



*Islamic Development Bank  
Islamic Research And Training Institute*

# WHAT IS ISLAMIC ECONOMICS?

*IDB Prize Winners' Lecture Series  
No. 9*

# ISLAMIC RESEARCH AND TRAINING INSTITUTE

## Establishment

The Islamic Research and Training, Institute (IRTI) was established by the Board of Executive Directors of the Islamic Development Bank (IDB) in 1401H (1981.) The Executive Directors thus implemented Resolution No. BG/14-99, which the Board of Governors of IDB adopted at its Third Annual Meeting, held on 10 Rabi Thani 1399H (14 March 1979.) The Institute became operational in 1403H (1983.)

## Purpose

The purpose of the Institute is to undertake research for enabling the economic, financial and banking activities in Muslim countries to conform to Shari 'ah, and to extend training facilities to personal engaged in economic development activities in the Bank's member countries.

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The functions of the Institute are:

- (a) to organize and coordinate basic and applied research with a view to developing models and methods for the application of Shari 'ah in the fields of economics, finance and banking;
- (b) to provide for the training and development of professional personnel in Islamic Economics to meet the needs of research and Shari 'ah observing agencies;
- (c) to train personnel engages in development activities in the Bank's member countries;
- (d) to establish an information center to collect, systematize and disseminate information in fields related to its activities; and
- (e) to undertake any other activities which may advance its purpose.

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The Institute consists of three technical divisions (Research, Training, Information) one division of Administrative and Financial Services.

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## Address

ISLAMIC DEVELOPMENT BANK  
ISLAMIC RESEARCH AND TRAINING INSTITUTE  
Postal Address: P.O.Box 9201, Jeddah 21413  
Kingdom of Saudi Arabia  
Cable Address: BANKISLAM= Jeddah Telephone: 6361400  
Facsimile: 6378927 6366871  
E. Mail Address : IDB @ ISDB.ORG.SA Home Page: HTTP ://WWW.IRTI.ORG



*Islamic Development Bank  
Islamic Research and Training Institute*

# **WHAT IS ISLAMIC ECONOMICS?**

**Dr. Mohammad Umar Chapra**

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## FOREWORD

As an international financial institution serving the *ummah*, the Islamic Development Bank (IDB) aims at fostering economic development and social progress of member countries and Muslim communities in accordance with principles of *shariah*. In order to achieve its objectives and to discharge the necessary obligations at an operational level, pertaining to research, training and dissemination of information, IDB established Islamic Research and Training Institute (IRTI) in 1401H (1981G) which became operational in 1403H (1982G).

In addition to conducting research and training activities, IRTI has started a number of schemes to promote and encourage Islamic economic activities all over the world. These schemes aim at promoting external expertise and harnessing the resources of the *ummah* for the promotion of Islamic economics. IDB prizes in Islamic economics and banking is one of these activities. The objective of these prizes is to recognize, reward and encourage creative efforts of outstanding merit in the fields of Islamic economics and banking. One prize is awarded every year alternating between Islamic economics and banking.

The IDB prize in Islamic economics for the year 1409H (1989G) was awarded to pr. Muhammad Umar Chapra, who is one of the pioneers of Islamic economics. The prize was awarded to him in recognition of his valuable contributions characterized by analytical rigor and deep command of Islamic economic concepts and in appreciation of his active role for the promotion of Islamic economics through international conferences, seminars, workshops and lectures.

Dr. Chapra has a thorough understanding of economic concepts and his writing style is highly scientific. His writings have inspired many Muslim and non-Muslim scholars. His style is so lucid that it appeals to



specialists and no-specialists alike. In view of these unique abilities of Dr. Chapra, he was requested to deliver the IDB prize laureates' lecture on the topic "What is Islamic Economics?". IRTI is now pleased to

present this valuable lecture for the benefit of all those who are interested in Islamic economics.

In this lecture, Dr. Chapra has explained both the subject matter of Islamic economics as well as its methodology in his usual masterly fashion. He has also presented a comparative perspective for solving the eternal `economic problem: He has explained how the Islamic economics. paradigm deals with this problem and allocates the scarce resources among their alternative uses in such a way that human well-being is maximized without sacrificing social objectives.

Being well-versed in conventional economics and at the same time being a pioneer of Islamic economics, there could be nobody better than Dr. Chapra to explain the paradigm of Islamic economics which has attracted the interest of Muslim as well as non-Muslim scholars in the last two decades. It is hoped that the publication of this valuable lecture will enhance the understanding of this nascent science and will help in its development on scientific lines.

Dr. M. Fahim Khan  
Officer-in- charge, IRTI

## **PREFACE**

This paper is the revised and expanded version of a lecture delivered by me on 29 October 1990 at the premises of the Islamic Development Bank in Jiddah, after receiving the Bank's Award kindly awarded to me as a recognition of my humble contribution to Islamic economics.

I wish to record my thanks to IRTI for its constant encouragement to complete the revision and expansion, which I was unable to do until now because of a number of other pressing commitments. The basic ideas in this revised version are the same as those in the original lecture. However, since the lecture was delivered before a mixed audience which did not consist of only economists, the ideas had to be expressed in non-technical language which everyone could understand. Such! a restraint sometimes makes it difficult to say everything that the author would like. Although an effort has been made even in the revised version to keep it simple to retain its accessibility to even the non-economist, the generally well-known technical words have not been totally avoided.

I have benefited from the translations of the Qur'an by Abdullah Yusuf Ali, T. B. Irving, and Muhammad Asad, even though I have not reproduced their translations. Translations of ahadith and other Arabic literature are my own.



## INTRODUCTION

The subject matter of all economics, irrespective of whether it is mainstream or Islamic, is the allocation and distribution of scarce resources which have unlimited uses. However, precisely because of the scarcity of resources and their alternative uses, it is not every allocation and distribution which is acceptable to society. Hence, economics has also been directly or indirectly involved in a discussion of human well-being, to be realized through an improvement in the allocation and distribution of resources in conformity with the social vision.

Different worldviews, however, reflect different social visions, and the worldview of a society, therefore, imperceptibly tends to exert a significant influence on economic discussions. Since conventional western economics dominates modern economic thinking, it may be easier for us to understand Islamic economics if we look at it against the backdrop of conventional economics. Part one of this paper, therefore, discusses the goals, worldview and method of conventional economics, to prepare a suitable background for the discussion of Islamic economics in part two.



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*PART I*

**CONVENTIONAL ECONOMICS**  
**CONFLICT BETWEEN GOALS AND WORLDVIEW**

Conventional economics has set before itself two different sets of goals. One of these is what may be termed positive, and relates to the realization of 'efficiency' and 'equity' in the allocation and distribution of scarce resources. The other is what may be called normative, and is expressed in terms of the universally-desired socio-economic goals of need-fulfillment, full employment, optimum rate of economic growth, equitable distribution of income and wealth, economic stability, and ecological balance, all of which are generally considered indispensable for actualizing human well-being. Both of these sets aim at serving individual as well as social interest in conformity with the worldview that underlies each of them. Nevertheless, the first set has been called positive because of the claim that efficiency and equity can be determined without value judgments, while the second has been called normative because it reflects the society's values about what ought to be. Whether or not these two sets of goals are mutually consistent depends on how efficiency and equity are defined. This will become clear with the progress of the discussion.

The use of scarce resources in a way that both the positive and the normative goals are realized brings into focus the need for three indispensable mechanisms: filtering, motivation, and socio-economic restructuring. Firstly, the unlimited claims on resources need to be passed through a filter in such a way that not only a balance is attained between supply and demand but also all those claims are eliminated that are in conflict with goal realization. Secondly, if coercion is ruled out, then such filtering needs to be brought about by motivating all individuals sufficiently to put in their best performance and to abstain from the use of resources in away that frustrates goal realization. Motivation acquires a great significance in economics as compared with, say, physics, because economics deals with human beings who may or may not always behave in a standard predictable manner. Hence, human beings need to be motivated to behave in a manner that would facilitate goal realization.

Thirdly, it is also necessary to have socio-economic restructuring to enable a prompt and smooth transfer of human and material resources from one use to another until both sets of goals have been realized. Within this perspective anything that prevents the kind of filtering, motivation and restructuring that goal realization requires is a distortion, and any use of resources that does not directly or indirectly contribute to, or is in conflict with, goal realization is 'unproductive', 'inessential' or 'wasteful' .

Whether or not conventional economics has been able to realize its positive goals is not possible to say because of the difficulty of defining and measuring both efficiency and equity in a dynamic economy. However, it is generally agreed that even the rich industrial countries have been unable to realize their normative goals in spite of substantial resources at their disposal. What could be the reason for this failure?

This failure may be due to two reasons: firstly, the inability of conventional economics to suggest a proper strategy, and . secondly, the inability of the society concerned to implement the strategy effectively. The question of implementation, however, acquires significance only if the strategy is proper. Within the perspective of this paper, the primary reason may perhaps be the inability of economics to suggest a proper strategy, and the primary reason for this may be the conflict between the worldview of conventional economics and its normative goals. The normative goals are the by-product of belief in human brotherhood, which is in turn the by-product of a religious worldview that emphasizes the role of belief in God, accountability of human beings before Him, and moral values in the allocation and distribution of resources. The strategy is, however, the outcome of the Enlightenment movement, the worldview of which was basically secularist. It considered all the revealed truths of religion as "simply figments of the imagination, nonexistent, indeed at the bottom priestly inventions designed to keep men ignorant of the ways of Reason and Nature".<sup>1</sup> This weakened the hold of religion and the collective sanction it provides to moral values, and thus deprived the

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<sup>1</sup> Brinton, 1967, p.520.



society of morally-oriented filtering, motivating and restructuring mechanisms. It also gave rise to materialism and social Darwinism which were both at variance with the concept of human brotherhood.

### **THE THREE BASIC CONCEPTS**

The secularist worldview gave rise to a number of concepts which constitute the paradigm of conventional economics. One of these was that of rational 'economic man'. Given the materialist and social Darwinist outlook of this worldview, rational behavior did not get identified with what was necessary to serve the social interest or to realize the normative goals. It rather became equated with unhindered freedom of the individual to pursue his self-interest. Individual self-interest in turn became identified with the maximization of wealth and want satisfaction, independent of its impact on the well-being of others. Such an emphasis on the pursuit of self-interest had a social stigma attached to it because of its apparent conflict with the prevalent social vision. Adam Smith helped remove this stigma by arguing that if everyone pursued his self-interest, the 'invisible hand' of market forces would, through the restraint imposed by competition, promote the interest of the whole society.' By thus implicitly assuming an inevitable harmony between self-interest and social interest, Adam Smith turned the eyes away from the social obligations of individuals to the 'unintended' consequences or the final social outcome of their actions. The general equilibrium theory is, as Rosenberg has put it, "the formalized approach to the systematic study of this claim about how the unintended consequences of uncoordinated selfishness result in the most efficient exploitation of scarce resources in the satisfaction of wants."

The second concept was that of 'positivism'. 'Positiveness' did not, however, become defined in terms of the impact on normative goals. It rather became defined in terms of unrestrained individual freedom.

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<sup>2</sup>Smith, 1776, p.423.

<sup>3</sup>Rosenberg, 1992, p.219; see also Backhouse, 1994, p.13.

Economics thus became "entirely neutral between ends",<sup>4</sup> and "independent of any particular ethical-position or normative judgements".<sup>5</sup> The preferences or subjective valuations of individual members of society were to be taken as given. No judgment could be passed on these in terms of their consistency with normative goals. This doctrine of *wertfreiheit* (freedom from value judgments) has become an indispensable and non-controversial part of the economics paradigm and is generally accepted unquestionably by the rank and file of the

profession. Consequently, it has become the primary task of economists to describe and analyze what 'is' to be able to predict what may happen in the future.' They cannot pass any judgment on what 'is', or suggest what 'ought to be'. They may discuss only the possibility function and not the preference function.

Positivism also became "associated with the belief that any question asked by economics must have an empirically determinable right or wrong answer." If the answer is not empirically determinable, economics should not consider the question. This automatically led to emphasis on concepts which are measurable in pecuniary or material terms. The Social Science Research Building at the University of Chicago reads: "If you cannot measure, your knowledge is meager and unsatisfactory".<sup>8</sup> Such an attitude deprived economics of the task of analyzing the impact of social values and institutions on the allocation and

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<sup>4</sup>Robbins, 1935, p.24.

<sup>5</sup>Friedman, 1953, p.4.

<sup>6</sup>There is a difference of opinion among economists on the goal of economic method. Positivists and operationalists, like Samuelson, emphasize that the role of economics is only to describe. Logical empiricists however insist that explanation is the goal of economics. In contrast with both of these, instrumentalists, like Friedman, emphasize that prediction is the primary function of economics (See Blaug, 1980; and Caldwell, 1982). Since I do not wish to get into this controversy in this brief paper, I have mentioned all three in the text.. There is another goal, persuasion, which has also become emphasized (McCloskey, 1986). It is, however, not different from explaining and predicting because it may not be possible to persuade without convincing explanation and reliable prediction.

<sup>7</sup>Colander, 1992, p.113.

<sup>8</sup>Cited by Kuhn, 1961, p.161.

distribution of resources<sup>9</sup> and of suggesting a programme of social steering to actualize the social vision.

The third concept, which was essentially a derivative of the assumed harmony between individual and social interests, was that of the efficacy of market forces. It was asserted that the economy will run efficiently if left to itself. Any effort on the part of the government to intervene in the self-adjusting market on the basis of society's normative goals could not but lead to distortions and inefficiency. The government should hence abstain from intervening. Market forces would themselves create 'order' and 'harmony', and lead to 'efficiency' and 'equity'. Even though the Great Depression and the resultant Keynesian revolution tended to undermine this faith in the efficacy of market forces, the recent disenchantment with large government role in the economy has restored it once again and there is a call for liberalism or return, as nearly as possible, to the classical model with 'minimum' government intervention.

## **PARETO EFFICIENCY AND NORMATIVE GOALS**

Such a paradigm had the effect of making the market the only determinant of efficiency and equity in the allocation and distribution of resources and of virtually eliminating the role of all other factors, including social values and institutions. Market-determined prices (and costs, which are also prices) became the only filtering mechanism and self-interest the only motivating force. It was argued that self-interest would lead the sovereign consumers to buy at the lowest price whatever was in conformity, with their preferences, the only constraint being their disposable income. Self-interest would also induce the producers to produce at minimum cost whatever they considered to be best for maximizing their! profit. The free interaction of utility-maximizing consumers and profit-maximizing producers would, under perfectly competitive market conditions, determine the market clearing prices for goods and services and lead to the production of that configuration of goods and services which maximizes not only consumer utilities but also

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<sup>9</sup> Blaug, 1980, p.149.

the incomes of factors of production on the basis of their contribution to output and revenue. At the point of equilibrium, consumer satisfactions (utilities) would be maximized, supplier costs minimized, and factor earnings maximized, thus ensuring not only the most productive use of resources but also harmony between public and private interests. This equilibrium is termed Pareto efficient.

There is perhaps no other concept which has acquired as firm a place in the paradigm of conventional economics as Pareto efficiency. The word equity is - normally not mentioned explicitly within this paradigm; it is implicitly assumed that Pareto efficient is also the most equitable.<sup>10</sup> Thus equity, became defined in terms of the Pareto optimum rather than the normative goals. Every socially-steered programme for change must pass the test of Pareto optimum - making at least one person better off without making anyone worse off. According to John Rawls, one must never act solely to increase general happiness, if in doing so one makes any particular person unhappy." Since economic policies do not in general make some people better off without making anyone worse off, what Pareto optimum did achieve in reality was a near-paralysis of policy-making, by leading, in the words of Solo, "to inaction, to nonchoice, to drifting".<sup>12</sup> Charles Schultze has, therefore, called the Pareto optimum as the "do no direct harm" principle - the precept that government actions must never harm anyone directly. He argues that this principle is a major reason why sensible economic reforms rarely prevail in the political arena." It also deprived theoretical discussions and policy prescriptions of a proper direction and perspective.

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<sup>10</sup>There is no doubt that a number of economists do not support this view. It is however a logical outcome of the belief in the efficacy of market forces, and economists like J. B. Clark felt that factor incomes in the real world closely approximated the marginal product and its value (See Stigler, 1941). Friedman very clearly states: "However, we might wish it otherwise, it simply is not possible to use prices to transmit information and provide an incentive to act on that information without using prices also to affect, even if not completely determine, the distribution of income". (Milton and Rose Friedman, 1980, p.23).

<sup>11</sup>Rawls, 1958.

<sup>12</sup>Solo, 1981, p.38; see also Sen, 1987, p.32.

<sup>13</sup>Schultz, 1957, Chapter 4.

Thus the terms efficiency and equity, as defined within the paradigm of conventional economics, were related to Pareto efficiency and did not necessarily have a direct relationship with the normative goals. The *ceteris paribus* clause ruled out the possibility of several equilibrium over time and space, only one of which may probably be consistent with the normative goals. This led to the implicit assumption that every market equilibrium was a Pareto optimum and would lead to the realization of normative goals, at least in the long-run, as a necessary concomitant of efficiency and equity brought about by the competitive equilibrium. Hence, equilibrium economics became "an apologia for existing economic arrangements;"<sup>14</sup> and led to the belief that any outside intervention to change the status quo would necessarily lead to results which were less efficient and less equitable. The only acceptable way to change the status quo was within the framework of Pareto optimality.

## THE BACKGROUND CONDITIONS

Keynes effectively demolished the belief that every market equilibrium was consistent with full employment. Since full employment is only one of the normative goals, it is important to see whether it is possible for every market equilibrium to be in harmony with the other normative goals. Such harmony may be expected to prevail, given the complete freedom on the part of individuals to pursue their self-interest and the absence of a socially-agreed moral filter, if certain background conditions were satisfied. Some of the most indispensable of these conditions are: (a) harmony between individual preferences and social interest; (b) equal distribution of income and wealth; (c) reflection of the urgency of wants by prices; and (d) perfect competition.

Adam Smith assumed : that condition (a) was automatically satisfied in a competitive free-market economy, and this assumption has become a part of the economics paradigm. However, while there is undoubtedly a harmony between individual and social interests in some cases, there is also a conflict in other cases. It is the possibility of this

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<sup>14</sup>Hahn, 1970.

conflict which may make' the realization of normative goals difficult unless the conflict is removed. This may be better appreciated if one were to examine the need for reducing domestic absorption (aggregate consumption and investment by both the public and the private sectors) to remove the macroeconomic imbalances that a number of countries are now encountering. If the effect on normative goals was to be disregarded, then the market strategy may perhaps be the most effective way of reducing domestic absorption. However, given the prevailing high levels of unemployment, it may not be possible to satisfy the imperative of full employment without accelerating investment and growth. Hence, consumption may perhaps be the primary component of domestic absorption that may have to be reduced. Moreover, if the goal of need-fulfillment is also not to be compromised, then it may not be desirable to reduce the consumption of all goods and services. It may be argued that social interest would be served better if the consumption of status symbols and other consumers' goods that do not necessarily fulfil a need or reduce a hardship were curtailed.

Such -a distinction between different goods on the basis of normative goals may not, however, be possible or acceptable within the paradigm of conventional economics. This is because conventional economics does not allow the passing of any judgment on individual preferences and relies primarily on choice through the market to determine the individual preferences that may or may not be satisfied. Any criteria other than prices and the ability to pay would involve interpersonal utility comparisons and value judgments and also violate the condition of Pareto optimality by requiring the rich to forego, in the interest of investment and need-fulfillment, something that they would prefer to have as individuals. It is not, however, certain whether choice through the market would help reduce the different components of domestic absorption in a manner that would be in conformity with normative goals.

Similarly, one could argue that preventing the pollution of a country's rivers was in the interest of social well-being. The market paradigm, however, leads one to argue that pollution is primarily a consequence of the misallocation of resources that results from the failure

of the market brought about by the divergence between private and social costs. However, any measure to internalize the externality (making the social cost of pollution enter private costs), may not only require value judgments but also violate the condition of Pareto optimality by making the consumers and producers of that product worse off through a higher price and lower profit, even though it would make the society as a whole better off. If social costs were to be entered into private costs in this case, then why shouldn't the social costs resulting from lack of need-fulfillment, unemployment, inequitable distribution, and economic instability also be taken into account? May one stop here to also ask why conventional economics does not hesitate to make some value judgments but abstains from making others?

Satisfaction of condition (b), equal distribution of income and wealth, would give all consumers an equal weight in influencing the decision-making process of the market. Producers, being assumed to be passive suppliers would automatically fall in line. Thus, assuming that everyone would 'give priority to need-fulfillment, there would be no distortion in resource allocation against need-fulfillment. However, since there are substantial inequalities of income and wealth and since the rich are also able to have a far greater access to credit, they have the ability to buy whatever they wish at the prevailing prices. Primary reliance on prices may not create any significant dent in their demand for status symbols and other inessential and unproductive goods and services. They may tend to divert scarce national resources, by the sheer weight of their votes, into products which may tend to command a lower priority on a social preference scale which has general need fulfillment as one of its primary objectives.

The value-neutral price system may not even be concerned with how many votes an individual has and how he uses them. It evaluates the urgency of wants of different consumers on the basis of their ability to pay the price. However, although the urgency for milk may be the same for all children, irrespective of whether they were poor or rich, the number of dollar votes that a poor family is able to cast for milk is not the same as those that a rich family is able to cast for status symbols. If the ability to pay, prices does not necessarily reflect the urgency of wants,

condition (c) does not get satisfied. Hence Arthur Okun has rightly observed that markets tend to "award prizes that allow the big winners to feed their pets better than the losers can feed their children."<sup>15</sup>

Coming now to condition (d), it is well-recognized that even though perfectly competitive markets are a theoretical construct of great analytical value, they constitute an unrealized dream in the real world, and are likely to remain so in the future. The innumerable imperfections that exist in the market thwart the efficient operation of market forces and produce deviations from ideally competitive marginal cost pricing; thus leading to prices that do not reflect real costs or benefits. Hence, while prices may not, by themselves, be capable of bringing about a socially-desired allocation and distribution of resources, they may tend to be more so if they do not even reflect real costs and benefits.

Since no real world market is likely to satisfy the background conditions even approximately,<sup>16</sup> there is a considerable distortion in the expression of priorities in the market place. This introduces a built-in bias against the realization of normative goals if reliance is placed primarily on prices for the allocation and distribution of resources.

### **THE INCONSISTENCY BETWEEN MICROECONOMICS AND MACROECONOMICS**

Conventional economics has thus become engulfed into self-contradictory positions. This is because of, using Kuhn's terminology,<sup>18</sup> the "scientific revolution" brought about by the shift from a religious to a secularist paradigm. The secularist paradigm has led to an excessive commitment to neutrality between ends, abstinence from value judgments, and choice primarily through the market. Nevertheless, the commitment to the normative goals of the previous religious worldview

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<sup>15</sup>Okun, 1975, p.11.

<sup>16</sup>Brittan, 1985, p.16.

<sup>17</sup>Tawney, 1948;  
p.12. <sup>18</sup> Kuhn, 1970.



continues. If the goals had also been derived from the secularist world view, there might perhaps have been no inconsistency. However, the adoption of the goals of a religious worldview in the face of an unavoidable resource constraint does not permit excessive individual freedom enshrined in the secularist paradigm. One of the primary functions of values, which the religious worldview provides and obligates its followers to abide by, is to facilitate the use of scarce resources in conformity with the needs of goal realization. The market is by itself unable to do this - it cannot discriminate between the various uses of resources on the basis of their contribution to normative goals. Dependence primarily on individual preferences and prices for allocating and distributing resources seems to work against the realization of humanitarian goals in a secularist paradigm if the background conditions are not satisfied. [This may be one of the major reasons why, in spite of living beyond means and the macroeconomic imbalances resulting from this, the needs of a substantial part of the population remain unfulfilled. There is also inadequate saving, investment, employment, and growth.

What conventional microeconomics should have done is to take the macroeconomic goals derived from the religious worldview as its starting point, and to indicate the individual and firm behavior that would be consistent with these goals. This has not been done. Hence, there does not exist a clear link between the goals of conventional macroeconomics and the analytical framework developed by its microeconomics. Lucas and Sargent have thus rightly pointed out that "since its inception, macroeconomics has been criticized for its lack of foundations in microeconomic and general equilibrium theory."<sup>19</sup> Arrow also considers the absence of this link as "one of the major scandals of current price theory."<sup>20</sup> In a market economy, where the government's role is expected to be limited, if the microeconomic analysis is also not conducive to goal-realization, the goals hang in the air without any logistic support.

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<sup>19</sup>Lucas and Sargent, 1979, p.4.

<sup>20</sup>Kenneth Arrow, 1967. p.734. See also, Peter Howitt, p.273.

Positive economics and normative goals are hence mutually inconsistent and cannot coexist harmoniously in the same analytical framework or what Lakatos calls, "scientific research programme". However, instead of trying to resolve this conflict between its paradigm and its normative goals and reforming its assumptions and logical structure accordingly to enable it to play a more effective role in policy formulation and goal realization, conventional economics has moved more and more in the direction of greater mathematical elegance. This has not only made it more abstract and difficult but also of little relevance to the policy maker who is answerable to his electorate for the realization of normative goals. The accepted wisdom of neoclassical economics is therefore being increasingly questioned and, as Blaug has rightly stated, "there are growing numbers who suspect that all is not well in the house that economics has built".<sup>22</sup> A number of economists have even emphasized the need for a new paradigm.<sup>23</sup> However, the form that the new paradigm might take is as yet incompletely articulated.

This brings us to a discussion of the paradigm, goals and method of Islamic economics.

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<sup>21</sup>Lakatos, 1974.

<sup>22</sup>Blaug, 1980, p.xiii.

<sup>23</sup>See for example, Balogh, 1982; Bell and Kristol, 1981; Dopfer, 1976.

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## PART

## II ISLAMIC ECONOMICS

### THE PARADIGM

Islamic economics is based on a paradigm which has socio-economic justice as its primary objective (Qur'an, 57:25).<sup>24</sup> This objective takes its roots in the belief that human beings are the vicegerents of the One God, Who is the Creator of the Universe and everything in it. They are brothers unto each other and all resources at their disposal are 'a *trust* from Him to be used in a *just* manner for the well-being of *all* (repeat all). They are accountable to Him in the Hereafter and will be rewarded or punished for how they acquire and use these resources.

Unlike the secularist market paradigm, human well-being is not considered to be dependent primarily on maximizing wealth and consumption; it requires a balanced satisfaction of both the material and the spiritual needs of the human personality. The spiritual need is not satisfied merely by offering prayers; it also requires the moulding of individual and social behavior in accordance with the *Shariah* (Islamic teachings), which! is designed to ensure the realization of the *maqasid al-Shariah* the goals of the *Shariah*, (hereafter referred to as the *maqasid*), two of the most important of which are socio-economic justice and the well-being of all God's creatures.<sup>25</sup> Negligence of either the spiritual or the material needs would frustrate the realization of true well-being and exacerbate the symptoms of anomie, such as frustration, crime, alcoholism)drug addiction, divorce, mental illness and suicide, all

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<sup>24</sup>For some details related to the paradigm see. Chapra. 1992, pp. 201-13.

". For a brief discussion of the *maqasid*, see Chapra, 1992, pp.7-9. There has been a substantial discussion of the *maqasid* in the *fiqh* literature, some of the most prominent exponents being: al-Matridi (d.333/944), at-Shashi (d.365/975), al-Baqillani(d.403/1012), al-Juwayni(d.478/1085), al-Ghazali (d.505/11 ii), al-Razi (d.606/1209), al-'Amidi(d.631/1234), 'Izz al-Din `Abd al-Salam (d.660/262), Ibn Taymiyyah (d.728/1327), and al-Shatibi (d.790/1388). For a modern discussion of these, see: al-Raysuni, 1992, pp.25-55: Nyazee, 1994, pp.189-268: and Masud, 1977.

indicating lack of inner contentment in the life of individuals. Within this paradigm, more may not necessarily be better than less under all circumstances, as conventional economics would have us believe. Much would depend on how the additional wealth is acquired, who uses it and how, and what is the impact of this increase on the overall well-being of society. More may be better than less, if the increase can be attained without weakening the moral fibre of society, raising anomie, and harming the ecological balance. .

In spite of its emphasis on morals, Islam does not recognize any watertight distinction between the material and the spiritual. All human effort, irrespective of whether it is for 'material', 'social', 'educational', or 'scientific' goals, is spiritual in character as long as it conforms to the value system of Islam. Working hard for the material well-being of one's own self, family and society is as spiritual as the offering of prayers, provided that the material effort is guided by moral values and does not take the individual away from the fulfillment of his social and spiritual obligations. Ideal behavior within the framework of this paradigm does not thus mean self-denial; it only means pursuing one's self-interest within the constraint of social interest by passing all claims on scarce resources through the filter of moral values. These values constitute an inseparable part of the Shariah and were continually provided to all people at different times in history, by a chain of God's prophets (who were all human beings), including Abraham, Moses, Jesus and Muhammad, the last of them. Thus, according to Islam, there is a continuity and similarity in the value system of all revealed religions to the extent that the message has not been lost or distorted over the ages.

It is presumed within this paradigm that morally-oriented individual behavior in an appropriate socio-economic and political environment would help realize socio-economic justice and overall human well-being, just as it is presumed within the market system's paradigm that self-interested behavior in a competitive market would ensure social interest. However, while mainstream economics assumes the prevalence of self-interested behavior on the part of all individuals, Islam does not assume the prevalence of ideal behavior. It adopts the more realistic position that, while some people may normally act in a purely ideal or

self-interested manner, the behavior of most people may tend to be anywhere between the two extremes. However, since ideal behavior is considered to be more conducive to goal realization, Islam tries to bring individual behavior as close to, the ideal as possible. This it does not do by coercion and regimentation. It rather tries to create an enabling environment through social engineering based on moral values, effective motivating system, and socio-economic reform. It also emphasizes the building of enabling institutions,<sup>26</sup> and the playing of an effective goal-oriented role by the government.

### **Two Levels of Filtering**

The necessity of using the moral filter in this paradigm for allocation and distribution of resources does not imply a rejection of the important role played by prices and markets. The moral filter only complements the market mechanism by making the allocation and distribution of resources subject to a double layer of filters. The first (moral) filter attacks the problem of unlimited claims on resources at the very source - the inner consciousness of individuals - by changing their preference scale in keeping with the demands of normative goals. Claims on resources are passed through this filter before they are exposed to the second filter of market prices.

The moral filter is needed because harmony does not necessarily exist between self-interest and social interest, as erroneously assumed by conventional economics. The moral filter tries to create such harmony by changing individual preferences in accordance with social priorities and eliminating or minimizing the use of resources for purposes that do not contribute to the realization of normative goals. If claims on resources are then passed through the second filter of market prices, the price filter may be more effective in creating a market equilibrium that is consistent with normative goals. This may be more so if financial intermediation is

<sup>26</sup>Institutions are defined here as divinely ordained or humanly devised constraints that, according to North, "structure human interaction. They are made up of formal constraints (e.g. rules, laws, constitutions), informal constraints (e.g. norms of behavior, conventions, self-imposed codes of conduct and their enforcement characteristics)", (North, 1994, p.360).

also restructured in conformity with the Islamic value system so as to play a complementary role.<sup>27</sup> The influence that wealth and power are able to exercise in the allocation and distribution of resources may then be substantially reduced. The moral -filter would tend to minimize the built-in bias that the absence of background conditions creates in the allocation of resources against the realization of normative goals.

### **The Problem of Motivation**

The question, however, is that even if a socially-accepted moral filter is available, what would motivate individuals, particularly the rich and the powerful, to pass their claims through it, if this hurts their self-interest? It may be unrealistic to expect a rational person to knowingly act against his self-interest. Moreover, the pursuit of self-interest is not necessarily bad. It is rather indispensable for realizing efficiency and development. It becomes undesirable only if it crosses certain Limits that frustrate the realization of normative goals. How does Islam induce individuals to pursue their self-interest within the bounds of social interest in situations where there is a conflict between self-interest and social interest?

Islam tries to accomplish this task by giving self-interest a longer-term perspective - stretching it beyond the span of this world to the Hereafter. While an individual's self-interest may be served in this world by being selfish in the use of resources, his interest in the Hereafter cannot be served except by fulfilling his social obligations. It is this longer-term perspective of self-interest, along with the individual's accountability before the Supreme Being and the reward and punishment in the Hereafter, which has the potential of motivating individuals to hold voluntarily their - claims on resources within the limits of general well-being, and thus creating harmony between self-interest and social interest even where the two are in conflict.

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<sup>27</sup> Chapra, 1985 and 1992.

## Socio-economic Restructuring

Both the filter mechanism and the motivating system may become blunted if the socio-economic environment is not geared to goal realization. Hence the first two ingredients of the strategy need to be third ingredient - socio-economic and financial restructuring - to create a proper socio-economic environment. Such an environment may be created by properly educating the public, creating an effective framework of checks and balances, and reforming the existing socio-economic, legal and political institutions or building new ones.<sup>28</sup> Congregational prayers, fasting in *Ramadan*, pilgrimage and zakat are a part, but not the whole, of the Islamic programme to create such an environment. They tend to make the individuals and groups conscious of their social obligations and more motivated towards the observance of values even when these tend to hurt their short-term self-interest. The existence of a proper enabling environment may help complement the price system in creating greater efficiency in the use of human and material resources! promoting simple living, and reducing wasteful and conspicuous consumption. This may help realize higher saving, investment, employment and growth. The absence of such restructuring may not only frustrate goal realization, but also exacerbate the existing macroeconomic and external imbalances through greater resort to deficit financing, credit expansion, and external debt.

### The Role of the State

Such a comprehensive socio-economic restructuring designed to help in the actualization of desired goals and minimizing the existing imbalances may not be possible without the playing of an active role in the economy by the state.<sup>29</sup> This is because, even in a morally-charged environment, it may be possible for individuals to be simply unaware of

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<sup>28</sup>For a greater discussion of the needed socio-economic and financial restructuring and its policy implications, see Chapters 7-11 of Chapra, 1992.

<sup>29</sup>See Chapra, 1979, for a more detailed discussion of the obligations, strategy and functions of the Islamic state.

the urgent and unsatisfied needs of others or to be oblivious to the problems of scarcity and to social priorities in resource use. Under such conditions the double layer of filters suggested above, even though indispensable, may not be sufficient

The Islamic state may, therefore, have to play an effective role in the economy. It may have to go beyond the generally recognized roles of providing internal and external security and removing market imperfections and market failure. It may have to help create a proper environment for removing injustice in all different forms and for realizing the society's normative goals. This may have to be done without resorting to regimentation and the use of force, or the owning and operating of a substantial part of the economy. The state may have to determine social priorities in the use of resources and to educate, motivate and help the private sector to play a role which is consistent with goal realization. This it may accomplish by helping internalize moral values among individuals, accelerating social, institutional and political reform, and providing incentives and facilities. It may have to create a proper framework for the interaction of human beings, values, institutions, and markets for the realization of goals without excessive government intervention.

The role of the state in an Islamic economy is not, however, in the nature of an 'intervention', which is an unsavory term and smacks of an underlying commitment to laissez-faire capitalism. It is also not in the nature of the secularist welfare state which, through its anathema to value judgments, accentuates claims on resources and leads to macroeconomic imbalances. It is also not in the nature of collectivization and regimentation, which suppress freedom and sap individual initiative and enterprise. It is, rather, a positive role - a moral obligation to perform a mission in compliance with the divinely-bestowed filter mechanism - to help keep the economic train on the agreed track and to prevent its diversion by powerful vested interests. The test of the Islamic state would lie in its performing the desired role effectively in a way that allows maximum possible freedom and initiative for the private sector. The greater the motivation people have in implementing Islamic values, and the more effective socio-economic institutions and financial intermediation are in creating the proper environment for a just



equilibrium between resources and claims, the lesser will be the role that the state may be required to play in realizing its desired goals. Moreover, the greater the accountability of the political leadership before the people, and the greater the freedom of expression and the success of the news media and the courts in exposing and penalizing inequities and corruption, the more effective the Islamic state may be in fulfilling its obligations.

## **REDEFINING EFFICIENCY AND EQUITY**

The total shift in paradigm should enable us to move away from the abstract mainstream definition of efficiency and equity in terms of Pareto optimality to a more down-to-earth definition in conformity with the normative goals.<sup>30</sup> An economy may be said to have attained optimum efficiency if it has been able to employ the total potential of its scarce human and material resources in such a way that the maximum feasible quantity of need-satisfying goods and services has been produced with a reasonable degree of economic stability and a sustainable rate of future growth. The test of such efficiency lies in the inability to attain a socially more acceptable result without creating prolonged macroeconomic imbalances, and without unduly upsetting the ecological balance. An economy may be said to have attained optimum equity if the goods and services produced are distributed in such a way that the needs of all individuals are adequately satisfied and there is an equitable distribution of income and wealth, without adversely affecting the motivation for work, saving, investment and enterprise.

## **SOCIALLY ACCEPTABLE MARKET EQUILIBRIUM**

Such a redefinition of efficiency and equity may rule out the possibility of considering every market equilibrium as optimum and acceptable. Only that market equilibrium may be considered to be optimum and acceptable which leads to the actualization of normative goals. If a market equilibrium of this quality does not get established, then this is because of distortions which frustrate its realization. The only

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<sup>30</sup> See Chapra, 1992, p.3.

distortions that conventional economics recognizes are, those that arise from market imperfections and market failure. To these may be added the distortions resulting from consumers' tastes and preferences, socio-economic institutions, and individual and group behavior not being in conformity with what is necessary to realize normative goals. These distortions may have to be removed to create an enabling environment for goal realization.

If consumer tastes and preferences and socio-economic institutions need to be reformed to create a harmony between individual and social interests, then the 'sovereign' consumer may not remain sovereign. It may not be realistic to talk of goal realization and absolute consumer sovereignty at the same time; the two are self-contradictory and may not be entertained simultaneously. A balance needs to be struck between the two. „Since coercion is also ruled out, then the injection of a moral dimension into the market system may perhaps be the best way to create a voluntary restraint on consumer sovereignty and thus bring about harmony between self-interest and social interest. It may not be desirable to be unduly concerned about this restriction of individual choice. If advertising is considered acceptable even though it tends to influence individual choice in the interest of private profit, then there seems to be no reason to oppose the education of the individual to mould his preferences and behavior in conformity with moral values willingly accepted by him in the interest of social well-being.

Individual tastes and preferences and socio-economic and political institutions which influence individual behavior cannot then remain exogenous; they need to be made a part of the economic model. If individuals do not behave in the way they need to for goal realization, then they may have to be educated and motivated properly, and the socio-economic and political institutions that influence their behavior may have to be reformed. Once the human being and the institutions that affect his behavior, behave in a manner that is conducive to goal realization, and the government also plays an important role in creating a proper environment, the entire burden of resource allocation and distribution may not fall on prices and markets alone. These have, nevertheless, to play an important role.

## ISLAMIC ECONOMICS DEFINED

In keeping with a prayer of the Prophet, may the peace and the blessings of God be on him, seeking the refuge of God from knowledge that is of no benefit,<sup>31</sup> the primary function of Islamic economics, like that of any other body of knowledge, should be the realization of human well-being through the actualization of the *maqasid*. Within this perspective Islamic economics may be defined as that branch of knowledge which helps realize human well-being through an allocation and distribution of scarce resources that is in conformity with Islamic teachings without unduly curbing individual freedom or creating continued macroeconomic and ecological imbalances.<sup>32</sup>

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<sup>31</sup>From Anas Ibn Malik, reported as a hadith sahih on the authority of Ahmad, Ibn Habbab, and Hakim by al-Suyuti in his *al-Jami' al-Saghir*, vol. I, p. 56.

<sup>32</sup>Islamic economics has been defined differently by different scholars. Some of these definitions, arranged chronologically, are:

S. M. Hasanuz Zaman

"Islamic economics is the knowledge and application of injunctions and rules of the Shariat that prevent injustice in the acquisition and disposal of material resources in order to provide satisfaction to human beings and enable them to perform their obligations to Allah and the society." (Hasanuzzaman, 1984, p.52).

M. A. Mannan

"Islamic economics is a social science which studies the economic problems of a people imbued with the values of Islam." (Mannan, 1986, p. 18).

Khurshid Ahmad

Islamic economics is "a systematic effort to try to understand the economic problem and man's behaviour in relation to that problem from an Islamic perspective." (Ahmad, 1992, p. 19).

M. Nejatullah Siddiqi

Islamic economics is "the Muslim thinkers' response to the economic challenges of their times. In this Endeavour they were aided by the Qur'an and the Sunnah as well as by reason and experience." (Siddiqi, 1992, p. 69).

Hence, while the " classics looked at the economic system primarily from the production angle, " and " the catallactists { marginalists } looked at it primarily from the side of exchange," <sup>33</sup> Islamic economics may have to look at it from the point of view of goal realization. It may accordingly have to study all those factors that affect the realization of these goals through their impact on the allocation and distribution of resources, they may have to become, along with the values and institutions (social, economic and political) that influence their behaviour, a part of the economic model and receive due attention. <sup>34</sup> This may not allow economics to concentrate only on the nature of the market and prices in take into account all the relevant aspects of human behaviour and other factors that affect allocation and distribution of resources and thereby human well-being.

If economics takes into account the whole relevant spectrum of human behaviour, then it may not be able to confine itself merely to self-interested behaviour on the part of individuals. Individuals do not always behave in a purely self-interested manner. Similarly, they do not always behave in an ideal or altruistic manner. Their behaviour generally tends to fluctuate between these two extremes. <sup>35</sup> This is in principle the

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M. akram Khan

"Islamic economics aims at the study of human falah {well-being} achieved by organizing the resources of the earth on the basis of cooperation and participation. (Khan 1994.p.33)

Syed Nawab Haider Naqvi

"Islamic economics is the representative Muslim's behaviour in a typical Muslim society. (Naqvi, 1994.p13)

<sup>33</sup>Hicks, 1976, p.212.

<sup>34</sup>For the significance of the human factor in economics, see El-Ghazali, 1994.

<sup>35</sup>According to the Qur'an human beings have the freedom and the ability to act rightly as well as wrongly. They are. Therefore, capable of either rising to great spiritual heights or of falling to the lowest immorality. (See al-Qur'an, 91:8, 92:4 and 95: 4-8 see also the notes of Muhammad

scientifically analyze their impact on goal realization. Thirdly, since there is a divergence between actual and ideal behaviour, Islamic economics must explain why the different economic agents do not behave the way they ought to. Fourthly, since one of the primary purposes of seeking knowledge is to help improve the human condition, Islamic economics must suggest measures which may help bring the behaviour of all market players that influence allocation and distribution of resources as close to the ideal as possible.

As far as analysis on the basis of actual behaviour is concerned, Islamic economics may be able to benefit from the increasing volume of literature made available by conventional economics, particularly that on the tools of analysis. Moreover, now there is also available a considerable analysis on the basis of altruistic behaviour. There should be no qualms about using this analysis. Islamic economics may have to show its deftness at filling the gaps, particularly those in the second, third and fourth parts of the task. It may be able to do this more effectively if it benefits from useful knowledge wherever it may be available.<sup>36</sup>

## METHODOLOGY

Linguistically, the term method refers to "following a path", or "the specification of steps which must be taken in a given order, to achieve a given end. The nature of the steps and the details of their specification depend on the end sought and on the variety of ways of achieving it." Technically, it refers to "the technical procedures of a discipline".<sup>38</sup> In the process, what methodology accomplishes is "to provide criteria for the acceptance and rejection of research programmes,

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<sup>36</sup>The Prophet, peace and blessings of God be on him, said: "Seek knowledge even though it may be in China because the seeking of knowledge is the duty of a Muslim." (Reported from Anas ibn Malik by Suyuti in his *al-Jami' al-Saghir* on the authority of al-Bayhaqi's *Shu'ab al-Iman*. This is a weak hadith. Nevertheless, it is quoted here because it indicates the importance of acquiring knowledge irrespective of where it is available. This was in fact the practice of Muslims during their *period of ascendance in the early centuries*.

<sup>37</sup>Caws, 1967, p.339.

<sup>38</sup>Blaug, 1980, p.xi.

setting standards that will help us to discriminate between wheat and chaff". These technical procedures and the criteria for acceptance or rejection would of course depend, as indicated above, on the end sought.

Since the end sought has been different - explanation,<sup>40</sup> prediction,<sup>41</sup> or persuasion,<sup>42</sup> there has been no clearcut answer to the question of methodology in economics in spite of a heated controversy on the subject. Before 1970, the literature on methodology was limited. However, after 1970 the literature has risen considerably, with a dramatic growth in the 1980s.<sup>43</sup> Nevertheless, the controversy continues. It seems however, that those who do not believe in the pursuit of any single given method seem to have the upper hand. Feyerabend has stated in an outspoken manner that "the idea that science can and should be run according to some fixed rules and that its rationality consists in agreement with such rules is unrealistic and vicious."<sup>44</sup> According to Klammer, theoretical disagreements were not settled by accumulating empirical evidence. "Economics involves the art of persuasion. In the absence of uniform standards and clearcut empirical tests, economists have to rely on judgments, and they argue to render their judgments persuasive. This process leaves room for nonrational elements, such as personal commitment and style, and social discipline."<sup>45</sup> Caldwell's response has, therefore, rightly been methodological pluralism.<sup>46</sup>

If the furthering of human well-being, rather than just explaining, predicting or persuading, is accepted as the goal of Islamic economics,

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<sup>39</sup>Blaug, 1980, p.264.

<sup>40</sup>Nagel, 1961.

<sup>41</sup>Friedman, 1953.

<sup>42</sup>McCloskey, 1986.

<sup>43</sup>Mackhouse, 1994, p.10.

P. Feyerabend, "Against Method: Outline of an Anarchistic Theory of Knowledge", cited by Lawrence Boland, "Scientific Thinking Without Scientific Method," in Backhouse, 1994, p.54.

<sup>45</sup>Klammer, 1984, p.234.

<sup>46</sup>Caldwell, 1982, pp.243-7.

then its task being much greater and harder than that of conventional economics, its methodology may also have to be fit for the task. It may then be futile to look for a single method for accepting, or rejecting hypotheses. Methodological pluralism may perhaps be the most suitable, and this is probably the method which seems to have been preferred by Muslim scholars in the past. Siddiqi has rightly indicated that "Islamic tradition in economics has been free of formalism, focusing on meaning and purpose with a flexible methodology."<sup>47</sup>

The first step that needs to be taken to accept or reject a given hypothesis is to see whether it fits within the logical structure of the Islamic paradigm, which is defined by the Qur'an and the *Sunnah*. However, since everything has not been spelt out in the Qur'an and the *Sunnah*, there is a great room for logical reasoning and human judgment or *ijtihad* without coming into conflict with the Qur'an and the *Sunnah*. Resort to the Qur'an and the *Sunnah* as the first step in the methodology for accepting or rejecting hypotheses is inevitable because "Islamic economics begins with an understanding of divinely-ordained ends and values and cannot be conceived without the." Instead of shying away from them under the cloak of *wertfreiheits*, economists may be able to make a valuable contribution by evaluating their hypotheses against the logical structure of the *Shari'ah*

This would lead to the second important step of the methodology - to evaluate the hypotheses through logical reasoning in the light of the rationale behind the teachings of the *Shari'ah*. A substantial use of this has been made in Islamic literature. Shah Waliyullah's book, *Hujjatullah al-Balighah* is an effort to show that there is a strong rationale behind every value or institution suggested by the *Shari'ah*.

A third step in the methodology may have to be the testing of the various hypotheses so derived, to the extent feasible, against historical records and statistical data available for present as well as past Muslim

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<sup>47</sup>Siddiqi, 1988, p.155.

<sup>48</sup>Siddiqi, 1988, p.168.

and non-Muslim societies. Dr. Naqvi has rightly emphasized that Muslim economists "should be ready to subject their theories to the toughest tests, and to discard `old theories once enough contrary evidence a priori or empirical, becomes available. The aim should be *scientific progress* in Islamic economics." <sup>49</sup>

It is the testing of hypotheses against facts which will help establish theory which is not empty but rather helpful in the realization of the *maqasid*. It will also help establish the separate identify of Islamic economics from the moral and philosophical literature of Islam. Testing may not, however, be possible without adequate historical and statistical data on all relevant variables as well as appropriate techniques of testing. Islamic economics need not hesitate to use the techniques of testing and the tools of analysis developed by conventional economics and other social sciences. All of these may not necessarily have their roots in the secularist paradigm.<sup>50</sup> Islamic economics may also adopt the theories of conventional economics that have become a part of the conventional wisdom, if these theories are not in conflict with the logical structure of the Islamic worldview.

The Qur'an and the *Sunnah* have both specified some of the major variables on which the well-being or misery of mankind depends. This has been done through a cause and effect relationship in the nature of, if A then B, where A is the needed norm or institution and B is the contribution that AI may make to the present and the future well-being of all living creatures on earth, particularly human beings. Just as the effort to explain actual phenomena results in hypotheses, the relationship between the *maqasid* and the different ways of individual and group behaviour as well as filtering, motivation, restructuring and government role indicated in the Qur'an and the *Sunnah* could also yield worthwhile hypotheses. All such relationships or hypotheses should be tested to the extent feasible. Such testing may also help us understand the texts (*nusus*) of the Qur'an and the *Sunnah* better and lead to a greater convergence of

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<sup>49</sup>Naqvi, 1994, p.xxi; italics are in the original.

<sup>50</sup>For the two different views on the subject, see Zarqa, 1986, pp.56-57.



ideas by reducing the number of alternative interpretations. However; revelation need not be the only source of establishing such ideal relationships. The experience of Muslim as well as non-Muslim societies as well as logical deduction may also be a source.

Testing of hypotheses, even when derived from the Qur'an and the Sunnah, has been an integral part of the Islamic tradition. The Qur'an itself emphasizes such testing. Even the hypothesis that "the Qur'an is the word of God", is falsifiable because the Qur'an has itself opened it to falsification by challenging mankind to produce something equivalent in terms of its linguistic beauty, force of logic, and quality of teachings.<sup>51</sup> Even after 1400 years, the challenge has not been met with respect to even one of its distinctive characteristics, and the hypothesis remains unfalsified. Moreover, the Qur'an is full of verses that induce human beings to look at the historical record of past civilizations which uphold the truth or positiveness of its normative theories. The Qur'an says, "Go, then, around the world and see the ultimate fate of those who rejected the Truth" (3:137). This verse as well as a number of other verses<sup>52</sup> are a clear indication that the Qur'an considers its normative theories to be testable against facts.

Scholars like Ibn Khaldun (d. 808/1406) tried to do this. They rightly believed that it was possible to test the cause and effect relationship even in social sciences by resort to historical evidence.<sup>53</sup> He asserted that "the past resembles the present just as water resembles water".<sup>54</sup> He was probably the first to state that "social phenomena seem to obey laws which, while not as absolute as those governing natural phenomena, are sufficiently constant to cause social events to follow regular, well-defined patterns and sequences. Hence, a grasp of these laws enables the sociologist to understand the trend of events around

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<sup>51</sup>See the Qur'an, 2:23, 10:38, 11:15 and 17:88.

<sup>52</sup>See, for example, 6:11, 7: 84 and 86, 7:128, 10: 39, 12:109, 27:51, 35:44, 40:21, 47:10, 65:9.

<sup>53</sup>Ibn Khaldun, *Muqaddimah*, pp.1 and 2.

<sup>54</sup>*Ibid.*, p.10.

him".<sup>55</sup> He further believed that "these laws can be discovered by gathering a large number of facts . . . from records of past events and observation of present events" .<sup>56</sup>

Shah Waliyullah (d. 1176/1762) reached the same conclusion by arguing that the cause and effect relationship that God has established in the universe as well as human life is a manifestation of His Wisdom. It shows that He does not operate arbitrarily. He rather acts in a methodical and systematic manner that befits His Wisdom. This idea is supported by him by means of a number of illustrations and by citing the Qur'anic verse, "And you will never find a change in God's *Sunnah* or set pattern" (Qur'an, 33:62, 35:43 and 48:23)<sup>57</sup> which shows the irreversibility of the cause and effect relationship established by God. This Wisdom is reflected in all the normative theories of the *Shari'ah*, which are addressed to the realization of human well-being.<sup>58</sup> He also uses this logic to rationalize the animosity of Islam towards astrology and magic because God has not given to stars and magical charms and spells the supernatural powers to undo the cause and effect relationship prevalent in natural phenomena and to cause harm or provide benefit to human beings.<sup>59</sup>

### A Word of Caution

The emphasis on .testing need not be taken to imply a vote in favour of logical !positivism, which is not only an "extreme form of empiricism",<sup>60</sup> but also "worldly, secular, antitheological, and antimetaphysical"<sup>61</sup> It requires every single statement to be positive and

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<sup>55</sup>Issawi, 1950, p.7.

<sup>56</sup>Ibid., p.8.

<sup>57</sup>See also Abdullah Yusuf Ali's note to the verse 35:43.

<sup>58</sup>Shah Waliyullah, 1992, vol.1, p.34.

<sup>59</sup>Shah Waliyullah, 1992, vol. 1, pp. 62-66; see also the Chapter on magic in Ibn Khaldun, Al-Muqaddimah, pp. 486-503.

<sup>60</sup>Chalmers, 1982, p.xiii.

<sup>61</sup>Herbert Feigl, 1978, vol.1, p.877.

not whether the subject matter of these concepts is itself observable or not, but whether its impact on human behaviour is observable, and particularly so, if it helps realize the kind of equilibrium in the allocation and distribution of resources which is in conformity with humanitarian goals. It is now well-recognized that prices and profits are not the only variables that influence allocation and distribution of resources. If belief in God and the Hereafter can motivate consumers and producers to internalize moral values and moderate their pursuit of self-interest and thus facilitate the realization of the *maqasid*, then why shouldn't economists take this factor into account. Effective operation of the moral criteria in resource use may complement the price system in introducing greater efficiency and equity in the use of resources.

Secondly, it may be argued that the Qur'an and the *Sunnah* provide norms about how economic agents should behave and what policies should be adopted to realize the 'kind of well-being that Islam stands for. These involve value judgments and one of the reasons for the frowning of conventional economics upon value judgments is that these refer to how people ought to behave and cannot by definition be verified or falsified.<sup>68</sup> It is for this reason that positive economics has confined itself primarily to a discussion of how economic agents and economies actually function and what the consequences of policies are. This attitude is perhaps one of the primary reasons for the absence of a link between microeconomics and 'macroeconomics. Most of the macroeconomic goals are based on value judgments. If complementary value judgments are not permitted to determine the microeconomic behaviour of individuals' and firms to bring it in harmony with goal realization, the goals may not be actualized. Mannan has rightly emphasized that "the normative and the positive are so interlinked that any attempt to separate them could be misleading and counter-productive" .<sup>69</sup> The sharp distinction that mainstream economics tries to create between the positive and the nominative does not, therefore, seem to be rational.

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<sup>68</sup>Lipsey 1989, p.16, and Blaug, 1990, p.7.

<sup>69</sup>Mannan, 1986, p.9.

Islam does, not look at the, normative as merely value judgments, which cannot be substantiated by empirical evidence. Every value or institution emphasized by the Qur'an and the *Sunnah* is essentially in the nature of a theoretical relationship between that value and human well-being even though the causal relationship or the *'illah* may not always be explicitly indicated. According to Islam, human beings ought to do what is morally right, not just because this is in keeping with the Divine Will, but also because this is the most beneficial for them and, therefore, the most rational . way of behaving.<sup>70</sup> Rational and morally-motivated conduct are thus considered synonymous. They both stand for behaviour which has proved to be ultimately in the interest of both the individual and the society.

Thirdly, it may also be argued that the theories adapted from the Qur'an and the *Sunnah* may not always be testable because of the wide gulf that now prevails in the Muslim world between the way the Muslims ought to behave and the way they actually do. The gap has, however, not always been wide. There have been periods in Islamic history when the Islamic ideals have been a reality in Muslim societies and the 'ought to be' has been an 'is', either totally or partially. Moreover, a number of norms and institutions prescribed by Islam are also a heritage of other cultures and civilizations and have been practised there. Testing may, therefore, be possible with the help of the historical records in Muslim as well as non-Muslim societies.

### **Realistic Assumptions**

Assumptions play an important role in the formulation of hypotheses and, while it may be possible to make some correct predictions even when the fundamental assumptions are false, it may be desirable to start with realistic assumptions to get a better record of reliable predictions. Nevertheless, the generally accepted principle is that the basic assumptions underlining the structure, or hard core, of a science "must not be rejected or modified". They are "protected from falsification

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<sup>70</sup> See Shah Waliullah's book, *Hujjat al A'illah al-Balighah*, for a rational argument of this thesis.

by a protective belt of auxiliary hypotheses, initial conditions, etc.""  
Accordingly, such assumptions "are not for testing".

. It may not be too much to expect that at least all the fundamental assumptions of economics about human behaviour are tested, particularly those about the spontaneous harmony of interests, rationality. and maximization, on which the whole structure of conventional economics is raised, to, ensure that the whole edifice does not collapse if these assumptions are false. It seems strange for conventional economics to keep itself at a distance from metaphysical realities, which have not yet been proved to be false, and yet to consider it, in the footsteps of Friedman, a "positive advantage" to base its hypotheses and theories on assumptions which are known to be "descriptively false".<sup>73</sup>

## THE RISE OF ISLAMIC ECONOMICS

Islamic economics had been developing gradually as an interdisciplinary subject in the writings of Qur'an commentators, jurists, historians, and social, political and moral philosophers. A large number of scholars including Abu Yusuf (d. 182/798), al-Mas'udi (d.346/957), al-Mawardi (d. 450/1058), Ibn Hazm (d. 456/1064), al-Sarakhsi (d.483/1090), al-Tusi (d.485/1093),. al-Ghazali (d.505/1111), Ibn Taymiyyah (d.728/1328), Ibn al-Ukhuwwah (d.729/1329), Ibn al-Qayyim (d. 751/1350), al-Shatibi (d. 790/1388), Ibn Khaldun (d.808/1406), al-Maqrizi (d.845/1442), al-Dawwani (d.906/1501), and Shah Waliyullah (d. 1176/1762) made valuable contributions over the centuries. These contributions are spread over a vast literature covering different intellectual disciplines.<sup>74</sup> It was perhaps because of this interdisciplinary contribution that human well-being never got conceived as an isolated phenomenon dependent primarily on economic variables. It was seen as

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<sup>71</sup>Chalmers, 1982,

p.80. <sup>72</sup>Lin, 1976, p.16.

<sup>73</sup>Friedman, 1953, p.14.

<sup>74</sup>See Spengler 1963; De Smogyi, 1965; Mirakhor, 1987; Siddiqi, 1992; and Islahi, 1994, for a brief account of some of these contributions.

the end-product of a number of economic as well as moral, intellectual, social, and political factors in such an integrated manner that it was not possible to realize overall human well-being without an optimum contribution from all. Justice occupied a pivotal place in this whole framework. This was to be expected because of its crucial importance within the Islamic paradigm.

These diverse contributions over the centuries seem to have reached their consummation in Ibn Khaldun's *Muqaddimah* or "Introduction to History". The *Muqaddimah* analyses the closely inter-related role of moral, political, economic, social and demographic factors in the well-being or misery of the people, which ultimately leads to the rise and fall of governments and civilizations. His analysis is not static and is not based on only 'economic variables. It is rather in the nature of socio-economic dynamics. The *Muqaddimah* contains a considerable discussion of economic principles, a significant part of which is undoubtedly Ibn Khaldun's original contribution to economic thought. However, he also deserves credit for a clearer and more elegant expression of the contributions made by his predecessors and contemporaries in the Muslim world. Ibn Khaldun's insight into some economic principles was so deep and far-sighted that a number of the theories propounded by him nearly six centuries ago could easily match some of the most modern theories on the subject.

Ibn Khaldun, however, lived at a time when the political and socio-economic decline of the Muslim world was already underway. He rightly theorized that sciences progress only when a society is itself progressing.<sup>75</sup> This theory is clearly upheld by Muslim history. Sciences progressed rapidly in the Muslim world upto the fourth century Hijrah. The development continued at a decelerated pace for a few more centuries, tapering off gradually thereafter. Only once in a while there appeared a brilliant star on an otherwise unexciting firmament. Economics was no exception. It also continued to be in a state of limbo in the Muslim world. No major contributions were made after Ibn

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<sup>75</sup> Ibn Khaldun, *Muqaddimah*, p.434.

Khaldun except by a few isolated luminaries like al-Maqrizi, al-Dawwani and Shah Waliyullah.

Consequently, while conventional economics became a separate scientific discipline in the West in the 1890s after the publication of Alfred Marshall's great treatise, *Principles of Economics*, in 1890,<sup>76</sup> and continued to develop since then, Islamic economics remained primarily an integral part of the unified social and moral philosophy of Islam until the Second World War. The independence of most Muslim countries after the War and the need to develop their economies in the light of Islamic teachings has given boost to the development of Islamic economics.

However, the valuable contributions made by some scholars in their individual capacities, could not provide the thrust needed to establish the separate identity of the subject. It was the First International Conference on Islamic Economics held at Makkah in February 1976, which served as a catalyst at an international level and led to an exponential growth of literature on the subject. Dr. Muhamad Omar Zubair and Prof. Khurshid Ahmad played a pioneering role in the holding of this Conference as well as a number of other conferences and seminars that have helped provide momentum to the discipline. Dr. M. Nejatullah Siddiqi's survey article on Muslim economic thinking<sup>77</sup> presented at this Conference served as a foundation for discussions and a catalyst for later development of Islamic economics.

A number of institutions have also played a crucial role. The most important of these are: the Association of Muslim Social Scientists, U.S.A (established in 1972); the Islamic Foundation, Leicester, U.K. (1973); Islamic Economics Research Bureau, Dhaka, Bangladesh (1976); the Centre for Research in Islamic Economics at the King Abdulaziz University, Jiddah (1977); the International Institute of Islamic Thought, Herndon, Virginia, U.S.A (1981); the Islamic Research and Training

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<sup>76</sup>Schumpeter, 1954, p.21. According to Blaug, (1985), economics became an academic discipline in the 1880s (p.3).

<sup>77</sup>Siddiqi, 1981.

Institute (IRTI) of the Islamic Development Bank (IDB), (1983); the International Institute of Islamic Economics, Islamabad (1983); the College (*Kulliyyah*) of Economics at the International Islamic University, Kuala Lumpur (1983);<sup>78</sup> and the International Association of Islamic Economics (1984). Out of these the Centre for Research in Islamic Economics at the King Abdul Aziz University and the Islamic Research and Training Institute at the IDB deserve a special credit for their outstanding contributions. The Centre's contribution has been already recognized by the IDB award in Islamic economics in 1993.

### **Lag in the Development of Theory**

Greater emphasis has, however, been laid so far on explaining what the ideal Islamic economic system is, how it differs from socialism and capitalism, and why it could better succeed in helping realize the humanitarian goals. Most of the discussion is of a normative nature - how all economic agents (individuals and households, firms, altruistic organizations, markets and governments) are expected to behave in the light of Islamic teachings. This has been accompanied by some sporadic historical data to show that the system has actually been in existence at different times in Muslim history and that this has produced positive results. This was natural, and in fact necessary. Economics is so closely related to the worldview and the economic system of a society that without clarity about the worldview and the economic system of Islam, Islamic economics may have perhaps groped in the dark for the direction in which to proceed.<sup>79</sup>

By now the contours of the ideal Islamic economic system have become sufficiently clear. However, Islamic economics as a theoretically- and empirically-oriented discipline has not yet evolved significantly. There is little, in the words of Dr. Kahf, "on the mechanism of the functioning of this system. Even more scarce are the writings that

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• 'See, Yalcintas, 1956, pp.33-37, for more details.

<sup>79</sup>In fact, according to Dr. Zarqa, Islamic economics is "the 'economic system', on the one hand, and 'the economic analysis thereof', on the other" (Zarqa, 1986, p.52).



interrelate the different facets of the Islamic economic system and form one whole theoretical structure that is internally consistent and externally valid.' For this purpose Islamic economics needs to perform all the functions specified earlier. It should not only indicate the functional relationship between different variables to show how these variables interact with each other, but also analyze factually the actual behaviour of economic agents. It must explain not only why the different agents behave the way they do but also why they do not behave the way they ought to in order to get the desired results. It must also show how to reach where we wish to go. Its task is thus broader and far more difficult than that of conventional economics. By its very nature it is an interdisciplinary discipline and needs to identify and discuss all the major moral, social, economic and political factors, and not just prices and incomes, that influence the behaviour of different economic agents. It is only by adopting such an interdisciplinary approach that Islamic economics may be able to predict the behaviour of economic agents with a reasonable degree of confidence, and influence the future course of economic events. Confining itself primarily to a discussion of how the different agents actually behave (conventional economics) or should behave (Islamic economics so far) may not lead it very far in the direction of making a worthwhile contribution to the realization of the *maqasid*.

The field where maximum, though still far from adequate, literature has become available is money and banking and Islamic finance. The goals that it may be possible to realize through the abolition of interest and the operation of an equity-based system have by now become quite well identified through the writings of a number of scholars. However, adequate data are not available to evaluate the actual performance of Islamic banks against these goals, to know the problems they 'are facing, and to explain why the ideal modes of financing have not become fully actualized. Moreover, there is hardly any information available on the perceptions and apprehensions of the general public, policy makers, shareholders and depositors about Islamisation of the

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<sup>80</sup> Kahf, 1978, p.1.

financial system. It may not be possible to work out an effective strategy for changing these perceptions or removing these apprehensions without the availability of actual data.

The available literature is preoccupied mainly with elaborating the different techniques of Islamic financial institutions. This may perhaps have been responsible for the false impression that the primary difference between conventional and Islamic economics lies in the mechanism through which financial intermediation takes place. It may not be possible to remove this false impression without a substantial theoretical advance in both microeconomics and macroeconomics. This would help identify the different variables that influence individual behaviour and goal realization, only one of which is interest, and specify the reforms needed in individual behaviour, institutional framework and environment for the Islamisation of the economies of Muslim countries.

Some progress has undoubtedly been made in macroeconomics. There has been a substantial discussion of the *maqasid*. There is, however, no theoretical model which would show how these goals may be realized. The attempts made so far "simply replace interest rate by profit-sharing ratio and introduce *zakat* as a tax without assuming any substantial change in the behaviour of the economic agents."<sup>81</sup> An appropriate macroeconomic policy structure in the light of Islamic economics has hence not developed and the *maqasid* remain unrealized in the Muslim world. This is probably one of the primary reasons for the tension and turmoil in the Muslim world. However, there are very few Muslim countries where the needed data are available to indicate the extent of the gap between the *maqasid* and the prevailing situation. Few Muslim countries have adequate data on the distribution of income and wealth and the nature and quality of life, particularly of the downtrodden people, to enable us to know the degree of equity prevailing in the allocation and distribution of resources, which is considered to be the most crucial criterion for judging the Islamisation of a Muslim economy. There are also inadequate data, about the extent of need-fulfillment in

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<sup>81</sup> Khurshid Ahmad, 1986, p.81.

different sectors of the population, their saving and investment behaviour, employment and unemployment, child labour, wages and salaries, working conditions, work habits, and productivity, along with a convincing scientific explanation for the deviation from Islamic norms. There is very little information available on the socio-economic condition of women, along with a comparison with the high status that Islam assigns to them in its value system. Unless we know the actual position as well as the reasons for it, it may not be possible to prepare a well-conceived program for social, economic and political change, and the measures that need to be adopted to actualize this change.

The field where very little progress has been made is microeconomics. Conventional economics has built its microeconomics on some hypothetical assumptions about the behaviour of individuals and firms. These assumptions have proved to be unrealistic. Nevertheless, the assumptions continue unperturbed. Moreover, conventional economics does not discuss the change needed in individual and social behaviour to realize its macroeconomic goals. This is because of its anathema to value judgments and commitment to unrestrained individual freedom and choice. This has prevented; as discussed earlier, the development of a clear link between its micro and macro branches and frustrated the realization of its macroeconomic goals. Islamic economics has thus to establish the relationship between its macroeconomic goals and the behaviour of different economic agents through the development of a more realistic microeconomics. This may take place if there is "a separate theory of consumer behaviour and a separate theory of firm in the context of Islamic economics".<sup>82</sup> Since no rigorous attempt has been made to fill this gap, Yalcintas is perhaps right in pointing out that: "Construction of microeconomic theory under the Islamic constraints might be the most challenging task before Islamic economics".<sup>83</sup>

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<sup>82</sup>Khurshid Ahmad. 1986. p.79.

<sup>83</sup>Yalcintas 1986, p.38.

## THE TASK AHEAD

The primary focus of Islamic economics may need to be on goal realization. This should help provide a direction and perspective to even the descriptive, explanatory and predictive functions of economics. What Islamic economics needs to do is to establish the micro foundations of its macroeconomic goals. The radical differences in the worldviews of Islamic and conventional economics may have to become clearly reflected in microeconomics. This has not yet taken place and the reason is understandable. Developing a different microeconomics not based on the concept of a value-free economic man interested primarily in serving his self-interest in a this-worldly perspective by maximizing his income and consumption is a difficult task. The simplistic, though unrealistic, assumptions about human behaviour made by conventional economics make the microeconomic models more manageable. Once these assumptions are removed and we make an effort to base microeconomics and the goals of macroeconomics on a consistent morally-charged worldview, we get into the difficult task of taking into account not only how economic agents actually behave but also how they should behave. This automatically makes the analysis more difficult. Such analysis may evolve gradually over time through the cumulative contributions of a number of creative scholars, each one laying perhaps one or a few bricks. Moreover, a number of variables that Islamic economics may be concerned with may not be measurable. Availability of data, trained manpower, and financial resources may tend to be a constraint. This may make Islamic economics a more difficult discipline. Nevertheless, Muslim economists may not find it possible to shy away from accepting the challenge. Their success in responding to the challenge may enable them to make a more effective contribution towards the realization of human well-being by solving many of the economic problems that mankind is now faced with.

Islamic economics, however has the advantage of benefiting from the tools of analysis developed by conventional economics. These tools, along with a consistent worldview for both microeconomics and macroeconomics, and empirical data about the extent of deviation from goal realization, may help identify the enabling social, political and

economic environment needed for the actualization of the *maqasid*. Economists may also have to explain why and when individuals do not behave in an ideal manner, why the existing institutions are unable to provide the enabling environment, and how individuals, households and firms could be made to behave in an ideal manner so as to remove the prevailing distortions.<sup>84</sup> All aspects of human behaviour, including individual tastes and preferences and the socio-economic and political institutions that affect the realization of goal-oriented efficiency and equity in the allocation and distribution of resources, may have to be taken into consideration, not just in their existing state but also in their ideal and enabling framework.

Islamic economics may not, in this case, be able to operate in a water-tight compartment. It may have to adopt a multidisciplinary approach. Though this may be more difficult, it may enable economists to have a more meaningful analysis of all important economic variables, including consumption, saving, investment, work, production and employment, and to suggest policy measures - a task which conventional economics is unable to perform effectively now because of an inadequate 'set of tools for filtering, motivation and restructuring. This may help prevent the driving away of Islamic economics from reality as has happened in the case of conventional economics.

Islamic economics thus has a long way to go before it may be able to become a distinct economic discipline. It has so far scratched only the surface. Its theoretical core has, as rightly indicated by Seyyed Vali Reza Nasr, "failed to escape the centripetal pull of western economic thought, and has in many regards been caught in the intellectual web of the very system it set out to replace".<sup>85</sup> The result is that its practical wisdom has been unable to come to a grip with the task of analyzing even the problems faced by Muslim countries. It has thus been unable to suggest a balanced package of policy proposals in the light of Islamic teachings to enable Muslim countries to perform the difficult task of actualizing their normative goals while simultaneously reducing their imbalances.

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<sup>84</sup>See also Siddiqi, 1988, p.169.

<sup>85</sup>Nasr, 1991, p.388.

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## **ISLAMIC DEVELOPMENT BANK**

### **Establishment of the Bank**

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent issued by a Conference of Finance Ministers of Muslim Countries held in Jeddah in Dhul Qadah 1393H, corresponding to December 1973. The Inaugural Meeting of the Board of Governors took place in Rajab 1395H, corresponding to July 1975, and the Bank formally opened on the 15<sup>th</sup> Shawal 1395H, corresponding to 20<sup>th</sup> October 1975.

### **Purpose**

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *Shari 'ah*.

### **Functions**

The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides *providing* financial assistance to member countries in other forms for economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially in capital goods, among member countries, providing technical assistance to member countries, extending training facilities for personnel engaged in development activities and undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to the *Shari 'ah*.

### **Membership**

The present membership of the Bank consists of 53 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of the Islamic Conference and be willing to accept such terms and conditions as may be decided upon by the Board of Governors.

### **Capital**

The authorized capital of the Bank is six billion Islami *Dinars*. The value of Islami *Dinar*, which is a unit of account in the Bank, is equivalent to one SDR (Special Drawing Right of the International Monetary Fund.) The subscribed capital of the Bank is now 3654.78 million Islamic *Dinars* payable in freely convertible currency acceptable to the Bank.

### **Head Office**

The Banks principle office is in Jeddah in the Kingdom of Saudi Arabia and the Bank is authorized to establish agencies or branch offices elsewhere.

### **Financial Year**

The Banks financial year is the lunar Hijra Year

### **Language**

The official language of the Bank is Arabic, but English and French are additionally used as working languages.





**Chapra, M. Umer;** (1933-), a Saudi citizen is presently serving as Research Advisor at the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB). Before joining IRIT in November 1999, he worked at the Saudi Arabian Monetary Agency (SAMA), from where he retired as Senior Economic Advisor after a long service of 35 years. He has also taught in the United States at the Universities of Wisconsin and Kentucky and worked in Pakistan at the Institute of Development Economics and the Islamic Research Institute. He has made seminal contributions to Islamic Economics and Finance over more than three decades in the form of 10 books and monographs and more than 70 papers and book reviews. Consequently, he has received a number of awards, including the Islamic Development Bank Award for Islamic Economics, and the King Faysal International Award for Islamic Studies, both in 1989(.

E-mail: [muchapra@isdb.org.sa](mailto:muchapra@isdb.org.sa)

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BANQUE ISLAMIQUE DE DEVELOPPEMENT  
INSTITUT ISLAMIQUE DE RECHERCHES ET DE FORMATION  
B.P. 9201, DJEDDAH - 21413  
ROYAUME D'ARABIE SAOUDITE  
ADRESSE TELEGRAPHIQUE: BANKISLAMI-DJEDDAH TELEPHONE: 6361400  
Facsimile: 6378927 / 6366871  
E-Mail: ARCHIVES @ ISDB.ORG.SA Home page: <http://WWW.IRTI.ORG.SA>