

A Critical Assessment of Islamic Economics

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ABSTRACT

This paper presents a critical assessment of the widely discussed concept of Islamic Economics. The two different interpretations of Islamic economics as the study of the functioning of an interest-free economy and the validity of moral values in the economy are discussed. It is shown that none of these interpretations can help to create an acceptable foundation for an Islamic economics. Far away from laying the foundation for such an economics the question is raised how an Islamic economy would function, based on the Islamic principle of controlling the Nafs. Microeconomics and macroeconomics of such an economy are analysed and its special features are compared to an economy functioning on the basis of laws devised by the conventional economic analysis.

Keywords: household behaviour, unemployment, moral values, Islamic economy

JEL-Klassifikation: D10, E24, P50

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1 Introduction

There exists a vast array of literature on Islamic economics. The library of the Kiel Institute of World Economics counts more than 80 titles on this topic. There are numerous websites dealing with Islamic economics. Even a Journal, "*Review of Islamic Economics*" was edited to underscore the importance of this topic. Looking at this literature it is not easy to define what the subject-matter of Islamic economics is. Phillip (1990, p. 126) maintains that "The point of departure" of the theory of Islamic economics "is not the investigation of the actual economic behaviour in an existing Moslem society or the historical evidence for such a behaviour in the past. Rather the Muslim economist treats an ideal order projected into the past as a historical fact and then draws from their legitimisation for his own theoretical endeavours". These economists are chiefly occupied with the criticism of western concepts of economics, capitalism and communism and with the presenting of a moral view of Islamic economy including Islamic Socialism.

We can therefore distinguish between two different branches of Islamic economics, one analytical and the other one based on moral values. The analytical branch uses the methodology of mainstream Economics to find solutions for problems understood as Islamic economic problems. Examples are "*The Concept of Zakah Evasion: An economic Interpretation*" (Diabi 1993), "*Measuring Consumption Function in an Islamic Framework*" (Bendjilali; al-Zamil 1993) or "*A Comprehensive Macroeconomic Income Determination Model for an Islamic Economy*" (Hussain 1994). One important sub-branch of this literature identifies an Islamic economy with an interest-free economy and analyses the question how such an economy would function theoretically and in practice (Mills, Presley 1999; Dalkusu 1999).

In the following we discuss first the issue of the ban on interest and afterwards the concept of Islamic economics based on moral values. In contrast to the conventional economic analysis we subsequently discuss the functioning of an Islamic economy. A summary of the conclusions is given in the last part of the paper.

2 Islamic Economics and Ban of Interest

This most famous conceptualisation of an Islamic economics is based on the idea that to earn interest is forbidden in Islam. Those who defend this position refer to Quran and ban all form of interest including modern bank interest. We have doubts about this interpretation of Quranic verses. There are four verses which are of utmost interest in this respect:

"That is because they say, trade is like usury but God hath
permitted trade and forbidden usury" (Yusuf Ali)

In this and many other English translations (Shakir, Picktall) of this verse the word "usury" is used for the Quranic word "Ar-Reba" and not for the word "interest". According to Collins English Dictionary (sixth edition 2003) the word "interest" means "a charge for use of credit or borrowed money", while "usury" is "an exorbitant or unlawfully high amount or rate of interest". If the Quranic word "Ar-Reba" means usury, usury is forbidden but not necessarily interest. "Interest" is a simple expression for a charge which under competition in the credit market would be reduced to the conventional interest rate in trading and commerce. Everything above this rate is forbidden but not this conventional interest rate. As the above verse says usury is forbidden because usury is not like trade. It can be economically sustained that a credit with a simple conventional charge under competitive conditions is, in fact, like trading but not usury. Under competitive conditions the interest rate reduces to a minimum not higher than the profit rate in trading and commerce due to intra- and intersectoral competition. Usury which implies a much higher profit rate is unlike trading and therefore forbidden.

In a free banking system interest charged by the bank cannot be higher than the rate of profit in trading and commerce. The competitive rate of interest contains a compensation for the inflation rate and a compensation for the profit otherwise realised by investing the sum lent in an alternative use¹. Any other additional component would be reduced to a level which would not overshoot the sum of the two mentioned items.

In the West, banks do not only charge an interest but ask also for collateral. In case of losses the banks bear therefore a lower risk compared to a trader investing his capital in commerce. This lower risk of the banks in the West is not due to the existence of interest but due to an excessive affection for avoidance of risk. In an Islamic bank interest in the sense discussed above would be allowed but without any collateral for the credit. Usually no problems would arise but in the case of losses an amicable arrangement should be found. This is due to the power of the verse (2:280):

"If the debtor is in difficulty, grant him time Till it is easy for him to repay.
But if ye remit it by way of charity, that is best for you if ye only knew" (Yusuf Ali)

¹ Instead of lending the sum, the amount could be, for example, used in trading or to buy a dwelling and to let it for the purpose of making a profit.

To grant time means also to provide advice for the process of adjustment and in case difficulties cannot be avoided to remit the debt by calling on reserves for contingencies. This procedure seems to be more effective and less costly than the usual long and costly procedure of insolvency occupying courts, lawyers and government agencies.

The third verse (2:278) reads:

"O ye who believe! Fear God, and give up what remains of your demand for usury, if ye are indeed believers." (Yusuf Ali)

To understand the true meaning of this verse one has to distinguish between interest and usury. "To give up" can not be understood as giving up everything because in this case there would remain nothing, neither usury nor something else. If we assume that "interest" in the sense discussed above is not forbidden then what is demanded and exceeds the interest rate is usury which is forbidden, and who fears God will give it up.

The necessity of differentiation between interest and usury can also be inferred from the verse 3:130:

"O ye who believe! Devour not usury, doubled and multiplied; but fear God; that ye may (really) prosper" (Yusuf Ali)

Charging interest "doubled and multiplied" means devouring usury. Interest as common in trading and commerce can not easily be qualified as devouring "doubled and multiplied".

The word used in all these verses in the Quran is "Ar-Reba". According to the Langenscheidts pocket dictionary German-Arabic this word means *Wucher* (usury) while the word for interest is "Rebhe" (Zins). Both words sound very similar but they are from different roots. While translating the Quran, it therefore may easily happen that the word "Ar-Reba" is interchanged with the word "Rebhe". The translation of the Quran may be a source for misunderstandings damaging the pure meaning of the Quran.

Islamic economics in the sense of scrutinising the laws of an interest-free economy may be therefore based on this misunderstanding. In a true interest-free economy inflation does not exist as well as a profit making business. In such an economy money does not exist in the literal meaning of the word. It is like a "geschlossene Haushaltswirtschaft" as it is defined in old German economic textbooks. In an Islamic economy interest can be charged by the banks but no credit collateral is demanded.

Phillip (1990, p. 132) writes that in the analytical description of an interest-free economy "the profit sharing arrangement, mudàraba, is usually suggested as an alternative". But in this case credit creation is not a function of the bank institution but

the distribution of dividends depending on the level of the profits of the investments. We are therefore not dealing anymore with a typical bank but with an investment funds (Phillip 1990, p. 133). It is not clear why such institutions should be called banks.

3 Islamic Economics and Moral Values

The branch of Islamic economics based on moral values is analytically less rigorous. Kuran (1997, p. 1) writes that "The declared purpose of Islamic economics is to identify and establish an economic order that confirms to Islamic scripture and traditions". According to wordiQ Dictionary & Encyclopaedia (01.06.04) Islamic Economics is economics in the political context of Islam that respects its associated ethical codes.

These definitions concentrate on religious morality and its corresponding institutional foundations in society (zakat, ethical investment etc.) as the quintessence of Islamic economics. It is not easy to understand this kind of conceptualisation of an Islamic economics. Economics is a science, meaning that it formulates laws of how an economy works. Islamic economics therefore, should study economic laws according to which a society in which Moslems live would develop economically. If these Moslems live according to the scripture and its ethical codes, will there exist laws different from those studied in the conventional economic analysis describing the functioning of a modern economy? In this case Islamic economics should scrutinise these laws. But in case the same laws as in a modern economy apply but there are differences in the economic order, where for example special care is taken for the poor or some investments are forbidden due to their unethical character and others are urged due to their moral value, there is no basis for an Islamic economics but only for a different economic order under the influence of Islam.

As a matter of fact, there may be differences between a market economy shaped by the behaviour of individuals not knowing any limitation in their moral attitude and another one shaped by the behaviour of Moslems, who live according to ethical codes mentioned in the literature. But it is not easily possible to draw the conclusion that such differences can lay the foundation for a new economic science called Islamic economics.

No meaningful economic analysis can be based on a long code of moral conduct consisting of many moral sentences. We propose to characterise a Moslem economy as one populated by individuals who control their Nafs. This would make a real difference in the functioning of the economy comparing to a society where this is not the case. To understand this significant difference one has to know what is meant by the Islamic

concept "Nafs". A simple definition would be to describe Nafs as that entity in the human being, which has forgotten God and seeks the fulfilment of its being solely in the pleasures of this earthen life.

Curious enough, most of the elementary economics text books begin with a statement which makes Economics a science of scrutinising the laws of functioning of an economy in which individuals with eager Nafs live. For Nafs, its earthen wants are unlimited. This seems to be the fundamental statement at the beginning of the conventional economics science. Some citations from text books may underline this claim:

"Economics is the study of how people, individually and collectively allocate their limited resources to try to satisfy their unlimited wants" (Byrns; Stone 1995, p. 5)

"human wants are virtually unlimited, whereas the resources available to satisfy these wants *are* limited" (Sloman 2000, p. 2)

"Moreover, it is realistic to assume that the utility perception of a human being changes with the development of the economy in a manner that the more they have the more they want (free translation, Schumann et al. 1999, p. 6)

"to economise means to reduce as far as possible the trade-off between unlimited wants and the limited resources which are available for their satisfaction"
(Bontrup 1998, p. 29)

A Moslem, who controls his Nafs has *limited* wants and the resources to fulfil these limited wants are provided by the divine promise.

As it is said in the verse 11:6:

"There is no moving creature on earth but its sustenance dependeth on God:
He knoweth the time and place of its definite abode and its temporary deposit:
All is in a clear Record" (Yusuf Ali)

A Moslem is not therefore disturbed about his living means and to economise for him means to search for the proper employment to become vested with the promised means. This is a fundamental difference from the usual conceptualisation of the economic activity as expressed in the above citations.

A human being with unlimited wants is eager because he knows no limitation and wishes to have always more in spite of the limited resources. Everytime one of his wants is fulfilled, others will unfold and he is permanently under pressure to fulfil the new ones. The very moment he gets satisfaction he develops the feeling of scarcity and shortage. He is therefore permanently discontented. In this process he is constantly

occupied with the question of how to mobilise the limited resources to fulfil ever newly unfolding wants. He is never in a position of stillness. He is disturbed.

In contrast to such a human being a Moslem with clear and limited wants is modest, content and undisturbed. His wants are limited because he is aware of the fact that he is on this planet to diminish his sanctionable failures by divine order and he is availed with enough resources to fulfil these limited wants.

4 Controlling Nafs and the Functioning of an Islamic Economy

What are the implications of this fundamental difference in the behaviour of a human being for the functioning of a Moslem economy? To discuss this question we can separately analyse the microeconomics and macroeconomics of a Moslem society.

Microeconomics is the systematic analysis of individual economic behaviour of consumers and entrepreneurs according to the principle of rationality. In the textbooks it is frequently assumed that consumers attempt to maximise their satisfaction and that entrepreneurs attempt to maximise profits. This is an expression of the maximal principle of rationality. But this cannot be the case for a Moslem consumer or entrepreneur. A Moslem consumer has clearly defined limited wants and would attempt to satisfy these wants with resources as small as possible. He behaves therefore rational too but according to the second expression of rationality i. e. the minimal principle.

The fundamental difference discussed above evolves also at the analytical level of the principal of rationality. Maximising profits is an activity which calls for permanent mobilisation of resources and expanding the boundaries of the firm. It is interpreted as a dynamic process and not as an one-act static activity. There is no limitation for the profits to be maximised. In contrast, a Moslem is content with a level of profits which allows a comfortable livelihood. He is not struggling to raise his standards of living to ever higher levels.

Microeconomics includes also the discussion of market forms. In a profit maximising economy all realistic market forms (oligopoly, monopoly, polypoly) would be possible and would be the different outcomes of the competition process to crowd out producers of similar goods and to control ever more segments of the market. In an Islamic economy there will be enough place for many producers to supply within the same segment of the market. The market form will be as a rule polypolistic. This is due to the fact that the single producer with his limited economic goals has no motivation for the capture of the whole market.

Macroeconomics deals with the process of income determination at the level of the economy as a whole and with the process of Growth. These processes can be disturbed by inflation and unemployment. In an Islamic economy the level of income is determined, as it is analysed in the textbooks, by the level of aggregate expenditure. But since there are differences in the character and level of expenditure between an Islamic economy and an economy populated with human beings with unlimited wants, the sectoral structure and the growth process must be different.

In a Moslem economy a maximum rate of growth is not aspired for due to the individual goal of maintaining a comfortable livelihood. The growth process is determined by transforming raw materials via the input of the factors labour, capital and technology. Due to the fact that a Moslem controls his Nafs, the technological development in a Moslem society does not aim at realising every possible innovation to promote the growth process. A Moslem is called upon in the Quran to contemplate nature and to learn from it. Moderate natural innovations serve for the improvement of living conditions, where a societal consensus on the nature and appropriacy of such improvements is possible. Technology for its own sake and subduing nature will be avoided. Since technology is one of the most important determinants of growth, the result would be a moderate rate of growth without dramatical changes in the growth rate or its sectoral structure. Moderate growth rates of around 2 percent would be the normal phenomenon in such an economy.

Inflation and unemployment therefore do not necessarily accompany the growth process in an Islamic economy. In the conventional analysis the major cause of inflation is either the excessive growth of aggregated demand (demand side inflation) or rigidities on the labour market (supply side inflation). The application of the minimum principle of rationality in a Moslem society means that an excessive aggregate demand is avoided as well as rigidities caused by drawing heavily on the resources. The minimum principle of rationality creates a boundary on each side helping to avoid extreme fluctuations.

To understand why there is no fear of inflationary processes in an Islamic society it is possible to look at the alternative interpretations of the so called Quantity Theory of Money. The quantity equation is defined as:

$$M \times V = P \times Y$$

Where M is the money supply, V the velocity, P the price level and Y the real output. Monetarists believe that changes in velocity are fairly predictable. Therefore the control over M gives the central bank control over nominal GDP. Since Y is independently determined, in the long run increases in the money supply would cause inflation.

Keynesians reject this view. They argue that increases in money supply would not inevitably lead to increases in inflation. Increasing M may instead lead to a decrease in V . In Keynesian analysis money affects the economy by first affecting interest rates.

In a Moslem economy we have to refer again to its stillness due to the moderate rates of growth without exaggerated fluctuations. V is fairly predictable as well as Y . But the crucial difference is the process of money creation. In such an economy the money creation process is organised in one of the two following methods:

- There exist neither a central bank nor credit banks but only institutions to finance foreign trade. National money is produced by a government house.
- The central bank issues the national money. Credit banks can dispose of reserve money only by receiving a credit from the central bank with a moderate interest rate.

In both of these methods there is no place for a wide variation of the quantity of money. Economic policy making in an Islamic society is based on deliberations by all different social groups. In this context, there must be therefore a societal consensus on the volume of money in circulation. Such a consensus can only be reached when the money creation is commensurate with the principle of limited wants in society. Eagerness to create money is constrained by the fact that there is no eagerness to produce more than necessary to fulfil the limited wants. There is no independent monetary policy in an Islamic economy. The multiple banking system with the possibility of manipulating the supply of money through diverse channels of injecting central bank's money into the banking system is alien in an Islamic context.

Unemployment is the second major macroeconomic problem. In the conventional analysis two kinds of unemployment are discussed. Natural unemployment exists when output is at full employment. It results from rigidities in the structure of the labour market. Cyclical unemployment is unemployment in the excess of natural unemployment. It occurs when output is below its full-employment level. In an Islamic economy only moderate fluctuations can exist in the output level, so that cyclical unemployment will be negligible. Furthermore, there exist no labour market rigidities due to the social organisation of work where power relations are substituted by principles of mutual backing and the principle of charity replaces the institutional assistance for unemployed (unemployment benefits). Natural unemployment is therefore also non-existent. Unemployment in Islamic economies is due to external shocks like war, immigration or natural calamities.

If there are a great number of people unemployed due to such events, there exists a keynesian policy which is adequate in an Islamic context. The keynesian employment

policy is usually misunderstood. For such a policy neither a deficit spending nor an expansive monetary policy is a pre-condition. Rather, it is the existence of ample opportunities to execute socially beneficial and relevant work which is decisive in this respect. To launch the process it is enough for the society to be able to draw on its ability to help. To finance the process, the principle of charity has to take effect. Donations by some members of the society with surplus funds would be mobilised due to their duty to diminish sanctionable failures or due to their bondage to serve in order to be in a state of grace. Then the income multiplier process comes into operation and the government will be able to participate in the financing of the latter steps of the process out of the new income received by taxation (Zakah). The money creation will be endogenous in the sense that the quantity of money would adjust to the additional production.

In an Islamic economy the government is therefore small since neither the monetary system nor the fiscal policy calls for huge bureaucratic institutions. As a matter of fact the society organises itself. Public goods are provided by the government as far as they can not be supplied privately.

The picture we have drawn of an Islamic economy gives an impression totally different from the functioning of a modern industrialised economy. This is principally due to "homos islamicus", who knows that he lives on this earth, not to obey his Nafs, but to control it. A Moslem may be poor. But to be poor does not mean to be discontent. It means only that he has brought with him a destiny diminishing sanctionable failures. To be poor and to be disturbed would mean either that the soul is neglecting the known or not accepting the known. Both increases the sanctionable failure, while accepting the known calls for patience and results in contentedness. The word Islam stems from the roots submissiveness and peace. A Moslem therefore gains peace by submissiveness under the divine law. The Quranic verse 10:62 describes the state of a Moslem, who is near to God as:

"Behold! Verily on the friends of God there is no fear, nor shall they grieve;"
(Yusuf Ali)

An Islamic economy is in accordance with Nature. The whole economic activity means extracting raw materials from nature and to allocate them through the process of production to the different human beings participating in the division of labour. In an economy populated with human beings satisfying unlimited wants there must be

pressure on natural resources to be extracted, transformed and used to realise maximum satisfaction. Man will be in constant confrontation with nature which could resist its temptation to satisfy ever more unlimited wants. In contrast, controlling the Nafs in an Islamic economy means that resources from nature are extracted as far as it is necessary to satisfy limited wants. The validity of the minimal principle of rationality in such an economy means that due attention is given to spare resources and not to waste. The verse: 6:141 reads:

"But waste not by excess: for God loveth not the wasters." (Yusuf Ali)

The Islamic economy is characterised by moderate growth rates, absence of inflationary processes and enduring unemployment and ecological safety. The question arises if there is an empirical basis for such an economy. There exist of course many Islamic countries on our planet, but one could hardly argue that they represent true examples for such a theoretical concept. Most of them have along their historical development line, especially since the beginning of the colonisation period, accepted the western patterns of living i. e. the picture of the human being as one of satisfying unlimited wants and maximising profits according to the maximising principle of rationality. It is therefore not easy to study the empirical validity of an Islamic economy referring to the currently existing Islamic countries. But at least two countries, Afghanistan and Saudi Arabia, in spite of some reservations, as well as Iran, could be used to check the empirical validity of the above statements on the functioning of an Islamic economy.

5 Conclusions

A religion can promote the development of sciences but it is not for the purpose of founding different branches of sciences. We could not find any foundation for an Islamic economics as a science based on the ban of interest. Also an Islamic economics based on the idea of zakah and ethical investment is too far away to have a general validity characterising a science. But there may be crucial differences between a market economy shaped by the behaviour of individuals not knowing any limitation in their moral attitude and another one shaped by the behaviour of Moslems who are obliged, according to the religious rule, to control their Nafs. In a Moslem economy inflation and unemployment are rare phenomena and as a rule the growth rate is moderate. The economy lives in peace with nature and the individuals are content, undisturbed and enjoying their lives. Poverty, of course, exists. But this poverty is accepted as one of the means to diminish sanctionable failures for those individuals who have been transgressive in their past lives. But there exists also the principle of charity where the

poor are taken care of and a basic solidarity exists where the feeling of brotherhood prevails.

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