Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Finance: Examining the Overpowering of *Homoislamicus* by *Homoeconomicus*

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INTRODUCTION

Recent developments in Islamic finance have surprised everyone involved in the financial industry even the people working in the Islamic financial sector. This vindicates the aspirations of many Muslims all over the world, in particular the founding fathers of Islamic economics. A critical approach to the development of Islamic finance, however, indicates a very pragmatist development. In its current state, Islamic finance does not seem to share the foundational claims of Islamic economics, despite the fact that the founding fathers of Islamic economics, in a modern sense, aimed at creating an Islamic economic system with Islamic finance being the operational aspect of that system. While developments in the discourse of Islamic economics have been weak, the emerging wealth in the Muslim world, particularly in the Gulf region, forced Islamic finance to develop beyond the framework of Islamic economics.

Since Islamic economic theory has not provided the operational axioms through which Islamic finance can work, with a pragmatist attitude Islamic finance has implicitly adopted neo-classical assumptions. In other words, Islamic finance could be justified in its position of following the neo-classical paradigm in its effort of managing wealth, as Islamic economics has not provided the foundation upon which an ethical financial system, as aspired by Islamic economics could have been built. The eclectic nature of Islamic finance can be observed in its methodological framework as, due to its neo-classical nature, it does not take into account the social welfare function suggested by Islamic economics, in which not only individual self-maximisation and efficiency but importantly the maximisation of social well-being is necessary.

Thus, Islamic finance does not support nor is it supported by the normative assumptions of Islamic economics. Consequently, such a pragmatic approach adopted by Islamic finance plays an important role in the internationalisation of 'capitalist' desires into Islamic finance, which have been attempted to be tamed in the western world with the emergence of social responsibility, and ethical finance and business. In this simplistic notion of Islamic finance, the entire effort is given to the removal of *riba* and conducting financial activity in given contractual norms which are derived from the *Shari'ah*. However, normative consequences and importantly sources of this working mechanism are not questioned. The result, therefore, has been the divergence between the assumptions, normative principles and aspirations of Islamic economics as a system and Islamic finance as an instrument of that system. Rather than being part of the Islamic political economy, Islamic finance has been developing its own course away from the systematic understanding by finding a surrogate financial framework in neo-classical economics. This trend has disturbed the founding fathers of modern Islamic economics too, as they asked the question: 'where has Islamic finance went wrong?' Thus, "a distinctive feature of the recent discussions on Islamic banking has been the growing wedge between its conventional theory and current practice" (Hasan, 2005: 11).

Thus, this paper, aims to highlight the tension areas between Islamic economics and Islamic finance by particularly making reference to its participants namely *homoislamicus* and *homoeconomicus*, and to its institutions including the political economy of their construct in terms of normative and positive principles, and outcomes of both paradigms. The paper, therefore, pursues discourse analysis as a methodology, through which it aims to highlight how each of these two paradigms are being constructed. In other words, a political economy approach and discourse analysis is adopted to locate the divergent trends and paradigms Islamic economics and Islamic finance have developed separate from each other. Consequently, failure in developing an ethical financial system and hence developing ethical norms away from legal interpretations of the *Shari'ah* is to be discussed.

This paper suggests that Islamic economics has a great potential to create an ethical Islamic financial system in which ethicality is not relegated only to the elimination of *riba*. This, however, requires a real effort in creating and perpetuating a political economy approach or systemic paradigm for such an end. Therefore, this paper argues that the next step in the evolution of Islamic banking should be Islamic social banking in accordance of global developments and reviving the initial and authentic experience of Islamic banking.

ISLAMIC ECONOMICS: UTOPIA

Islamic economics in its modern sense came into existence in early 1970s mainly as a critique of the capitalist economy in relation to economic development. Therefore, in the opinion of the founding fathers, the failure of economic development was attributed to capitalist economic development strategies, which ignored the importance of human being and its well-being. Their objective was therefore to develop an economic system understanding, which could develop a human-centric development strategy.

While Kahf (2003) among others suggest that Islamic economics cannot be considered outside the main discipline of economics, the Islamic economics paradigm generally aimed at the creation of the Islamic paradigm of economics with its own values, rules and institutions with the politically oriented systemic understanding. The foundational axioms, conceptualisation and assumptions of this paradigm, then, operationalised the aspirations of Islamic economists in aiming at the creation of human-centric economics. In other words, Naqvi (1994), Ghazali (1990) and Ariff (1983) developed an axiomatic approach to justify the Islamic economic strategy by treating Islamic ethos as an ideal through which social and economic policies dealing with poverty reduction are assessed. These axioms are:

Tawhid (unity), which as an axiom indicates the vertical dimension of the Islamic ethical system;

Al-'adl wa'l-ihsan (equilibrium): This axiom provides for the horizontal dimension of equity;

Ikhtiyar (free-will);

Fard (responsibility), which implies that individuals and society need to conserve the public good;

Rububiyyah implies divine arrangements for nourishment, sustenance and directing things towards their perfection;

Tazkiyah, which implies growth with purification, which should endogenise the good of the others and has to be conducted with ethical and moral considerations;

Khilafah, which indicates individual's role as God's vicegerent on earth.

Maqasid-al Shariah, which as the last axiom, aims to interpret the text and in restoring the principles of Islamic economics in relation to the objectives of the *Shari'ah*. This further is interpreted in a way that Islamic economic principles must lead to 'human well-being'.

These axioms define the economic framework for economic activity to take place within intra-and intergenerational social justice, which reveal themselves in the methodological framework of the Islamic economic system. In comparing methodology of Islamic economics and conventional economics, these can be seen in a more unambiguous manner. To see this, first the methodological framework of the neo-classical economics is summarised as follows:

(i) The point of departure is *methodological individualism*.

(ii) Behavioural postulate: *self-interest oriented individuals* who (a) seek their own interests, (b) in a rational way, and (c) try to maximise his/her own utility;

(iii) *Market exchange*.

Hence, conventional economic system is based on a *one dimensional utility function*, which leads to *homoeconomicus* or the economic individual in a market system. The methodological postulates of Islamic economics, on the other hand, can be summarised as follows:

(i) *Sociotropic individual*, not only individualism but social concern is a prerequisite;

(ii) Behavioural postulates: socially concerned God-conscious individuals who (a) in seeking their interests is concerned with the social good, (b) conducting economic activity in a rational way in accordance with the Islamic constraints regarding social environment and hereafter; and (c) in trying to maximise his/her utility seeks to maximise social welfare as well by taking into account the hereafter as well.

(iii) *Market exchange* is the main feature of economic operations of the Islamic system; however, this system is filtered through an Islamic process to produce a socially concerned environmentally friendly system. In this process, socialist and welfare state oriented frameworks are avoided not to curb incentives in the economy.

Hence, the *two-dimensional utility function* (present and the hereafter), which leads to *homoIslamicus*, or as Arif (1989: 92-94) names '*tab'ay*' (obedient) human-being. "To be a Muslim is a necessary but not a sufficient condition to be a *tab'ay*" (Arif, 1989: 91). As to be qualified as a *tab'ay*, one needs to operationalise Islamic principles in every aspects of her/his life.

The discussion indicates that Islamic economics aimed at a world order, where the ontological and epistemological sources namely the *Qur'an* and *hadith* determine the framework of the economic value system, the operational dimension of the economy and also the behavioural norms of the individual Muslims. Islamic economics, thus, is an "approach to, and process of, interpreting and solving the economic problems of human beings based on the values, norms, laws and institutions found in, and derived from the sources of Islam".

This, however, implies a systemic understanding and a political dimension. Recalling that modern Islamic economics emerged as part of the Islamic movements in 1970s, which had political visions and aspirations with identity politics, it is very normal that Islamic economics was perceived to be a complementary part of this political project. However, since in Foucaltian philosophy, power is central to the definition of social and political meanings, actualisation and knowledge, Muslim not having such global power were deprived of establishing their political and, hence, economic order.

This has consequences for Islamic finance, which is the operational tool of Islamic economics, since Islamic finance is the institutional aspect of Islamic economics, as to finance the economic activity in an Islamic framework, thus there is a need to have institutions using instruments according to rules and regulations, which are all bound by the *Shari'ah*. Islamic finance, hence, refers to these institutions, which in the aspirational sense aims to operationalise and fulfil the economic systems of Islam. Since the systemic understanding of Islamic economics could not be achieved, Islamic finance has developed its own working framework in a very pragmatist manner, as it has ended up being located within the neo-classical paradigm.

FROM UTOPIA TO REALITY: ISLAMIC FINANCE AS A HYBRID FINANCIAL SYSTEM

As mentioned previously, it was expected that the creation of Islamic banks would provide the capital base through which economic development can be achieved in the Muslim countries, as capitalist and socialist developments failed in those countries.

In its alternative system understanding, thus, Islamic finance and banking, was assigned an important role: economic development with the objective of human well-being and social justice. The initial experience of Islamic finance and banking in Egypt and Malaysia had such objectives, as they were socially oriented institutions.

However, since 1980 Islamic finance internationalised, in which the petro-dollar played an important role. In particular since the 1990s an unprecedented development has taken place in the number of Islamic financial institutions, and their assets bases. The close scrutiny of their financing, however, indicates that the social dimension is limited with their *zakah* and other charitable activities, which does not imply any systematic economic development and social justice action. While the operations of Islamic finance and the nature of Islamic modes of financing have expanded, the lives of Muslim individuals have not been touched upon by this enormous growth.

Indeed, it can be seen that Islamic banks and financial institutions have opted profitable Islamic financing such as *murabahah* instead of *musharakah* for instance. This is important as this indicates that difference in the orientation of Islamic finance. While *musharakah* is equity finance oriented, *murabahah* is debt financing. Taking into account that Islamic economics aims that Islamic finance should be equity financing towards a particular value-added creating economic activity, the change in the directions of Islamic finance is rather meaningful. To evidence this, Iqbal and Molyneux (2005: 29) demonstrate that out of ten sample Islamic banks, while the percentage weight of *musharakah* and *mudarabah* in the total activities of this sample for the period of 1994-1996 was only 7% each, *murabahah* claimed 70% of the total financing. Therefore, Aggarwal and Yousef (2000: 94) according to their evidence that "most of the financing provided by Islamic banks does not conform to the principle of profit-and-loss sharing. Instead, much of the financing provided by Islamic banks takes the form of debt-like instruments". In addition, Hasan (2005: 19) provides more recent data for the Malaysian case, according to which while the percentage share of *musharakah* declined from 1.4% in 2000 to 0.5% in 2003, it seems that the major Islamic financing modes are in the form of *bay bi thaman al-ajil* and *ijarah thumma al-bay* with 47.4% and 27.9% respectively in 2003. Considering that equity or profit sharing financing is considered superior to debt like financial instruments by Islamic economics and finance thinking, due to risk sharing properties as well as creating more value added in the economy by expanding business and ownership base in the society, having IBFs involving more debt-like financing is an indication that IBFs have deviated from the aspirational stand of Islamic economics.

Considering also that Islamic economics aims at economic development this can only be achieved with long-term financing. However, evidence provided by Aggarwal and Yousef (2000) as well as Iqbal and Molyneux (2005) shows that "Islamic banks rarely offer long-term financing to entrepreneurs seeking capital" (Aggarwal and Yousef, 2000: 94). In addition, developmentalist financing with the objective of economic growth necessitates financing sectors such as agriculture, industry, and manufacturing. However, "the majority of Islamic banks' financial transactions at least initially were directed away from agriculture and industry and toward retail or trade financing" (Aggarwal and Yousef, 2000: 94). Their calculation is based on twenty-two Islamic banks from various countries, which reveals that "on average, 56.7 percent of financing by nominal value were for maturities lasting less than a year. Medium-term (one to two years) and long-term (two to five years) financing averaged 0.7 percent and 1.9 percent, respectively” (Aggarwal and Yousef, 2000: 103). Such evidence can also be found in Ahmed (2005), who evidenced that in the case of the Sudan, after initial years, Islamic banks moved away from financing agriculture and industry using profit-loss sharing schemes due to various reasons including moral hazard or imperfect information related issues. Furthermore, Warde (2000: 175) also states that “not only were Islamic banks less likely to invest in industry or agriculture, but they were more likely to invest their money abroad and to keep it foreign country”. Thus, the value added of IBFs to the local economy further declines in such cases.

Since debt-financing is short-term oriented but equity financing can be for longer term, equity financing contributes to economic development. However, avoidance of Islamic finance from equity financing clearly indicates that IBFs are not particularly interested in economic development and social welfare. It should also be noted that such concerns were raised by Choudhury (2001) who even criticises *musharakah* and *mudharabah* type equity financing due to their failure in internalising socio-economic justice and the value of work, and consequently introduces a new venture capital mode of financing with the aim to “transform these financial instruments to realise the ameliorative goals of *shari’ah*, extensively cooperative participation must be explicitly introduced. Such rules must reflect the organisational and management processes involved in such extensively co-operative and co-ordinated participatory enterprises” (Choudhury, 2001: 21). In addition, Warde (2000: 175) is also concerned with the utopia and realities of Islamic economics and finance, and therefore states that “the gap between promise [Islamic economics] and performance [Islamic finance] was greatest in the area of economic development. Despite their support and special privileges … obtained by Islamic banks, they behaved like risk-averse agents. The early goal of concentrating on profit-an-loss sharing was soon abandoned. The objective of penetrating the hinterland and serving the rural areas was not fulfilled” (Warde, 2000: 175).

In relation to social lending, the percentage of *qard-al-hassan* is at an ignorable level in IBFs (Aggarwal and Yousef, 2000). In addition, further involvement of IBFs in debt-like financing including *tawarruq* issues clearly undermines the productive economic activity discourse of Islamic economics. The realities of financial markets which prioritise economic incentives rather than religious behavioural norms, thus, has forced the Islamic finance to become part of the international financial system, in which it is recognised as heterogenoisation of financial products deprived of their value system imposed by utopian Islamic economics. In other words, in real life since the 1990s, Islamic finance represents hybrid financial products of the international financial system, in which it is accepted that this particular hybridisation requires religious construction rather than secular. Thus, the difference has been reduced to technicality, and the value system is no longer mentioned beyond describing the prohibition of *riba* in quotation verses from the *Qur’an*.

It is important to understand the reasons of this divergence between Islamic finance and banking and Islamic economics (system). As mentioned Islamic economics aimed at creating a world order with political aspirations. In this identity politics, the Islamic version of the modern institutions and behavioural norms such as the *homoIslamicus* or *tabaa’ya* individual are sought for. However, this is related to systemic aspirations with the value system expressed in identity politics. The realism of this constructivist ideology is tested with the developments which have taken place in Islamic finance, which has given up the value system, identity politics and systemic understanding of Islamic economics and has become part of the international financial system, which has been criticised by Islamic economists for its failure for economic development in the Muslim world and also for being materialistic. In other words, Islamic economics with the conceptualisation of *homoIslamicus* proposed a normative world or the utopia, which states “what people should strive towards, as opposed to how people are likely to behave (the ‘ought’ as opposed to the ‘is’)” (Warde, 2000: 47). Islamic finance, hence, in its deviation from the norms and axioms of Islamic economics followed a realistic attitude based on positivism rather than normativeness; and hence gave up the utopia imposed on or assigned to itself by Islamic economics.

Indeed, this epistemological difference is related to the modern interpretation of the Qur’anic verses and Islamic injunctions. Because, the pragmatist position of Islamic finance as opposed to the foundational and aspirational position of Islamic economics is based on the notion that “the revealed word of God in the Qur’an itself embodies rational economic principles that are quite in line with the modern assumptions of neoclassical economic theory. As a form of universally applicable theory about human beings’ economic behaviour, economic theory necessarily is in accord with and confirms the source of universal knowledge, the *Qur’an*: *homo islamicus* and *homo economicus* are one and the same” (Maurer, 2005: 55-56). Kahf’s argument (2003) in rejecting the systemic understanding of Islamic economics and making reference to the fact that human behaviour is governed with the similar norms provides further evidence for the pragmatist positioning of Islamic finance. Within such an understanding Islamic finance puts emphasise on the interpretations of *Shari’ah* which focuses on rationality and formal equality, in which the ban on *riba* is perceived as a mechanism through which decisions are made within the rational economic framework with the objective of rendering optimality of the market mechanism (Maurer, 2005: 56). On the contrary, Islamic economics’ reading of the same *Shari’ah* rules emphasize social justice, need fulfilment and redistribution, namely a socio-political reading within a political economy framework. The position of Islamic economics, thus, named as *moralist modelling methodology* by Tag El-Din (2004). In sum, Islamic economics suggests a new paradigm, while Islamic finance utilises the same Islamic foundation in locating a place for itself within the existing conventional paradigm, because, as Ahmad states “like any other financial system, Islamic banking has to be viewed as evolving to meet modern requirements” (Ahmad, 2005: 26).

In conclusion, with Islamic finance we are yet again in the beginning of the vicious circle, due to the Islamic banks’ lending criteria, terms and costs of loans, financial exclusion from personal banking remains an issue. Importantly, due to the same reasons entrepreneurs who have been excluded from conventional banking are also excluded from the use of Islamic finance. Thus, the needs of those entrepreneurs who cannot provide collateral is not met in the Islamic financial sector either. The existence and prevalence of such developmentalist issues negates the entire discourse of Islamic economics and finance in relation to social justice or *maslahah.*

TESTING THE ASSIGNED VALUES OF ISLAMIC FINANCE

Practitioners suggest that Islamic finance aims to hold the following values among others (Khan, 2007):

(i) Community banking: Serving communities, not markets;

(ii) Responsible Finance, as it builds systematic checks on financial providers; and restrains consumer indebtedness; ethical investment, and CSR Initiatives;

(iii) Alternative Paradigm in terms of stability from linking financial services to the productive, real economy; and also it provides moral compass for capitalism;

(iv) Fulfils Aspirations in the sense it widens ownership base of society, and offers 'success with authenticity'.

While similar notions can be found in Iqbal and Molyneux (2005: 28-34), it is clear that these are the aspirations of Islamic economics as well. A critical examination of these objectives, however, indicates that in reality Islamic finance is far away from fulfilling these objectives. Regarding the first objective of community banking, the real life experience shows that Islamic finance has not done much to contribute to capacity building in the communities. On the contrary, Islamic banking and finance has aimed at becoming part of the international markets, despite the imposed social identity "Islamic banks are quick to point out that they are not charitable organizations, and that they must turn a profit" (Warde, 2000: 154). This is due to the fact that "in the harsh environment of the global economy, [Islamic] banks must compete with conventional banks that usually focus exclusively on profit maximisation. [As] this allows them to offer better remuneration to their depositors and to their shareholders" (Warde, 2000: 154). However, this as the primary aim rules out their assigned social identity.

Regarding responsible finance, there is not a universally accepted regulatory body, which can systematically check on financial providers. The initiatives by AAOIFI and IFSB remain weak and are not generally accepted. As part of restraining consumer indebtness, the data indicates that IBF institutions prefer to involve themselves in transactions, which are debt financing oriented, as they are more profitable, as discussed previously. Thus, this claim in not fulfilled either.

In relation to ethical investment, restraining the investment areas of Islamic finance does not necessarily makes Islamic finance ethical, but only implies that Islamic finance fulfils the legal expectations as the screening of Islamic investment is part of the *Shari'ah*, which makes Islamic finance active. However, considering that ethicality refers to be pro-active in the case of IBFs, there is not much indication that IBFs are ethical as such. This again refers to CSR initiatives, as recent studies on CSR of IBF demonstrate that they have not pro-actively developed such an understanding and their perceptions of CSR remains within the framework of *zakah* distribution and other non systemic charitable activities (Sarially, 2005).

As an alternative paradigm, Islamic finance is no longer part of the Islamic economics system understanding, and therefore does not have macroeconomic consequences. In addition, claiming that it links financial services to the productive side of the economy is not convincing either taking into account that the most preferred financing is debt financing as opposed to the original expectations that it would be equity financing undermines this claim too. With the *murabahah* type of financial activities being the most popular forms of financing and lesser venture capital type of project financing, it is difficult to state that Islamic finance is related to the real economy beyond financing the retail markets. Furthermore, becoming part of the international financial system through hybridisation, it is difficult to state that Islamic finance plays the role of a moral compass for capitalism. On the contrary, it seems that Islamic finance has much to learn from conventional finance in terms of ethical and CSR financing issues (Sarially, 2005)

As regards to fulfilling aspirations, Islamic finance has not affected the social capacity building, and therefore has not been involved in widening ownership, which could have been possible through venture capital or profit-loss sharing type of investments. However, as discussed previously, these do not seem to be preferred by IBFs. As to the last point, while referring to the Qur'an and locating the principles governing Islamic finance in Qur'an refers to authenticity, consequences of Islamic finance do not show success in the intended meaning of this authenticity or *Shari'ah* as located in the aspirational notions of Islamic economics.

SOCIAL WELFARE FUNCTION AND ISLAMIC FINANCE: RE-EXAMINING *MASLAHAH*

It should be stated that the mentioned social justice and economic development objectives are exogenously created objectives for Islamic finance. This is because; the main epistemological source of social objective is derived from the concept of *maqasid-al Shari'ah* (*objectives of the Shari'ah*). However, a close examination of *maqasid-al Sahriah* will show that it does not indicate anything related to the social dimension or sociotropic individual. The objective of the *Shar'iah* (the Islamic way and code of conduct) are in the words of al-Ghazali (d. 505 AD) are: "The obligation of the *Shari'ah* is to provide the well-being of all human kind, which lies in safeguarding their faith, their human self (*nafs*), their intellect (*'aql*), their progeny (*nasl*) and their wealth (*mal*)". This clearly demonstrates that these are all individual oriented objectives and none of these have social connotations. This implies that making reference to *maqasid-al Shari'ah* and deducing the social dimensions of Islamic economics and then imposing this on Islamic finance is not realistic, and it represents aspirational expectations, which does not have its epistemological sources. In other words, Islamic finance imposed a definition, which is based on aspirational interpretation of *maqasid al-Shari'ah*. Thus, the suggested value system that Islamic finance needs to uphold is not properly defined. Therefore, it is also important to examine the nature of the *maqasid*, because as Siddiqi (2004) pointed out for a systemic and dynamic understanding "*maqasid al-Shari'ah* could not be confined only to protection (*hifz*), preserving what people had or saving them from harm, rather they must include broader measures ensuring welfare [as] asserted by Ibn e Qayyim … who emphasized justice and equity. Furthermore, he insisted that the means to justice and equity could never be captured by a finite list. Reason will guide us how to ensure justice and equity in changing circumstances (Ibn e Qayyim, n.d., vol. 4, pp. 309-311)".

It is crucially important, therefore, to make the distinction "between the objectives of Islam, as a way of life and the objectives of Islamic Law [*maqasid al-Shari'ah*]. The former involves aspects of personality and society the later does not cover. Also, the former has a larger box of tools than available to the latter. Envisioning Islamic economy in twenty-first century is better done with reference to goals of Islam as a way of life rather than being done with reference to the goals of Islamic Law. This will enable us to handle issues like poverty and inequality that a Law-based approach has failed to handle" (Siddiqi, 2004). This point particularly reinforces the earlier statement that Islamic economics has imposed an incomplete frame of reference or an aspirational framework on Islamic finance to fulfil.

Islamic economics, like neoclassical economics suggests an implicit social welfare function, and expects Islamic finance to work towards maximisation of this social welfare function. However, the neoclassical economic theory's suggestion of the existence of an implicit social welfare function has been undermined in particular with the discourse and analysis developed by the new political economy and public choice. The very idea that there is a social welfare function which is, assumed to be, maximised by a benevolent authority is no longer a norm, as each government and institutions are perceived to be consistent of individuals who attempt to maximise their own utility. In other words, the organic state with the social welfare function objective is no longer a reliable maxim.

Initially it could be argued that within the Islamic framework, the existence of the social welfare function and its maximisation by various actors in the society might be possible as religious norms essentialise the 'socio-tropic' individual, as Islam aims to create *homoislamicus* or *taba'aya* individuals. However, recent developments in the evolution of Islamic finance indicate, as contended by Kuran (1983), such norms that have not emerged despite the increasing awareness of Islam all over the world. It is interesting to note that Siddiqi (2004) also acknowledged that "even Islamic economists failed to come up with historical evidence and current empirical data on that kind of behaviour [the acts of caring for others, serving the social interest while protecting one's own, and avoiding doing any harm to man, animal or the physical environment are not a rarity], with some notable exceptions". Therefore, unless, a dictatorial rule takes place which determine the attitudes in public sphere, it seem that the behavioural norms will follow an adaptive attitude in perpetuating neo-classical norms through following adaptive rationality and therefore will remain within the framework of neo-classical economics. Since dictatorial rules even failed to change the behavioural rules in Iran or in Sudan, there is not much chance that this might take place through voluntary action. Although voluntary action cannot be denied as an important source, it still is not enough to maximise a social function, as free rider problem remains to be an important issue.

It is also important to discuss whether Islamic economics suggests the maximisation of the social welfare function. This is because there is no real reference for this within the Islamic political economy framework. The only reference provided is the *maqasid-ul-Sharia*, which is interpreted to provide justification for social justice, social welfare and socio-tropic individual. However, as suggested by Siddiqi (2004), as discussed previously, *maqasid ul-Sharia* does not have such a social objective, as it is only related to the individual level; as the components are all individual objectives. This demonstrates similarity with Adam Smith's contention and eager understanding that the market economy would better serve the social interest through the maximisation of individual interests and utilities. However, developments in capitalism have shown that individualistic attempts to maximising personal interest became the prevailing norm, and therefore Smith's predictions did not hold. This is again related to the behavioural norms.

SECOND BEST SOLUTION: FAILURE OF THE ISLAMIC ECONOMIC PARADIGM

It should be acknowledged that the reality today indicates that Islamic finance does not represent the aspirations of Islamic economic philosophy nor fulfils the expectations of many Muslims in underdeveloped societies, for whom Islamic finance was proposed as a way out. This reality is against the aspirations and philosophical framework of Islamic economics. The developments in Islamic economics and Islamic finance, thus, indicate that Islamic economics can be considered as the 'first best solution' by borrowing the conceptual understanding from neo-classical economics. In this 'first best solution', like conventional economics' aim of creating *homoeconomics*, Islamic economics aimed at involving in the project of creating *homoislamicus* by introducing and changing the behavioural norms of individuals for this project. Therefore, its aspirational project supported by behavioural and philosophical norms should be considered as the first best solution. Similar to conventional economics where the first best solution failed to work, it is clear that the Islamic first best solution cannot be attainable as well, as Kuran predicted in 1983. Whether Kuran's argumentation is correct or ideologically acceptable to the founding fathers of Islamic economics, the experience now shows that he is right as Muslim individuals and Islamic banks remain affiliated to utility and profit maximisation respectively. The research indicates that Islamic banks aim at efficiency by ignoring and relegating the importance of social efficiency. Thus, in the trade off between economic and financial efficiency and social efficiency as El-Gamal (2006) states, the choice has been economic and financial efficiency. This result is an indication of the overwhelming power of *homoeconomicus* behavioural norms over *homoislamicus*.

Recalling that the first best solution is not held in conventional economics, and therefore, neo-classical economics offered the second best solution to the failure of the market economy by offering rationale and certain institutions to curb the excesses of this failure, the same analogy can be offered to the current state of IBF institutions and the consequences of their working mechanism. In other words, since it seems that Islamic economics is now going through the same experience, the conceptual framework of conventional economics can be used to further explain the dilemma faced by the developments in Islamic finance.

Since Islamic economics' first best solution of producing a financial system based on authentic moral ethics has failed, in the next stage of evolution the second best solution must be accepted. The second best solution is the current nature of Islamic banks and financial institutions. The Islamic economics behavioural norms and axioms in reality have been relaxed by the practice of Islamic finance. This should be accepted as a norm instead of having a desperate state of mind that 'it went wrong'. In this second best solution, Islamic banks are not expected to conduct social justice oriented activities beyond what they are legally expected and also they are not expected to fulfil the ethical norms, hence, to move beyond their legalistic requirements in relations to social issues.

However, the important question is now how the social justice is to be served? What social-financial institutions Islamic finance can offer to solve economic development issues in the Muslim world? While justice may not have been properly articulated by Islamic economics, it remains to be an important discourse of Islam and the prophetic tradition. Therefore, the search for fulfilling social justice should continue. Looking at the institutions of Islamic economics to overcome the economic underdevelopment issues, it does not provide much hope to directly tackle the development. These institutions include elimination of *zakah*, *waqf* and *taqaful*. However, these are part of the legal responsibilities of Islamic financial institutions. In other words, as part of the second best solution, elimination of *riba* would not result in a social welfare maximising state, despite the general claims and remarks made in this direction, such as Tag El-din (2000). *Zakah*, on the other hand, has not been systematically organised to serve the development needs of the society in a systematic manner. *Taqaful* again is not a development oriented financial contract, while the creation of *waqf* is left to the philanthropists.

It is important to note that at this stage of development, this paper does not suggest that IBFs should be restructured to incorporate the authentic appeal to the ethics and social justice. On the contrary, they should be perceived as the second best solution, which could not achieve the framework provided by the Islamic economic system understanding. IBFs, therefore, should remain to respond to the market as it is, as "the current Islamic experience, notwithstanding its limitations, has proved to offer an invaluable service for both consumer and producer needs and it may well remain for this particular purpose" (Tag El-Din, 2004). However, the social justice and developmentalist purpose including long-term financing and venture capital can be structured in "more specialized Islamic institutional set up … in line with the recent global developments where a broad variety of institutional structures" (Tag El-Din, 2004) exists as examples.

OVERCOMING THE FAILURE: (ISLAMIC) SOCIAL BANKING AS A WAY FORWARD

Thus, accepting that the current state of Islamic finance, failed to internalise the social dimension and social justice into its own operational function, as the second best solution, requires new models of development. In this new modelling or reorienting "the brand name of Islamic finance [should] emphasize issues of community banking, microfinance, socially responsible investment, and the like" (El-Gamal, 2006: xii). The difficult state of economic affairs in the developing world requires direct attention, which Islamic finance, hence, will not deal with. Therefore, like in the neo-classical framework, there is a need to develop a welfare economics oriented paradigm, in which social justice and ethical norms can be exercised. In other words, the need to moderate the consequences of the failure of Islamic economics and finance or the second best solution is important. This moderation can be done by introducing ethics and social justice directly to the working of the Islamic financial institutions. In other words, in this moderating function, new institutions should be created as a new project for ethical Islamic finance beyond IBFs, as the latter remains loyal to legalistic dimensions of Islamic but not Islamic ethics. In this effort, the experience of the evolution of finance in the West can be taken as an example. Thus, creation of ethical Islamic finance and investment institutions in the form of Islamic social banking as part of the civil society and also creation of social banks should be considered as the next stage of financial development aimed at social capacity building and individual functioning as defined by Sen (1999). This probably is not something entirely novel; as the very first initial experience in Egypt was a social bank. Thus, in this new stage equity based finance with direct involvement of civil society should be the solution.

Such an institutional solution aiming at correcting and moderating the consequences of Islamic finance will contribute to the development of individual lives by focusing on micro dynamics of the society rather than aiming at affecting the financial equilibrium. This fits into the new development paradigm as well; which has shifted the focus from macroeconomic development to micro dynamics. Thus, evolvement of Islamic finance in such a direction will imply maximisation of welfare of the society by extending the financial involvement of the larger society in the dynamic economic involvement.

Social banks in its modern form are practised in many European countries in order to provide ethical financing but at the same time to work towards micro development purposes, because it is a way forward to overcome banking exclusion but at the same time aims to expand the ownership base of the society. Reifner (2001: 198) defines social banking as "a socially responsible form of banking in which suppliers of financial services have a vested interest in the social outcome and effects of the distribution of their products". Also, social banks internalises the moral dimensions of the market system "to introduce 'need orientation' (Amartya Sen) into the exchange of commodities and services to further the general welfare" (Reifner, 2001: 199) of the society. The European experience indicates mainstream private banking; state-owned banks and specialist lenders offer social lending and serve social objectives (Mayo and Guene, 2001). Therefore, social banking has the private banking nature as it works 'in a competitive environment, necessitating profit orientation and cost cutting as major goals of its economic activity. On the other hand it implies a reference to social standards" (Reifner, 2001: 198). Thus, in addition to micro financing, the social banks involve many social development projects as depicted in table 1.

Table 1: Social Banking Target Markets

Market	**Examples of Needs**
Low-income consumers consumer credits	Saving mechanism, payment service
Small business finance	Development finance
Micro-enterprise for individuals and family	Start-up/working capital, business skills
Third system social enterprise	Project finance, working capital, facility finance
Ecological enterprise	Development finance

Source: Mayo and Guene, 2001: 4

The examination of the markets and examples of needs in table 1, show the great similarity between aspirational IBF and social banking. Therefore, adopting social banking to IBF should not be a difficult exercise in terms of objectives. On the contrary it will enable us to overcome some of the difficulties and tension areas between Islamic economics and the current state of Islamic finance. Examining the nature of social banks further substantiates the claim that social banking can be considered as the new phase of IBF with *maslahah* objectives. The social banks, as the post-war European experience demonstrates, does not only include "traditional core bodies of the social economy, mutuals, co-operatives and associations, but also new organisational models which fit neither the classical public or private sector forms" (Mayo and Guene, 2001: 5), as they:

(i) try to find solutions rather than to place themselves in a new market sector;

(ii) often refer to factors as social solidarity, democratic organisations or the primacy of the individual over capital;

(iii) are often the results of public/private partnership and have a close relationships with their local communities;

(iv) do not have the market as their sole source of income instead securing public subsidies, donations or loans – they often have very mixed income;

(v) often give specific attention to disadvantaged people;

(vi) have small scale structures with larger numbers of non-active associates of unpaid volunteers.

In highlighting the importance of social banks, the European Commission identifies the need of such banking by stating that: "The social economy and the activities oriented to meet the need unsatisfied by the market can lead to the development of a new sense of entrepreneurship particularly valuable for economic and social development at local level. This sense of entrepreneurship is closer to the aspirations and values of people that do not seek profit making but rather the development of socially useful activities or jobs. These forms of entrepreneurship have a useful role in promoting social cohesion and economic local performance" (as cited in Mayo and Guene, 2001: 5).

Social banking should not only be considered as development oriented banking. On the contrary as the European examples show they provide personal financial services including bank accounts and mortgages and small business lending activities. In other words, social nature of these banks does not imply that they are not financial institutions. On the contrary they are such banks which aim to achieve financial efficiency and use this to promote social efficiency, as Mayo and Guene (2001: 5-6) states "the social dimension allows the financing institutions to innovate around method [social objective] to reduce risk and improve returns". As without this, social banks would repeat the experience of Islamic banks by duplicating or mimicking mainstream banking by supporting the bankable projects. "Instead, social banking methods widen the frame of those able to access finance" (Mayo and Guene, 2001: 6) and capital whereby contributes to cohesion of social and economic objectives.

As to the introduction of social standards into the objectives functions of banks, Reifner (2001: 198) suggests that these can be introduced by:

(i) internal moral standards of social responsibility from the corporate identity and market image of the bank, or:

(ii) through legal obligations for community reinvestment and equal treatment of citizens, or:

(iii) merely by the pressure of institutional investors and other customers who are willing to act as agents of public goals.

In checking the extent to which social banks complement Islamic banks, it is clear that *maslahah* provides the moral standard for social good, and *Shari'ah* requires justice and benevolence. Therefore, development of consciousness on the side of the banks about the consequence of their business beyond narrow *Shari'ah* compliancy into pro-active thinking should be satisfactory enough for IBFs to practise social banking. Islamic banks being specialised bank have the experience and the knowledge of developing "new products and procedures for the distribution and administration of financial services which promise better social effects for users and society, without creating losses and disadvantages for the general business of its provider" (Reifner, 2001: 198), as social banks do.

In reorienting towards social banking, "the 'Islamic' in 'Islamic finance' should relate to the social and economic ends of financial transactions, rather than the contract mechanics through which financial ends are achieved' (El-Gamal, 2006: xiii). Thus, as Siddiqi (2004) argues a move towards goals and policy rather mechanistic and legal structure of Islamic finance will serve the human well-being much better.

CONCLUSION

Islamic economics heavily relies on behavioural norms to bring about a social welfare maximising state shaped by the foundational axioms. However, the discussion so far indicates that such aspirational expectations have not held by the operational side of Islamic economics, namely Islamic finance. In opposing the views of Islamic economists, Kuran (1983 and 1995) argue that religious norm are not enough to change people's economic behaviour in creating *homoIslamicus* when they face the problem of maximising their utilities and welfare. Therefore, he finds that the main shortcoming in Islamic finance, and hence the source of failure, is economic incentives. Empirical evidence discussed earlier suggests that Kuran's prediction was right, as not the religious norms but economic incentives determine the structure of Islamic financing as discussed above. This is evidenced with the lesser financing extended to *musharakah* and *mudarabah* type of financing as part of profit and loss sharing.

It is also important to state that the aim of the Islamic economics is novel by making reference to social justice and well being. It is a fact that under no circumstances economic incentives can fulfil such objectives in Islamic or conventional economics. Therefore, correcting the failure of Islamic finance, which has deviated from the aims of Islamic economics by giving way to the economic incentives, should be in the form of introducing further but robust social justice oriented principles into Islamic finance by endogenising social justice into its operational nature as in the example of social banks.

Therefore, there is a need to go beyond the legal interpretations and reading of the text; as value and objective oriented approach would help to overcome the growing tension between the performance of Islamic finance and Islamic economics utopia. This can be possible by recognising and diagnosing the problem that the first best solution based on the axioms and foundational principles of Islamic economics have failed; and IBF has come out as the second best solution. By using the analogy of the neo-classical theory, IBFs have to move into the third stage of institutional development by introducing social banking into the market. With the existence of such banking institutions, it will be possible to respond to the growing economic development need of the society by increasing the social capacity of individual and making individuals functioning as Sen (1999) defines. This is the objective of Islamic economic system also: to create an equilibrium between the scarce resources and unlimited needs through a moral filter system by producing a socially and financially optimal state of the economy in which human well-being is served through inclusive policies and economic value creation oriented economic activity (Chapra, 2000). In other words, goals and objectives should have primacy over rules and regulations so that the correct institutions and financial products can be created for the need fulfilment purpose as well (Siddiqi, 2004). Islamic social banking, thus, can provide the "new identity based on substantive and ethical religious tenets" (El-Gamal, 2006: 191).

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