

Module 6: Islamic Economics and Finance

Lecture Notes

Islam is a complete code of life and therefore it outlines guiding principles for every aspect of human life. The economic life of a Muslim community is also supposed to be guided by the teachings of the Qur'an and the Sunnah. The distinguishing features of an Islamic economic system can be understood in a better way if analyzed in comparison with capitalism and communism, two economic ideologies which have prevailed in the modern world.

Capitalism and Communism are both economic ideologies which were set to explain and guide the economic function of the human societies after the Industrial Revolution. The Industrial Revolution (circa. 18th and 19th centuries) refers to the large scale development of industries, mostly in Europe, which initiated a shift from agricultural mode of production to an industrial mode of production. Although a mostly European phenomenon, the Industrial Revolution did cause major socio-political changes in societies all over the world. Many thinkers tried to make sense of the profound change in the outlook of human society due to the Industrial Revolution. Capitalism and Communism were two prevalent thoughts which explained the nature of the industrial societies in contrasting fashions.

The ideology of Capitalism was inspired by the thinking of economists like Adam Smith (d. 1790) who favored free functioning of the market economy and private ownership of property as the key to development in industrial economies. Adam Smith argued that the economy can function well if it is left on its own with no state intervention. The market itself has the capability to efficiently distribute the economic benefit to all the members of the society. Capitalist economists favor private ownership of property over public ownership. Individuals are allowed to own and expand their property and capital. Profit maximization at an individual level is the force which drives the overall functioning of the market.

The socio-economic philosophy of Karl Marx (d. 1883) was the main inspiration behind Communism. While Adam Smith put his confidence in the intrinsic mechanism of free markets, Karl Marx went on to criticize the same. Karl Marx argued that if the economy is left to function on its own it leads to ever increasing economic disparity. He said that the economic disparity in the modern world has reached an unprecedented level so much so that there have emerged two distinct economic classes in the world: the capitalist class and the working class. There is a perpetual conflict of interests between the two classes. Karl Marx said the solution to the problem of economic disparity lies in a revolution which must be brought by the working class to end the dominance of the capitalist class. The revolution can bring about a new economic system, i.e. a Communist system, in which there is total economic equality. Communist system is based on the principle of state-controlled market and public ownership of property. The state which is the representative of the public is supposed to control the market and to own all the

property and resources in the economy. A Communist system is driven by profit maximization at the collective level.

Capitalism and Communism are two extreme view-points on the functioning of the modern economy. Islam presents a moderate view about which lies in between the two extremes. Therefore, rather than free-market or state-controlled market, Islam favors the concept of regulated market economy. An Islamic state is supposed to supervise the functioning of the market and keep the level of intervention to a minimum. In an Islamic society people are allowed to individually manage and develop properties and businesses but at the same time they have to give a small share of their wealth to the state in the form of *zakat*. *Zakat* contributes to the distribution of wealth in the society which is crucial for the economic well-being of a society. An Islamic state is responsible for collecting and distribution of *zakat*. In this way the state plays a regulatory role in the economy.

Islam is the religion of submission and the submission has to be realized both at the individual and collective level. Therefore the ultimate goal of an Islamic Economic System is not to maximize the individual or collective profit but to follow the will of Allah (S.W.T). Muslims are required to make a distinction between the necessities of life and the objectives of life. Economics is meant to fulfill the human necessities but it is not the ultimate objective. The ultimate objective is the submission to Allah (S.W.T). This fact is elaborated in the Qur'an in the following verse:

وَأْمُرْ أَهْلَكَ بِالصَّلَاةِ وَاصْطَبِرْ عَلَيْهَا ۖ لَا نَسْأَلُكَ رِزْقًا ۖ نَحْنُ نَرْزُقُكَ ۗ وَالْعَاقِبَةُ لِلتَّقْوَىٰ

Enjoin Salah on your people and be diligent in its observance. We do not ask you to provide (for them); instead We provide you sustenance. Blessed shall be the end of the Righteous. [Surah at-Taha: 132]

The Islamic society is based on the principle of submission to God. The economic function of the society should also conform to the commandments of God. A major challenge which the Muslims face in this regard is to establish a system of finance which is according to the teachings of Islam. In modern economies financial services are provided by the banks which are specialized financial institutions. The banks are commercial organizations which often give loans to finance different commercial and domestic projects and charge interest on those loans to earn profit. In Islam, however, interest is considered to be unlawful. Interest or usury is known as *riba* in Islamic law and it is considered as one of the gravest sins in Islam. Allah (S.W.T) says in the Qur'an:

يَا أَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّهَ وَذَرُوا مَا بَقِيَ مِنَ الرِّبَا إِن كُنْتُمْ مُؤْمِنِينَ
فَإِنْ لَمْ تَفْعَلُوا فَأْذَنُوا بِحَرْبٍ مِنَ اللَّهِ وَرَسُولِهِ وَإِنْ تُبْتُمْ فَلَكُمْ رُءُوسُ أَمْوَالِكُمْ لَا
تَظْلُمُونَ وَلَا تُظْلَمُونَ

O You who believe! Fear Allah and waive what is still due to you from usury if you are indeed believers; Or war shall be declared against you by Allah and His Rasool. If you repent, you may retain your principal, causing no loss to debtor and suffering no loss. [Surah al-Baqara: 278, 279]

In the above-stated verse Allah (S.W.T) has declared war against those who do not leave taking interest. Such severe admonishment has led some of the scholars to opine that taking interest is the second most serious sin in Islam after *shirk* (associating partners with Allah (S.W.T)).

In one hadith it is narrated by Abu Hurairah that the Prophet (S.A.W) said: “Refrain from seven deadly things.” The companions asked him: What are these? He said: “To associate partners with Allah (S.W.T), sorcery, to kill a soul without valid reason, to devour interest, to devour the property of the orphan, to flee from the battlefield and to falsely implicate chaste, innocent, believing women of vulgarity.” [Reported in: Bukhari, Muslim, Sunan Abu Dawood, Sunan Nisai]

In another hadith narrated by Jabir bin Abdullah the Prophet (S.A.W) cursed the receiver of interest and the payer of interest, the one who records it and the two witnesses of such agreement. He said: “They are all alike.” [Reported in: Muslim, Tirmidhi, Musnad Imam Ahmad]

This hadith also attests to the repugnance that Islamic law has for interest. Even a person who becomes witness to an agreement of usury deserves the displeasure of Allah (S.W.T). Therefore interest must be avoided at every cost from an Islamic society.

By definition interest is the profit gained on monetary loan. Islamic law does not allow any profit made on money. Profit can only be earned on the basis of assets. An asset is anything which has a direct use in the society. Money is only a medium of exchange which does not have any direct use of its own. Rather it is only used to buy or sell assets. Islamic banking and finance is asset-backed finance. Islamic banks can only earn profits on real assets and not on money. For example if a person wants a bank to finance a car worth 1 million a conventional bank would simply give 1 million in loan to the person and demand 1.2 million in return on installments. But Islamic banks would avoid such a transaction involving interest. An Islamic bank would rather buy the car for 1 million and then sell it to the person for 1.2 million on installments. In such a

transaction there is an involvement of a real asset (a car) and the bank is earning profit on the sale of the asset and therefore the possibility of interest is avoided.

In the recent years scholars have identified various solutions which the Islamic banks can use to provide sharia-compliant financial services. Some of the financial services provided by Islamic banks are: Musharaka (مشاركة), Mudharaba (مضاربة), Ijara (إجارة) and Salam (سلم). In the following lines it will be elaborated that all these modes of Islamic finance fulfill the principle of asset-backed financing by involving real assets in all transactions.

Musharaka means a business project in which two (or more) partners invest money and share the profit and loss among themselves. Islamic banks often offer musharaka services by becoming partners in the commercial projects of the clients and thus sharing the profit. Example: A person 'A' wants to establish a business and needs 100,000 but has got only 50,000. So 'A' will go to a bank 'B' and ask it to become partner in the business by providing 50,000. So person 'A' and bank 'B' will both be partners in profit and loss. In a musharaka contract the ratio of profit-sharing is decided by mutual agreement while the ratio of loss-sharing is the same as the ratio of investment.

Mudharaba contract is slightly different from Musharaka. In Mudharaba one partner invests the money while the other partner runs the business. The partner investing the money is known as the investor while the one running the business is known as the manager. Islamic banks offer mudharaba contracts by becoming investors in business ventures while the clients play the role of managers. In a mudharaba contract the profit is decided by mutual agreement but the loss is always borne by the investor. Example: A person 'A' needs 100,000 for a business he will go to the bank 'B' which will provide this amount. 'B' will become the investor and 'A' will become the manager of the business. Both 'A' and 'B' will have a share in the profit according to mutual agreement but the loss will be borne by 'B' only.

Another mode of financing offered by Islamic banks is Ijara. Ijara literally means leasing of a commodity or hiring of services of an individual in return for monetary compensation. Islamic banks mostly offer ijara contract in car-financing. A bank purchases a car and then gives it to a client on monthly rent. The client uses the car and keeps paying the rent to the bank which is specifically calculated so that after sometime the client would have paid total rent which would be more than the cost of the car. When the amount received in rentals crosses the cost by a set margin the bank simply gives the car as a gift to the client. Example: A client 'A' wants to buy a car worth 1 million. Bank 'B' buys the car and gives it on lease (ijara) to A for a monthly rent of 20,000. After 60 months (5 years) the bank would have received 1.2 million in rentals which is more than the cost of the car. At that time the bank can simply gift the car to 'A' and 'A' becomes the owner. Thus in the end 'B' has earned a profit of 200,000.

A mode of financing specifically offered to the agricultural sector is Salam. Salam is a type of sale in which the price of a commodity is paid in advance and the delivery of the

commodity is deferred to a later date. Mostly farmers can use this method in financing the cultivation of crops. The farmers can sell their crops to Islamic banks in advance and use the payment they receive to acquire the resources they need like seeds, fertilizers, etc. The price of crops in such cases is lower than the expected market price. Therefore after acquiring the crops from the farmers the banks can sell the same with profit. Example: A farmer 'A' wants financing for growing wheat. He can get 100,000 from the bank with the promise of delivering 5 tons of wheat to the ownership of the bank after 4 months. The bank can sell the 5 tons of wheat in the market for 120,000 to earn a profit of 20,000.

All the modes of finance that we have discussed above are based on the principle of asset-backed financing. Islamic banks are supposed to gain profit exclusively on the basis of assets. Only then can the Islamic banks avoid the possibility of interest in financing. But to achieve this goal the concept of banking in an Islamic society will have to undergo radical transformation. In an Islamic society the banks are meant to deal not only in money but in commodities as well. For this to happen, the banks will have to develop capabilities to deal in goods and commodities. They will have to develop facilities and human resource to assist in the transport, storage and maintenance of commodities.