Some implications of the Quranic message for the Economic System

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An earlier slightly different version of a Chapter in Abdur's book "Exploring Islam in a New Light [11]".

(O mankind!) Give full measure; and be not of those who give less. And weigh with right scales. And wrong not men of their things (or rights), and act not corruptly in the earth, making mischief. --Shu'ara (26): 181-183

Introduction

Some might question if economics or an economic system has anything to do with religion. Yet, it is instructive to see if religion has anything to offer in this regard. Religion provides normative guidance and inspiration to man to be true and honest in all respects, to be good to others and to do justice in all of his dealings, including economic dealings. We do need to translate the concept of justice as proclaimed by religion in the conduct of ourselves in all affairs, including economic activities and transactions. And, for maintaining equity and ensuring special humanitarian treatment of disadvantaged groups, religion offers not only inspiration but also specific guidelines. Overall, we get broad guidelines from religion for conducting our economic affairs. Everything cannot perhaps be specifically spelled out by religion. God repeatedly exhorts us in the Quran to reflect on His message, and apply our sense [Sad (38): 29; Yunus (10): 24; Muhammad (47): 24; Zumar (39): 27; Hashr (59): 21]. This highlights the need for efforts to interpret the Quranic message carefully and appropriately to work out its implications in various areas.

A vibrant and prosperous economic system is built upon the bedrock of certain core human values, which are values of any religion including Islam - values of truthfulness and honesty, fairness and justice and rule of law, respect for human dignity, and freedom and human rights. In such an economy, some preconditions that need to be fulfilled include social harmony and political peace and stability, decent living conditions for the labor force, a supportive government with a good legal system and corruption-free service providers, and freedom for all men and women to uninterruptedly pursue their economic goals. Religion in a proper sense embraces all elements of modernity that make things better, fairer and just for all people with proper checks against the bad elements. Islam properly understood does embrace the elements of modernity that define the western economic system - the ideas of liberty, competition, free enterprise, integrity and business ethics, etc. Religious groups like Muslims have lagged behind because of their obsession with wrong traditions. The wrong fatalistic attitudes fostered and cultivated among Muslims, which are not part of Islam but wrongly attributed to it, are largely to blame for their lack of initiative and drive for their own development. The Quran makes it amply clear that “Man hath only that for which he maketh effort” [Ta-Ha (20): 15; Najm (53): 39], and that “God changeth not the condition of a people until they themselves change their own condition” [Ra’d (13): 11]. Thus to come out of their economic doldrums, the first thing Muslims need to do is to shun and change their fatalistic attitudes and come to believe that they can expect rewards or results to follow according to, and proportionately to, what they actually do and try to get accomplished.

The Quranic guidelines and some implications for the economic system

A careful study of the relevant Quranic guidelines points to some broad and important implications for the economic system as follows:

· Islam favors neither pure capitalism nor pure socialism, but a capitalist system with a socialistic overtone to care for the basic needs and welfare concerns of the poor and disadvantaged groups in society;

· Islam is for an egalitarian or equitable economic system where economic inequalities are not starkly high;

· Islam allows trading and endorses a free market system with appropriate qualifications; and

· Islam condemns and forbids all kinds of exploitation, including market manipulating behavior.

One theme that runs through strikingly in the Quran is that we must be fully alive to the need for ensuring distributive justice in society, and should not neglect the needs of the poor and the deprived. The Prophet Muhammad himself was an orphan and a needy person, and when he found shelter and became free of want, he was strongly urged by God not to be oblivious of the needs of the orphans and the needy [Dhuha (93): 6-10]. The Quran thus emphasizes distribution; but at the same time it lays down certain broad guidelines that point to the need for an efficient production and marketing system in the economy to support what we might say is the most important objective of human endeavor, i.e., moral and spiritual uplifting of all men and women in society.

According to the Quran, some of the essential elements or principles of an ideal economic system would include the following:

· Respect for private property;

· Respect for individual economic freedom, initiative and enterprise;

· Requirement of recording of loan and debt dealings, and respect for contractual obligations, and requirement of returning of trusted properties;

· Recognition that everything belongs to God, which calls for an equitable distribution of wealth, and allowance for social security, social welfare and common good;

· Condemnation of exploitation or monopoly power and promotion of sufficient market competition;

· Allowing free play of economic forces, i.e., freedom of work, initiative and enterprise, freedom of production, free movement of factors of production, and goods and services with some exceptions (See below); and

· Promotion of an environment conducive to both spiritual development and supportive material development, i.e., social and economic development.

The Quran recognizes the sanctity of private property, but not of ill-gotten property, which demands confiscation by the state, and then proper redistribution among the poor, deserving citizens or for other beneficial social causes. Recognition of private property rights along with the related stipulation that none should encroach upon others' property is clear from the following verses of the Quran:

And devour not each other's property among yourselves wrongfully, nor seek to gain access to that by bribing judges so that you devour a part of the property of men wrongfully while ye know. [Baqarah (2): 188]

Come not near to the orphan's wealth except with what is better till he attains maturity. Keep up the promise; verily of the promise you will be asked. [Bani Israel (17): 34]

On the other hand, the Quran advises the custodians of orphans' properties not to return the properties to them if the orphans are found weak in understanding, which implies, if they are unable to manage the properties themselves:

And give not unto those (orphans) weak in understanding your (maintained) properties that God hath entrusted with you to maintain; but feed and clothe them from it, and speak to them kindly. And check the orphans for their puberty. And if ye find them of sound judgment, restore unto them their property. Devour it not extravagantly in a hurry, lest they should grow up. If the guardian is well-off, let him refrain generously (from taking any remuneration from the orphans' property), but if he is poor, let him have thereof for himself what is just and reasonable. When ye return them their properties, call witnesses in their presence. And God sufficeth as a Reckoner. [Nisa (4): 5-6]

Though these verses refer to orphans' property, the substance of the message contained in these verses is equally applicable to any properties, the owners of which are found to be unable to manage them, or manage them properly or efficiently, for some reason. According to this message, in cases where some valuable national property is found to be mismanaged by its owner(s), the state has a right to vest its management in others who are more efficient, while giving the owners their due after deduction of the reasonable management fees.

Note that some of the above verses urging the well-off custodians to refrain from taking any remuneration for managing the property, and the poor custodians to take reasonable remunerations point to the need for avoiding any form of exploitation of others' property and the need for observing restraint on sharing poor men's wealth on the part of rich men managing their assets.

The Quran encourages recording of loan and debt operations, and urges honoring of contractual obligations, and returning of trusted properties:

O ye who believe! When ye contract a debt for a fixed term, record it in writing. Let a scribe record it in writing between you with equity… And be not averse to writing down (the contract) whether it be small or large, with (record of) the term thereof. That is more equitable in the sight of God, and more accurate for testimony, and the best way to avoid doubt among you, except only in the case of ready merchandise which ye trade from hand to hand [Baqarah (2): 282]

If ye be on a journey, and cannot find a scribe, then a pledge in hand (shall suffice). And if one of you entrusteth to another, let him who is trusted deliver up that which is entrusted to him, and let him be careful (of his duty) to God. Hide not testimony. He who hideth it, verily his heart is sinful. God is aware of what ye do. [Baqarah (2): 283]

Verily God commandeth you to restore trusts to their owners, and if ye judge between mankind, judge justly. [Nisa (4): 58]

These verses underscore the importance of recording of all economic deals, where such deals involve a time element, and honoring of all contractual obligations. Indeed an economy cannot function well and prosper unless these norms of behavior are meticulously followed. One of the reasons why developed countries in the world are more developed than the less developed countries is precisely the fact that business ethics is much more strictly observed in the former countries than in the latter. Corruption is generally widespread in developing countries and it significantly affects their economic development.[1]

Since hoarding is often resorted to by unscrupulous businessmen to artificially raise prices of the hoarded goods in the market, such hoarding is both economically and socially unjustified. Hoarding is a device for gaining market (or monopoly) power and thus for cheating or exploiting consumers. As mentioned in Chapter 3, hoarding hurts an economy by creating artificial scarcities and high prices of the hoarded goods. Hoarding of monetary assets leads to curbing of effective demand in the economy. The Quran strongly condemns hoarding [Imran (3): 180]:

And let not those who hoard up that which God hath bestowed upon them out of His grace think that it is better for them. Nay, it is worse for them. That which they hoard will be tied to their necks like a collar on the Day of Resurrection. God's is the heritage of the heavens and the earth; and God is aware of what ye do. [Imran (3): 180]

The Quran rules out any kind of human injustice, exploitation or cheating of any kind, whether it is individual, societal, religious, sectarian, political or economic:

Verily God enjoineth (on you) the doing of justice and the doing of good (to others) [Nahl (16): 90]

O ye who believe! Be steadfast as witnesses for God with justice, and let not malice of any people (toward you) induce you to depart from justice. Deal justly, that is nearer to piety, and be careful (of your duty) to God. Verily God is aware of what ye do. [Maidah (5): 8]

(O mankind!) Give full measure; and be not of those who give less (who cheat). And weigh with right scales. And wrong not men of their things (or rights), and act not corruptly in the earth, making mischief. [Shu'ra (26): 181-183]

Give full measure when ye measure; and weigh with right scales. This is fair and better in the end. [Bani Israel (17): 35]

When it comes to economic matters, economic policies, activities or transactions that cannot be justified by the norm of justice should be considered as not permitted by Islam. A just and exploitation-free economy conceived by Islam has far-reaching implications. Some are as follows:

· There should be competition in economic dealings – in trading (selling or buying) of anything (goods, services and factors of production such as capital, land and labor), and appropriate measures should be taken to curb monopolistic behavior and elements found in any such dealings;

· There should be no hurdles or obstructions to the free production, and free flow and movement, of goods and services and factors of production, including capital, labor, and knowledge and technology within a country as well as across the borders of countries, excepting for some goods that can be restricted on religious and health grounds or for strategic reasons;

· Work in the work place should be judged by quality or efficiency of work alone, and there should be no discrimination according to sex, creed, color, or geographical origin. If concessions are to be made for disadvantaged groups, these should be made in a policy-neutral way that does not affect the production system or the allocation of resources. This would require that the social safety net or subsidization programs, if undertaken by the state, should be financed by the state general budget from general government tax revenue, not by taxes on or subsidies for specific economic activities; [2]

· From the point of view of creating equitable opportunities for access to resources for all men and women and from the point of view of making maximum possible contribution to the production and welfare potential of an economy, where existing distribution of land and other resources is found grossly unequal, a redistribution of such resources should be carried out;[3] and

· Economic policies should be directed to ameliorating the material and spiritual conditions, and facilitating such pursuits of all men and women, and to removing distortions in all economic activities, and creating an environment conducive to private enterprise, growth and development.

It will take much beyond the confines of this chapter to elaborate on these implications. It may suffice here to make some brief observations as follows:

· Islam advocates an appropriate synthesis of both capitalistic and socialistic systems. The socialistic features that need to be incorporated in a predominantly capitalistic system are appropriate social security and safety net measures embodying the charity system and social welfare programs that the Quran prescribes. (See the section on Spending in God's Way in Chapter 3).

· Islamic principles call for abolition of all controls and taxes on production and trade of all goods and services except for goods that qualify for a prohibition on religious, medical or strategic defense grounds. Controls and licensing create vested interests and artificial scarcities and scope for corruption and exploitation, and production or trade-specific direct controls and taxes cause distortions in the allocation of resources that is consistent with natural efficiency in each line of production. Since production or trade subsidies also distort the allocation of resources by artificially encouraging such production or trade, these subsidies are also not permissible from the point of view of economic or social justice that Islam endorses.

· By the same token, there should be no direct restrictions or tariffs or subsidies on imports and exports of any country. Modern economic theory and also available empirical evidence on the effects of trade liberalization and other globalization measures worldwide suggests that free trade fosters maximum economic growth and welfare of all countries, including developing countries. The world will be a much better place if existing protectionist practices and tendencies both in developed and developing countries are significantly reduced and phased out as quickly as possible. This calls for co-operation and support on the part of all countries for multilateral trade reform programs being conducted through the auspices of the World Trade Organization (WTO). Opposition to free trade and globalization that comes from certain quarters on fears of losses of jobs in previously protected industries to foreign countries, and less growth of developing countries is largely misperceived. However, any adverse effects on employment that may follow from a free trade situation can be effectively tackled by additional safety measures, as recent and ongoing donor-supported policies and practices of developing countries suggest. The fear of any loss of economic growth is simply misplaced, since it is protection that causes a net loss of economic growth.

· The state should take appropriate effective measures to curb monopolistic practices of both suppliers/sellers and buyers of any goods and services, as well as of factors of production such as labor, land and capital. That means that the government should endeavor to ensure competitive pricing of the following prices:

· Prices of all goods and services;

· Wages of labor;

· Rent on land; and

· Interest or return on borrowed and lent capital.

o **Note that competition in such prices can be encouraged by curbing of monopolistic practices, not by any direct price controls. Direct controls on prices are counter-productive: they distort the allocation of resources. (For more, see below.)**

· And the state should also take the responsibility of putting in place appropriate economic policies and measures to ensure an environment that is conducive to economic development with reasonable price stability. The State should also make use of pro-active policies to promote and accelerate economic development to alleviate poverty and create employment for the unemployed. Inflation is a hidden and regressive tax on the poor; and deflation is damaging to development. The state needs to ensure a reasonable price stability to avoid too much price increase, which is unjust to the poor, and at the same time the state should not allow price inflation to go below a certain level that may trigger deflation, recession or depression, which is more damaging to an economy.

Islamic principles are thus basically oriented to promotion of a free market competitive economy. The Quran urges us to compete one with another in all good work:

So vie ye one with another in good work. Unto God is your goal [Maidah (5): 48].

By implication, competition in good work should be extended to all economic activities. The best or most effective way to eliminate monopolistic behavior or exploitation is to ensure competition in all economic activities and transactions. Note, however, that competition must be a fair one in the sense that it must not be cutthroat competition at below cost price, which is sometimes resorted to by unscrupulous businessmen to gain monopolistic control of the market. This cannot be approved of by religion. The state should assume the responsibility to enforce sound and effective competition rules for the market.

But at the same time Islam requires a well-devised safety-net or social welfare program to safeguard the interests of, and cater to the basic needs of, the poor and disadvantaged groups in society. It also requires state promotion of economic and social development to effectively solve the problem of the poor and the unemployed. If the distribution of economic resources is grossly unequal, Islam requires some appropriate redistribution of such resources, especially of land. These points need some further elaboration.

As already explained in Chapter 3, a society is neither egalitarian, nor healthy for its all-round development when some people swim in wealth, while others are ill-fed, ill-clad and ill-housed, and when they cannot provide for their health and education even at a basic level. A highly unequal distribution of income and wealth is not good for an economy, as it adversely affects the development of its human resources, and holds down effective demand and holds back economic expansion. High inequality of income and wealth destroys social cohesion, peace and harmony, and breeds bitter feelings on the part of the poor and deprived people, and creates scope for social crimes, immorality and frustration. After all, everything belongs to God:

Unto Him belongeth all that is in the heavens and all that is in the earth [Hajj (22): 64].

So, in nations where stark inequality of resources, especially land, is found as in many countries, it will be advisable to carry out appropriate redistributive land reform in such countries (See also endnote 3). There is also a need for the state to shoulder a major part of the required spending for welfare or benevolent activities for the poor and disadvantaged groups in society, which is sadaqa in the Quranic terms. There is a well-devised social security system in many developed countries. Such a system should be replicated in all countries, including developing countries, and the required fiscal (appropriate taxation and expenditure) implications and responsibilities should be worked out and borne by the respective states. Also the state needs to take a great deal of responsibility to devise an appropriate tax and expenditure system to cater to the needs of public goods and services, which if left to the private sector alone will risk being grossly neglected or inadequately met.[4] And, as already mentioned in Chapter 3, in an impoverished developing economy, the state has a special role to play in promoting economic development, which indeed is the best answer to alleviation of poverty for the poor. For promoting economic development, considerable investment is needed in physical infrastructure (such as roads, highways, railways, waterways, ports, telecommunications, power and energy, etc.) as well as in human skills and education, technology and research. Promotion of such development is crucial for expanding employment opportunities and raising living standards and, in the long run for dealing with the problem of the poor.

Monopoly in production, selling or buying of any goods and services and factors of production leads to an undue constriction in their production and supplies causing monopolistic pricing of such goods and services. That demands abolition of all existing controls or barriers that impede competition in such activities, e.g., existing barriers or difficulties to, and controls on, new entry to business by aspiring entrepreneurs. However, in the case of production, even with full removal of existing controls and barriers to production, the very nature of the scale of production can create monopolies, both at individual and state levels. In such situations of what are known as natural monopolies, the government needs to resort to effective taxation measures to siphon off monopoly profits with some qualification. The qualification relates to the need for retention of a sufficient incentive to technological innovation. Technological innovation has played a very significant role in fostering growth, reducing costs of production, reducing prices that consumers pay, and improving living standards of man. A proper synthesis or compromise needs to be struck between mopping up excess profits from the production and distribution system and retaining a sufficient incentive for those who innovate.

Monopolistic sellers charge higher than normal prices; monopolistic buyers (monopsonists) cause the sellers to sell at lower than normal prices. Both such sellers and buyers cause exploitation, which needs to be tackled by appropriate policy response, but not through direct price control or regulation. Price regulation has been proven to be an inappropriate policy for possible adverse effects on the allocation of resources. Economists advocate appropriate taxation in the case of both monopolies and monopsonies.

In sum, the implications of the Quranic guidelines as analyzed above thus profess an economic system that is ideal in all respects: which has a distribution of productive resources that is not grossly unequal in the first place, which ensures as much equality of opportunities for all as possible; which ensures maximum possible protection from human exploitation;

which ensures maximum possible economic liberalization and competition, while trying at the same time to reward private initiative and enterprise, and technological innovation; which ensures basic needs of all disadvantaged groups by humanitarian safety-net programs; and which promotes economic and social and spiritual development.

The Quran prohibits interest charged to the poor and disadvantaged, not interest per se

A careful reading of the Quranic advice on interest or usury (riba) clearly suggests that its prohibition really relates to interest on loans that are extended to poor and disadvantaged people, who deserve humanitarian treatment or charity (sadaqa). This is evident from the following verses:

Those who devour usury cannot rise except as one who rises whom the devil hath prostrated by touch. That is because they say: 'Trading is just like usury'; but God hath permitted trading and forbidden usury. … God blesseth not usury; but He causeth charitable deeds (sadaqa) to prosper. He loveth not an ungrateful sinner. [Baqarah (2): 275-276]

O ye who believe! Devour not usury, doubling and quadrupling; and be careful of (your duty to) God, that ye may succeed. [Imran (3): 130] … That which ye give in usury in order that it may increase people's property hath no increase with God, but that which ye give in charity (zakat), seeking Allah's pleasure, hath increase manifold. [Rum (30): 39]

O ye who believe! Be careful of (your duty to) God, and give up what remaineth of usury, if ye are (true) believers. And if ye do not, then be warned of war (against you) from God and His messenger. And if ye repent, then you have your principal. Wrong not and ye shall not be wronged. And if the debtor is in straitened circumstances, then postpone (the debt repayment) till it is easy for him to repay. But if ye remit it by way of charity (sadaqa), that is best for you if ye only knew. [Baqarah (2): 278-280]

Some points of these verses deserve close attention:

· Interest or usury is not comparable to trading. This is suggestive of the practice of interest during that period of revelation, when interest was indeed not comparable to profits in trading. Trading is between two commercial groups, but interest was charged on loans extended generally to people who did not engage in commercial trading or production.

· Charging of interest to people who deserve sadaqa or zakat is unethical and hence cannot be permitted. The kind of interest or usury that God forbade was really the kind which was being charged to people who deserved rather charity or compassionate treatment, not business-like treatment. The individual lenders in the past usually did not consider the plight of the people whom they lent money, and they used to lend money at exorbitant rates exploiting the monopolistic situation they enjoyed, which enabled them to double and quadruple their lent capital as evidenced by the Quranic verse in [Imran (3): 130]. This was a practice, which indeed deserved to be condemned not only by religion, but is worth condemnation also from the point of view of good economics.

· The lenders should consider the circumstances of the borrowers, and if they are found in financially straitened conditions, the lenders should remit interest altogether, postpone the loan repayment and, still better, write off the loans as sadaqa.

These verses do not categorically prove that interest per se is to be condemned. Interest has become an integral part of a modern economy where it is being universally used for lending and borrowing for commercial purposes and also as a monetary policy instrument and an essential device for efficient allocation of productive resources (See below for elaboration).

The Quran mandates that we strictly maintain justice in all of our dealings. We will see below that abolition of nominal interest on loans extended to businessmen will rather result in inflicting injustice to the lenders who comprise the relatively poor people keeping their deposits in banks. Also, doing away with nominal interest does not eliminate the involvement of a “real” interest, i.e., interest in real prices (See below for explanation).

It is ironic that Muslim jurists have always equated interest, however small, with usury (riba), which the Quran prohibits. Rauf rightly points out that the invention and use of interest was one of the pillars of capitalism, which, together with the development of limited liability corporate businesses and the growth of liberalism, was instrumental in dramatically changing the economic fortunes of the Western world, while the Muslim world lagged far behind. “The strict prohibition on charging interest still prevails in the Muslim world and has largely prevented it from robustly developing the financial market’s institutions of banking, capital markets, and stock exchanges, the foundations of capitalism. Neither could the Muslim nations effectively control their own monetary policies, since raising and lowering interest rates is the chief way a nation’s central bank controls inflation and the amount of money in circulation.”[5]

There has been a surge of so-called Islamic or interest-free banking institutions in many countries around the world and such banks are working side by side with conventional interest-bearing banking system. However, the basic question that may be raised in this context is whether the Quran really forbids interestper se, or it forbids interest or usury charged to people who could not really bear it. That means that the Quran forbids interest or usury that could be conceived as extortionate or exploitative. In the pre-Islamic Arabic practice, interest was being charged at an extortionate rate – it was doubled at the first instance of default of loan repayment, and quadrupled at the second default. This practice was indeed reprehensible and the Quran forbade it [Imran (3): 130].

Note also that God has permitted trading, but not exploitative trading, where the seller can dictate the price (seller’s market), and where the buyer can dictate the price (the buyer’s market). Exploitative or monopolistic trading gives rise to excessive or extortionate profit, which the Quran certainly does not approve of. Extortionate interest or usury is analogous to extortionate profit. Both deserve the same condemnation. So trading that is not comparable to exploitative usury is trading that is free from any exploitation element. If exploitation elements are stripped from both trading and usury, they should stand on the same footing. So it follows that interest, which can be conceived as exploitation-free is not really disapproved of by the Quran.

Now let us analyze a little closely whether or not we can really get rid of interest in an economy. Interest is usually understood in the context of borrowing of money from the borrower’s point of view or lending of money from the lender’s point of view. Such a transaction necessarily involves some time element, as the money is lent or borrowed for some period of time. Now let us say a lender lends some money at a zero (nominal) interest. After a year the borrower gives back that money without any interest. It will be understood that no interest has been involved here. But is this really correct? This is correct in only nominal terms. If there is no inflation or deflation in the economy in the year, no interest will be involved also in real terms, i.e., interest in real prices, as opposed to nominal prices. But some real positive or negative interest (i.e., interest in real prices) will accrue to either the borrower or the lender depending on whether there is some inflation or deflation in the economy in the year. In the case of inflation, it will be the borrower who gains, and the lender loses. In the case of deflation, it is the other way round: the lender gains and the borrower loses. In reality, almost no economy has a zero inflation or zero deflation situation, and usually economies undergo an inflationary situation. It is then realistic to think that money lending or borrowing almost invariably involves some interest element in real terms, even if no nominal interest is charged on the loan. One may call it interest due to inflation or deflation reason, but interest nevertheless.

Now think of lending or borrowing not in money but in real goods. Will there be any interest involved here? Most will probably say: No. But is this correct? The answer will depend on whether the relative prices of goods change or remain unchanged over the time. If the relative prices of the goods concerned that are lent, i.e., the prices of such goods relative to the prices of other goods, rise over time, the borrower will lose in real terms in repaying the loan in the same amount of the same goods, and the lender will gain. If their relative prices fall, the exactly opposite will be the gainer and loser situation. None will gain or lose if the relative prices remain the same. But the real world situation almost always involves some change in relative prices. Interest in real terms is thus almost inevitably involved. We cannot get rid of interest in most cases, even when we have a barter system in the economy, and deal in real goods for lending or borrowing purposes.

It can thus be seen that however hard we try, it is almost always the case that some interest gets involved in the lending (or borrowing) transaction, whether the lending transaction is in money or real goods, in view of the usual real world changes in prices.

It should be recognized that interest could arise also because of other factors such as time preference and the occurrence of a return or profit on capital invested in any economic activity such as trading, production, etc. People value a thing at the present moment more than at a future date. This is time preference. If for example, a person would like to exchange $100 today for $110 a year after, his rate of time preference would be 10 percent. Interest plays an essential vital role in helping individuals allocate his income into present consumption and future consumption (i.e., saving) by bringing individuals' time preference at the margin into equilibrium with the interest rate.[6] The higher is individuals' time preference, the higher will be the interest rate that will be in equilibrium with time preference, which means that the interest incentive will need to be higher for one to save for the future. Or which means the same thing, an individual will go on saving his present income up to the point at the margin, i.e., up to the last dollar of his saving, where he finds his time preference for this last dollar of saving equal to the prevailing interest rate. Interest has an essential link also to profit or return on capital. A producer would like to borrow money to use in his enterprise so long as he earns a return at the margin higher than, or at least equal to, the rate of interest he pays on borrowed capital. The higher is the return on capital, the higher will have to be the interest rate to be in equilibrium with the rate of return situation.[7] In both cases, it can thus be seen that interest plays a vital role in allocating resources – in the first case between consumption and saving, and in the second case, between different uses of capital. In the second case, interest also plays the role of a rationing device, rationing uses of resources to the limit of the available resources. The scarcer the available amount of capital, the higher is the interest rate that will serve as an appropriate rationing device.[8]

In an equilibrium situation, the prevailing rate of interest is equal not only to marginal rate of time preference, but also to the marginal rate of return on capital. That means that interest that is paid to depositors of a bank must be closely linked to, and must mirror, the actual profitability situation in the ground. Interest here is a substitute for the profit that can be actually earned with the money. So, this interest cannot be termed as exploitative, and is not disapproved of by the Quran.

In a modern economy interest plays a central role in many kinds of economic decision-making. In both developed and developing economies, interest is a vital instrument used for directing appropriate monetary policy for achieving sustained economic growth with reasonable price stability. Countries' commercial and other banks adjust their interest rates on loans and deposits to the central rate that is governed by the central bank. Interest influences, among other things, money supply and demand in the economy, economic project panning, selection and evaluation, inventory planning and management, and a myriad of other economic decisions. Interest represents the opportunity cost of capital. Unless a producer is conscious of such a cost, it is likely that he will engage in inefficient lines of production, use inefficient methods of production and end up producing the wrong products, which are uneconomic or unprofitable. Indeed the role of interest in economic decision-making of various kinds is so deeply entrenched that the efficient working of a modern economy is not conceivable without interest. This is interest that plays a very useful and beneficial role in the economy. It is not exploitative interest or usury that the Quran prohibits.

In so-called interest-free (i.e., with zero nominal interest) banking system, the following two types of concepts are used and practiced:

· In the first concept, depositors entrust their money with banks only for safekeeping; they are neither paid any interest (in nominal terms) nor any profit (in nominal terms). Their capital (in nominal terms) is guaranteed. Banks lend on behalf of the depositors to the borrowers and charge a fee for their services. In this practice, the depositors derive no income from their savings, though the borrowers do business with their own money and generate profits and income for themselves.

· A second concept used in such interest-free banking allows for sharing of profits and income among the depositors, banks and borrowers in what is called participatory banking, where the bank, using the money entrusted to it by depositors, participates in an enterprise. It is a partnership between the entrepreneur, the bank and the depositor, in which all risks are shared among them. The funds invested come from depositors' time deposits in the banks in so-called "investment accounts", which bear no interest, nor are such deposits guaranteed.

Under the first concept, it is obvious that the depositors are deprived, and the borrowers who do business with the money are given an unfair advantage. The borrowers are mostly traders or other business concerns or individual entrepreneurs who make money at the cost of the depositors. This practice is not only unjust and inequitable, it is not defensible also from the point of view of good economics, since such use of scarce capital could be a diversion from its most efficient or productive use and thus could result in its misallocation. It cannot be conceived that the Quran approves of this kind of inequitable banking.

The second concept of participatory banking can make sense and be appropriate only if a good synchronization can be achieved between the depositors, the banks and the investors in all of the activities where the money gets invested. However, as a review by Berk (Berk 1998[9]) of two recent books written by Gafoor on Islamic banking shows, such synchronization is difficult to achieve. The problems and drawbacks with such banking are that:

· "The intermediary role played by the banks implies that these institutions need to have considerable expertise and experience in project selection and evaluation and assumes that the bank knows as much about the business in question as the entrepreneur does. If not, there is asymmetry in information which could make the banks averse to such participations.

· "Moreover, participatory financing seems applicable only to certain types of projects, i.e., entrepreneurs investing in new enterprises. The failure to recognize the latter drawback is, according to the author (Gafoor), the main reason for the problems currently faced by the Islamic banks. The latter applied the concept of participatory financing to projects for which conventional financing through lending from their deposit accounts would be appropriate.

· "Also, they used funds from other accounts than the investment account for financing the participations. This caused problems as the guarantee of capital is (in the absence of interest) the sole reason for holding these other accounts (i.e. time and savings deposits), and capital is not guaranteed under participatory financing."[10]

Thus the second concept of so-called Islamic banking cannot be appropriately applied to businesses other than new enterprises. This is a serious limitation of such banking. The attempt to apply these banks to other areas has landed them into insurmountable problems emanating from internally contradictory rules of participation. It is far from clear why depositors should be subjected to taking risks of losses in projects where their money is invested. Banks can and should take on full risks on depositors' behalf, as in the conventional interest-bearing system, as this makes them more responsible in investing money.

It thus appears that the attempt to go without interest in banking activities is genuinely problematic, economically inefficient, unjust to the depositors, and is not so useful in a modern economy. The problems of so-called Islamic banks are compounded also by the fact that they operate side by side with, and are still in need of the economic functions performed by, the "Western-style" interest-bearing banking system.

Note that a substantial part of bank deposits belongs to the poor and middle-income groups of people, and that the relatively rich people employ such deposits for business investment purposes. In such a situation, if the depositors are deprived of any return on their deposits, or if, in the case of participatory financing, even their original capital is not guaranteed, then will this not be a highly inequitable, discriminatory treatment meted out to the relatively poorer people? Can we think that this is what the Quran approves of? The answer should be unequivocally: No. It is obvious that such a system exposes the depositors to great risks of losses, risks that they can avoid from the conventional interest-bearing banking system. At the same time they are also deprived of even a minimum return on their deposits, which they can earn from the conventional banking system in the same country or abroad.

Thus the so-called Islamic or interest-free banking is a misnomer – a deviation from the true spirit of the Quranic message. The Quranic message of interest-free loans is applicable only for disadvantaged borrowers, who deserve to be treated with a humanitarian approach. The kind of interest that the Quran prohibits is usury or interest that is charged to people who deserve to be given an interest-free loan on humanitarian grounds. This is Qarz-Hasana or a beautiful loan that the Quran talks about in several verses [Baqarah (2): 245; Hadid (57): 11, 18; Tagabun (64): 17; Maidah (5): 12; Muzzammil (73): 20]. This is a loan without interest or expectation of any gain to deserving people on humanitarian grounds. The question of interest cannot arise in such cases. The Quran even encourages the lenders to write off the original loans in cases where the borrowers are in difficulty to repay them. Some of the relevant verses are as follows:

Who is it that will lend unto God a beautiful loan, so that He will increase it manifold? God straiteneth and enlargeth. Unto Him ye will return. [Baqarah (2): 245]

O ye who believe! Observe your duty to God, and give up what remaineth of usury, if ye are indeed believers. And if ye do it not, then be warned of war from God and His Messenger. And if ye repent, then ye shall have your principal. Deal not unjustly, and ye shall not be dealt with unjustly. And if (the debtor) is in difficulty, then postpone (repayment) until (he is in) ease; and that ye remit it as almsgiving (Sadka) is better for you if ye but knew. [Baqarah (2): 278-280]

It is clear from these verses that in cases, which deserve humanitarian considerations, loans should indeed be extended free of interest, and where appropriate, such loans should be given as grants or alms (which is sadaqa in Quranic terminology). But when loans are extended for business purposes, taking no interest as a substitute for potential profits, which borrowers can make on such loans, is clearly unjust to the lenders, and cannot thus be disapproved of by the Quran. In a Muslim country like Iran, banks charge what they call “estimated profit” on loans extended to traders and enterprises, and provide “an estimated profit” on bank deposits. This is nothing but interest in the guise of profit. Co-operative banks in the USA provide what they call “dividends” on their members’ deposits. But this is nothing but interest. Where money is used for profitable purposes, it is only just that that profit the borrower earns be distributed between the borrower and the lender. The return the lender gets is profit-linked but essentially interest in nature.

The Quran in fact encourages and approves of what are just and equitable. And whether any nominal interest is charged or not in any lending-borrowing transaction, some interest in real terms is almost always involved in view of the real world situation where prices of goods and services invariably change. However hard we try to do it, we generally cannot go without interest. And the working of the modern economy in an efficient manner is inconceivable without interest playing a central positive and beneficial role. This is not what the Quran forbids.

We need also to take into account the fact that side by side with the institutional credit market served by banks, an informal credit market also exists and operates in many countries. The informal credit market operates precisely because the formal banks do not serve the needs of all willing borrowers. Banks operate by lending against collateral. However, small businesses and poorer borrowers often lack such collateral, and accordingly they have little or no access to bank credit. The informal market serves such borrowers, and usually the interest rate charged on such loans is considerably higher than that charged by banks. It is most likely that lenders in this market charge exorbitantly high interest rates that deserve to be condemned. Taking advantage of the unusual character of the informal market, even a reputable institution such as the Grameen Bank of Bangladesh, which lends to the destitute people, charges very high interest rates. In such a situation, it should be the duty of the government to bring such interest rates into line with the rates charged by the regular banks by subsidizing the Grameen Bank in an interim period, and by introducing pro-active policies that allow more credit institutions of the same type to come into existence and operate like the Grameen Bank. Currently the Grameen Bank is in a position to charge a high interest rate precisely because of its monopolistic situation. Having said this, it should, however, be recognized that despite the high interest rate, the very availability of credit for the poor has been serving a very noble cause, in recognition of which the Grameen Bank and its founder Dr. Muhammad Yunus were awarded the Nobel prize for peace in 2006. But a change of the current situation into one where the poorer people get access to credit at rates comparable to, or even lower than, those charged by banks will be highly desirable There is clearly a need for benevolent people who should come forward to extend interest free loans or even grants to needy and deserving people, in the way the Quran dictates.

Finally, we need to also point out that an excessive interest rate hurts both investors and consumers, and hurts growth and development of an economy. At the same time too low a rate encourages excessive credit expansion in the economy, too much investment and consumption, leading to an overheating of an economy and inflation. On the other hand, a high inflation in the economy requires a high nominal interest rate to be maintained to control inflation. An excessive budget deficit causes inflationary pressure in an economy, which in turn causes the nominal long-term interest rate to rise. The interest rate also influences a country’s exchange rate by influencing capital flows. On the other hand, a country’s investments, and thus growth may be influenced by external capital flows, which in turn can influence the interest rate. An increase in the real rate of growth in an economy raises the real interest rate and hence the nominal interest rate as well. Thus interest in an economy is interlinked with many economic variables. The central bank of any economy needs to carefully weigh all such relevant variables to set its central interest rate at an appropriate level, around which all other interest rates in the economy are adjusted.

Conclusion

The Quran calls for a free and exploitation-free egalitarian economic system. Strict observance of justice and fairness necessarily implies ensuring a system that has the least distortions in economic activities (production, trade, etc.) and prices (prices of goods and services, of capital, etc.) that come from controls, restrictions and monopolistic practices, etc. While there should be recognition of private initiative and enterprise, and hence of private property and ownership, this should be subject to an understanding that all things ultimately belong to God. One important implication of the Quranic directions is that there should be an equitable distribution of economic resources, especially land, if these are found to be starkly unequal in a society. An important message of Islam is that none should fully enjoy his own fruits of labor but share them with his fellow beings through an appropriate distribution system. Such a system must necessarily encompass public welfare and development expenditures. Contrary to what is generally believed among Muslims, the Quran does not really condemn interest per se that is being universally used for lending and borrowing purposes and also as a monetary policy instrument and an essential device for efficient allocation of productive resources. What it condemns is interest that is charged to people who deserve humanitarian treatment. So-called Islamic interest-free banking is a misnomer, an unsound institution and a drag on the development of Muslim countries.

[1] For some illumination on this point, see endnote 1 of Chapter 6.

[2] This is an economic argument. It states that tinkering with taxes and subsidies that may affect production itself or prices (of goods, services or factors of production) would distort the appropriate allocation and efficiency of productive resources, resulting in less than optimal production and growth in the economy. Hence public assistance programs should be devised in such a way that they do not distort production and prices in the economy.

[3] The neo-classical position that market-clearing activities under laissez faire leads to an optimal solution is valid only when the given distribution of income and wealth in society can be considered as sacrosanct or optimal. If, however, the given wealth and income distribution is considered to be highly or significantly inequitable, there should be a prior redistribution of such wealth and income. For example, there are countries, where the existing distribution of land resources is highly unequal, which requires redistribution in favor of the landless. This is dictated also by good economics from the point of view of maximizing or optimizing production in the economy.

[4] For some discussion of this point, see Chapter 3, Section on the Significance of Spending in God's Way.

[5] Rauf, Imam Feisal Abdul, What is Right with Islam: A New Vision for Muslims and the West, HarperCollins Publishers, Inc., New York, 2004, pp. 3-4.

[6] This happens as follows: As long as an individual's marginal time preference (i.e., time preference at the margin of his spending, i.e., time preference when he spends his last dollar) is larger than the current interest rate, he will continue to spend on his current consumption until his marginal time preference (which falls with higher and higher spending) becomes equal to the interest rate. He cannot increase his marginal spending on current consumption beyond this point, since in that case interest cost of present consumption would be larger than his time preference. Thus interest plays the essential role of an allocative device between consumption and saving of individuals.

[7] A higher rate of growth in the economy, which is associated with higher profits or returns on invested capital, thus gives rise to a higher real rate of interest.

[8] Capital can be used in alternative ways. One will invest in ways where the return on capital is the highest to the point where the return at the margin, i.e., return on the last dollar invested becomes equal to the existing interest rate. The interest rate thus plays both as a rationing device, i.e., it helps ration the uses of the capital to the amount of the existing available capital and it also allocates capital

resources between different uses so that the possible maximum profit potential can be realized, and possible misuses avoided.

[9] See Berk, Jan Marc, “Book Review” (Review of two books by A.L.M. Abdul Gafoor: Interest-Free Commercial Banking, Apptech Publications, Groningen, 1995, and Participatory Financing through Investment Banks and Commercial Banks, Apptech Publications, Groningen, 1996), De Economist(Quarterly Review of the Royal Netherlands Economic Association), Vol. 146, No. 1, April 1998.

[10] Berk 1998, ibid

[11] http://www.iuniverse.com/bookstore/BookDetail.aspx?BookId=SKU-000063556