islamic system need to pay even more attention to this issue.

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