Islamic Economic System – A Threat to Development?

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The economic backwardness of the Muslim world since the beginning of the industrial revolution in the West in the 18th/19th century can hardly be disputed. There basically two groups of explanations for this phenomenon:

- The first group emphasizes mentality factors and a mindset originating from the Islamic worldview which induces behavioural patters impeding economic development.
- The second group stresses institutional factors and deficits originating from a particular historic constellation responsible for the lack of institutions necessary for economic development.

Mentality and institutional deficits may explain the economic backwardness of the Muslim world, by neither mindsets nor institutions are immune to change, and the present shape of both cannot mainly be attributed to Islam. On the contrary, an economic policy based on Islamic principles may be more conducive to economic development than the socialist experiments, nepotism and state interventionism of past decades.

1. 'Islamic mindset' as an obstacle to economic development?

It is often argued that the Islamic worldview supports a mentality and value system which attributes little importance to individual performance and responsibility, effectiveness and efficiency or material wellbeing. Muslims are more concerned with the life in the hereafter. They belief in a kind of predetermination, and all these components lead, in total, to a fatalistic attitude which seriously obstructs economic development.

It is doubtful whether this is an accurate description of the value orientation and behaviour of the vast majority of Muslims. But even if it could be observed in today's Muslim societies, it is very doubtful whether it can be ascribed to the teachings of Islam. An alternative explanation is that seclusive attitudes are a reflex and response to the experience of many generations that individual efforts and endeavours do not pay in repressive systems.

Fatalism stands in a strange contrast to the economic teachings and ideology of Islam. The literature on Islamic economic teachings (ranging from business ethics to systemic issues) explicates and propagates attitudes and concepts which come close to what we would call a social market economy. Major elements are the following:

- Everybody is obliged to cater for subsistence by his/her own labour.

- The final owner of everything is Allah. Man has only the right of use but no right to waste or destroy it. Private property of means of production is permissible but must not be misused.
- Wealth can be acquired legitimately through work and inheritance. It should not be used for lavish or luxury consumption, and the use for social purposes is encouraged (and rewarded in the hereafter).
- The poor and needy have a claim to be sustained by the society. This claim is institutionalized in the system of *zakat* (sometimes translated as poor due or alms tax), a compulsory levy of 2.5% on assets and 5% or 10% on agricultural produce and earmarked for a list of purposes initially outlined by the Prophet Muhammad and further specified by the early caliphs.
- Prices should be just – which means that they should be formed on competitive markets. Monopolization and hoarding lead to exploitation and must be combated.
- The monetary policy must ensure the stability of the price level.
- The fiscal policy should balance tax income and public expenditures in such a way that the overall budget will be balanced (no deficit spending).
- The state shall provide a basic infrastructure (including a legal system) and specific public goods but must not intervene into competitive markets.

Islamic economic teachings imply or plead for a set of institutions (private property, enterprises, capital markets, anonymous markets, labour laws, competition, etc.) deemed crucial for the rapid economic development which took place in the West since the 18th century. However, such institutions either did not exist in the Muslim world until rather recently or were not effective. Their introduction was often initiated from outside, for example in the context of structural adjustment programmes and policy reform packages under the guidance of the *International Monetary Fund*. An explanation for this phenomenon is offered in the following section.

2. Institutional deficits in the 'Islamic heartlands'

Islamic economics emerged only since the mid-1970s as a new academic discipline (a mixture of positive and normative economics with a strong ideological dimension), and seemingly teachings such as those quoted above do not adequately reflect the realities of the economic systems of Muslim countries. In particular, they cannot explain the institutional deficits. It is often assumed that the traditional Islamic law could neither provide an adequate protection of individual property rights nor could it accommodate to institutional innovations and structural changes in particular from the 18th century onwards when the industrial revolution changed the economic and social systems in Europe and initiated an unprecedented economic development there.

Obviously, the Ottoman Empire – which ruled most of the Islamic heartlands in the Middle East and North Africa (MENA) – did not create adequate institutions during this crucial historical period. But this failure must not be attributed to an alleged rigidity of the traditional Islamic law. There are other – probably much more important – explanatory factors: When the territorial expansion of the Ottoman Empire came to a halt and the disintegration of the periphery began (in the 17th/18th century), the Ottoman rulers could no longer buy the loyalty of their governors and military leaders by the distribution of newly conquered land. Instead, they had to extract rewards from the own territory, and they adopted on a large scale a system of tax farming. In a period of retreat and decline, tax-farmers tried to maximize their income in the short term and often set tax rates to confiscatory levels. This undermined private property and made it irrational to build-up immobile real assets (including production facilities) exposed to the access of the tax-farmers. It was much better to keep capital as liquid and invisible as possible. This explains a strong preference of the entrepreneurs of that period for trade ventures and a strong aversion against factories and industrial plants. The military and economic decay of the Ottoman Empire in the 19th century was in sharp contrast to the industrial revolution which spread throughout Europe. It was driven by private entrepreneurship and private capital, and crucial institutions such as joint stock companies and capital markets developed during that period. Nothing comparable took place in the MENA region – neither in the Ottoman heartland nor in the Arab periphery which came under European colonial control in the 1800s.

When countries in the MENA region gained independence in the 20th century, either nepotism in autocratic regimes or state bureaucracies in socialist systems dominated the economies and suppressed entrepreneurial potentials (outside established elites) and hindered the emergence of institutions essential for the functioning of competitive markets which, in turn, are the driving force behind economic development. This changed only in the last decade when the recognition of entrepreneurship and private property and the market paradigm became guiding principles for economic reforms all over the world, including the MENA region.

3. The *riba* problem

Even if the Islamic mentality and the basic institutional setup of an Islamic economy is supportive to development, one must not ignore one distinctive element in the Islamic economic teachings with institutional implications which may turn out as a fundamental obstacle for development, namely the prohibition of *riba* – which means all kinds of interest (and not just usury) related to a loan. It must be noted that *riba* is prohibited for loan transactions only, i.e. it is limited to purely financial transactions. A trade transaction, where one party transfers an asset (good or non-financial service) and the other party transfers money, does not create interest but profit. This is true even if the financial transfer happens at a later date and the seller adds a mark-up on the spot price for the deferred payment. In this respect rent is similar to

trade. Interest is created only if both transactions are financial in nature. While interest is prohibited, profit from trade is allowed, and even in an interest-free economy capital has a price.

The sector which needed – for centuries in Islamic history – the most sophisticated forms of finance was trade. Islamic jurists developed a comprehensive and sophisticated corpus of contracts for the financing of various types of trade transactions. All these contracts avoided interest. The more entrepreneurial and venturous transactions (such as long distance trade expeditions) were financed on the basis of profit and loss sharing. In more standard transactions (especially local trade) financing was not done by interest-bearing loans but by mark-ups on the spot price for the deferred payment of the purchased items.

When trade ventures and their financial needs became more complex, double trade techniques were introduced. In its extreme form, two reverse trade contracts are combined in such a way that they made interest-bearing loans commercially possible without recourse to the legally prohibited loan contracts. In principle, in the first contract party A sells to party B an object at a price P, and B pays the price on spot to A. In the second contract, party A immediately (re-) purchases the same object from party B at a price of P + X, payable after a certain period of time. Factually, party A never gave up the possession of the traded object, and party A received a loan from B amounting to P at a fixed cost X which is interest in economic terms (but profit from trade and deferred payment in legal terms).

Seemingly such financing techniques facilitated flourishing trade, crafts and agriculture in the 'Golden Age' of Islam – even without banks in the modern sense. However, sceptical observers fear that a more complex modern economy without interest would be an economy without financial intermediation and without capital markets. This, in turn, would seriously jeopardize an economic system based on private property, entrepreneurship, and competition. The emergence of Islamic banks and interest-free financial markets over the last 30 years cannot dispel the reservations in total, but there are clearly recent trends towards a more sophisticated and efficient Islamic financial system with links to conventional national and global financial markets.

When Islamic banking emerged in the 1970s/1980s, its proponents strongly emphasized the profit and loss sharing techniques and portrayed an ideal economy based on equity and partnership. This economy was deemed more efficient, just and stable than the conventional capitalist and interest-based system, and it was expected that it would boost the economic development of the Muslim world after its introduction and spreading. The reality of Islamic banking did not meet the high expectations: Instead of providing capital on the basis of profit and loss sharing, Islamic banks acted as traders on behalf of their clients and bought and sold objects with mark-ups and mark-downs and rented or leased objects against fixed rental charges or leasing rates. It is debatable whether and to what extent Islamic banks applied double trade techniques. Profit and loss sharing was only applied in relation to depositors: Money paid into

so-called savings or investment accounts does not receive a fixed interest but a share of the profit (or loss) of the bank. Although Islamic banks were able to meet the basic financial needs of their customers, the early system as such was incomplete, more complicated, less efficient and inferior to conventional banks due to high transaction costs.

But the number of Islamic financial institutions and their funds under management increased rapidly since the 1990s, and more and more conventional global players such as HSBC or Citibank and recently even Deutsche Bank joined the Islamic segment with new financial products, separate departments ('windows') or subsidiaries. The new actors no longer restrict themselves to the traditional financing techniques of previous centuries but have engaged massively in financial engineering. They developed not only new interest-free banking techniques but also instruments for interest-free capital markets (such as *sukuks* as alternative to conventional bonds). Today's Islamic bankers are not worried about systemic superiority (as were the Islamic economists in the 1970s/1980s) but are content with the legal *Shariah* compliance of their new techniques and products. Their prime objective is no longer ideology but market performance.

New interest-free tools as such hardly promote development, but efficient techniques are by all means a necessary precondition. The replacement of outdated techniques removes some impediments to the progress of Islamic finance and thus enhances he chances for an integration of an Islamic economic subsystem into secular market oriented economic systems in Muslim countries. This tendency is supported by authorities for supervision and regulation of financial institutions and markets (= central banks, monetary authorities, etc.) in many Muslim countries: They observe with great interest the formulation of accounting and auditing standards issued by organizations of the Islamic finance industry (such as the *Accounting and Auditing Organization for Islamic Financial Institutions*), and many of them actively participate in the design of regulatory standards (primarily in the framework of *Islamic Financial Services Board*). Both types of standards have only the legal quality of recommendations, but these recommendations are translated into authoritative standards by governments and central banks of an increasing number of Muslim countries.

The improvement of techniques, the refinement of accounting standards, and the regulatory integration into existing financial systems clearly remove possible obstacles which might originate from the prohibition of interest. It remains to be seen whether the modernized *Shariah* compliant financial toolbox will be used by ideologically motivated bankers in order to address the financial needs of new entrepreneurs, self-employed people, local communities etc. who so far are widely neglected by conventional banks. If this happens, Islamic finance could make a distinctive contribution towards the development of a Muslim country – even if the overall economic system remains mainly secular.

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