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WAS *SHARI'AH* INDEED THE CULPRIT?

by

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WAS *SHARI'AH* INDEED THE CULPRIT?

Introduction:

There is no doubt that Islam was the leading civilization during the period seventh-thirteenth centuries. Its achievements in sciences and philosophy are well known.¹ Its achievements in establishing efficient economic/financial institutions and how these had been borrowed by the medieval West are also now well documented.² Yet, in sharp contrast to these early achievements, Islamic world presently is considered to be as one of the most backward regions of the world. Timur Kuran has argued that the Islamic law of inheritance and the rigidity of Muslim jurists have impeded the development of the corporate form and consequently condemned businesses established by Muslims to small size and short life span.

The Corporation:

¹ Sezgin, *Einführung*.

² Çizakça, "Cross-cultural Borrowing".

Though important, corporations do not constitute a sufficient condition for economic development. Thus a civilization may have invented the corporate form, but this does not mean that it will achieve economic development. This is best demonstrated by China, where for all practical purposes the corporation had been invented during the sixteenth century Chinese commercial revolution. But as it is well known, China never made the transition from commercial capitalism to industrial capitalism. The Chinese corporation, the *tang*, alone, was simply not sufficient for the task.³ In any capitalist civilization the corporation needs to be supported by a host of other principles and institutions such as the rule of law, freedoms and democratic institutions. Whether these principles are compatible with the basic teachings of Islam is a difficult question that is being discussed elsewhere.⁴

A corporation is an association of individuals with common interest, who come together for a specific purpose. This association, as if it were a living being, is considered to have its own personality. This is of course a fictitious (or judicial) personality and is distinct from those of its real members. Consequently, although these individual members may die or exit from the association, the

³ Faure, *China and Capitalism*.

⁴ A huge literature is emerging on this question. For a few examples see; Mirakhor and Hamid, *Islam and Development*; Islam, *Freedom of Religion*; Kamali, *An Introduction*; id., *Freedom of Expression*; Çizakça, “Democracy”.

corporation continues to have a distinct life of its own. The corporation can own property in its own name separately from its members. It can also contact third persons in its own name. It can sue third parties and be sued by them. It can discipline its own members. A great advantage of the corporation is that it provides both “owner shielding”, limited liability for members, and “entity shielding”, limited liability for the company itself.⁵ In the former, the personal assets of an individual partner are protected from the creditors of other partners and in the latter those of the corporation. Furthermore, because the corporation outlives the lives of its members and provides sufficient entity shielding, it enjoys longevity and allows capital accumulation. This is one of the reasons why western corporations had substantially more capital at their disposal than un-incorporated Islamic partnerships.⁶

The Catholic church was organized, probably, as one of the very first corporations. Thus, it is generally accepted that the most important corporate body emerged in Europe sometime between 1075 and 1122 A.D., the period marked by the *Investiture Struggle*. But, its application to commerce came

⁵ Hansmann, “Law”, pp. 1337-43.

⁶ Çizakça, *Comparative Evolution*, pp. 130-31, 134.

about much later, during the sixteenth-seventeenth centuries, with the advent of the East India companies.⁷

Theories Explaining the Lack of Corporations in the Islamic World:

The massive accumulation of capital and consequently power achieved by western corporations, which enabled them to colonize vast territories overseas, invited the question whether such organizations ever developed in the Islamic world. The answer, with the possible exception of the wealthy Karimi merchants, was negative.⁸ It was observed that powerful incorporated private companies with massive capital accumulation and power did not exist in the heart-lands of the Ottoman empire which covered much of the Islamic world.⁹ This observation naturally triggered further research and scholars tried to explain this absence. Indeed, why is it that the Islamic world, the probable inventor of *commenda*, the most important contract form of medieval Europe, failed to proceed with the evolution and did not invent the next big thing – the corporation?¹⁰

⁷ For a more precise explanation see the section: “The Geographical Factor”, below.

⁸ On the Karimi merchants see; Labib, “Capitalism”, pp. 82-3 and Constable, *Trade and Traders*, pp. 147, 254-55.

⁹ Çizakça, *Comparative Evolution*, passim.

¹⁰ On the very likely Islamic origins of the *commenda* see; Udovitch, “*At the Origins*”, and on the debate about the origins; Çizakça, *Comparative Evolution*.

Several explanations have been provided for the failure of Muslims to develop the corporate form. First of all, as already mentioned, the corporation was invented by the Catholic Church seeking legitimacy and independence from the secular authority, the Holy Roman Emperor. This was a unique western European phenomenon. Indeed, the Eastern Orthodox Church in the Roman/Byzantine Empire was subjugated by the Emperor in Constantinople and could not develop as an independent power. In the Islamic world also with the rise of the Buwayhid dynasty, after 945 A.D., the Caliphs, though continued to be respected, in fact, became *de facto* subjects of the sultans. In short, while the Roman Catholic Church emerged in the west as an independent centre of power and needed to organize itself as a corporation, this need was felt neither in Orthodox Christianity nor in the world of Islam.

Second, Avner Greif has argued that whereas the Islamic world was dominated by extended family and tribes, Western Europe became dominated by the nuclear family. This happened when the Catholic Church prohibited polygamy and discouraged endogamic marriages up to four degrees of kindred and declared incest a sin and crime. When the nuclear family emerged out of all this as the dominant social formation, an institutional vacuum was created. This vacuum was filled by corporations, which rapidly spread to the independent cities, guilds and universities. Thus, Greif argues, the Europeans developed the

corporation as a substitute for what was missing in the west – the extended family.¹¹

Third, Kuran explains the small size and short duration of Islamic partnerships as well as the absence of the corporate form in the Islamic world, by focusing on the Islamic inheritance and partnership laws. He claims that, according to the latter, an Islamic partnership ends when one of the partners dies. In the absence of primogeniture, according to Kuran, it is not possible for the eldest male heir of the deceased partner to replace him automatically. Therefore, if the enterprise is to continue, a new partnership has to be negotiated.¹² Consequently, every additional partner increased the risk of premature liquidation. Thus, keeping the partnership to a minimum number of partners as well as limiting its planned duration were rational policies.

Fourth, still another obstacle to large Islamic partnerships, again, according to Kuran, was that they lacked judicial personality. This meant that third parties had to deal with partners as individuals rather than as representatives of an enterprise with its own life span and legal personality. Consequently, they avoided providing services or loans beyond the financial capacity of the particular partner they were dealing with. This must have resulted with a credit

¹¹ Harris, “The *Commenda* and the Corporation”, p. 31.

¹² Kuran, “Islamic Commercial Crisis”, pp. 421-22.

crunch, because an Islamic partnership could never obtain credit from third parties beyond what its individual partners could cover with their own means.

Another reason why Islamic partnerships faced credit crunch was the much higher transactions costs of collecting the credit advanced from the various individual partners, each necessitating a separate litigation. By contrast, lending to a corporation has the advantage that in case of conflict a single litigation against the judicial personality of the corporation should suffice.

Fifth, Kuran has argued further that Islamic law of inheritance and the multitude of heirs it led to were other important impediments for the introduction of the corporate form into the Islamic world.¹³ When one of the partners died, Islamic law demanded that the partnership must be liquidated, often prematurely. But the cost of liquidation depended on the number of heirs. By requiring the division of the deceased partner's property among numerous heirs, Islamic law, according to Kuran, raised the cost of liquidation. Moreover, the very multitude of these heirs impeded the continuation of the enterprise as well. This is because, if the enterprise was to continue, each one of these heirs needed to be included in the partnership as new members replacing the deceased partner. By contrast, in many parts of Europe, where primogeniture prevailed, the eldest son of the deceased partner automatically replaced him and the association, whether in the form of a partnership or corporation, continued usually without any major

¹³ "The Absence", p. 816.

problem. In short, the transactions costs pertaining to the intergenerational continuity of Islamic partnerships must have been significantly higher than those of western partnerships. Kuran argues that due to these reasons, partners must have deliberately limited the size and duration of their partnerships.¹⁴ This meant that the corporate form was simply not desired or needed in the Islamic world. Kuran recognizes that Muslim jurists could have introduced the corporate form. If they did not, according to him, the reasons should be sought in a lack of need caused by the rigidity of the *Shari'ah* rather than an inability to innovate.

A Critique:

I will now provide here a critique of these explanations for the lack of the corporate form and its consequence, the small size and duration of Islamic partnerships in the Islamic world.

The corporation was indeed an invention of the Roman Catholic Church. By contrast, neither the Eastern Orthodox Church nor the Islamic Caliphate could claim to be independent of the secular power of the emperor or the sultan. Not seeking, or even daring to seek such power, these religious institutions hardly needed to incorporate.

¹⁴ *ibid.*

Greif's argument that the Europeans developed the corporation as a substitute for the missing extended family, is a weak one. This argument suffers from the fact that Islamic cities, where the corporation would have flourished, were not necessarily characterised by extended families or tribes. These were prevalent in rural areas or deserts. Moreover, the existence of extended families in the Islamic world is a highly controversial subject.¹⁵ True, polygamous urban Islamic families might have been larger than monogamous European families, but the claim that this impeded the adoption of the corporate form is not entirely convincing.

Kuran's argument that an Islamic partnership must be immediately liquidated upon the death of one of the partners is also problematic. Kuran, based upon Avram Udovitch and Udovitch based upon the classical jurist Kasani, have argued that when one of the partners dies, an Islamic enterprise has to be immediately liquidated and the assets distributed among the surviving partners and the decedent's heirs.¹⁶ For Kuran, this constitutes one of the most important causes behind the lack of capital accumulation and ephemeral nature of Islamic partnerships. But when we check other sources, we find certain complications.¹⁷

¹⁵ Powers, "Inheritance System", pp. 14-15.

¹⁶ Kuran, "Commercial Crisis", p. 421.

¹⁷ Ibn Abidin, *Redd al-Muhtar*, vol. 9, pp. 184-208; Kuwait Ministry of Awqaf, *Al-Mavsuat*, vol. 26, p. 89; Gözübenli, "Inan", pp. 260-61; Siddiqi, *Partnership and Profit-Sharing*, p. 93;

To start with, liquidation of an Islamic partnership upon the death of one of the partners, depends on the actual number of partners.¹⁸ This is confirmed by paragraph 1352 of the Ottoman law code, known as the *Mecelle*, which is based upon the classical Islamic-Hanefite law. The *Mecelle* states that if only two partners are involved, the company indeed needs to be liquidated whenever one of them dies. But under the same circumstances this code clearly permits the continuation of an Islamic enterprise (*şirket*) with three partners or more. In this case, only the shares of the deceased partner are to be converted into cash and paid to his inheritors, but the company itself will continue to live with the surviving partners.¹⁹

It is possible that the inconsistency is due to the different partnerships considered: whereas Kuran, based upon Udovitch, refers to the liquidation of a *mudaraba* partnership, the *Mecelle* reference is more general. Ömer Nasuhi Bilmen also mentions the immediate liquidation of a *mudaraba*, but clearly confirms the continuation of an *inan* partnership with more than two partners.²⁰

Billah, *Applied Islamic Law*, p. 54; Çizakça and Kenanoğlu, “Ottoman Merchants”, pp. 195-215.

¹⁸ Gözübenli, *ibid.*, p. 261.

¹⁹ Berki, *Açıklamalı Mecelle*, p. 277.

²⁰ Bilmen, *Kamus*, vol. 7, p. 86.

Thus, when he insisted that at the death of any one partner, *all* partnerships immediately had to be liquidated, Udovitch apparently had based his entire argument on the implicit assumption that the partnership had only two partners.²¹ But providing these partnerships had more than two members, liquidation was not necessary.

It is clear that Udovitch's implicit assumption has inadvertently misled Kuran. In other words, providing there are more than two partners, Islamic law does provide one of the greatest advantages of western law, namely the longevity of the firm.

The other argument of Kuran that lack of primogeniture and multitude of heirs in Islamic inheritance law increase transaction costs leading to short life of firms and lack of capital accumulation is also not entirely correct.²² His argument is as follows:

“...the *mudaraba*... became null and void if any partner died before fulfillment of the selected mission...The greater the number of heirs, the lower the capacity to renegotiate a new partnership aimed at completing the initially contracted mission. The prevailing inheritance system mattered, then, to contractual practices. In mandating the division of

²¹ Udovitch, *Partnership and Profit*, pp. 117-18, 140.

²² Kuran, “Why”, pp. 78-79.

estates among a potentially very long list of relatives, the Islamic inheritance system created incentives for keeping partnerships small”.

I disagree with Kuran’s argument that the Islamic law of inheritance “created incentives for keeping partnerships small” for a number of reasons. First, Islamic law allows family waqfs, *waqf ahli*. If a wealthy Muslim wants his most able offspring to manage his wealth, he could transform his wealth into a family waqf and put his preferred offspring in charge of this waqf. In this way, even primogeniture could be applied notwithstanding the Islamic law of inheritance. Kuran has argued that a waqf cannot substitute for a firm, primarily because it suffers from information asymmetry problems. However, not only waqfs were permitted to make profits so as to channel these to charity, they could also have been protected from information asymmetry problems by preparing sufficiently flexible endowment deeds.

Second, and more importantly, even in those areas of the Islamic world where the classical law of inheritance is applied,²³ the problem of multitude of heirs could be avoided much more directly, again, by the same law. This is because the rules of inheritance take effect only at the moment of death. This means that a proprietor is legally free to dispose of his property in any way he sees fit *prior* to his final death sickness. Indeed, Islamic law imposes no limitations whatsoever upon the amount of property that a person may alienate in the form of a gift during his life time, whether in favour of his eventual heirs or anyone else.²⁴ Indeed, it has been stated that during health, a gift which may be of any amount can be given to any individual, rich or poor, who accepts the offer of the

²³ In any case, in many areas of the Islamic world, such as Algeria, Sumatra, Nigeria, India and Java, customary law rather than the strict Islamic law of inheritance prevails. See on this; D. S. Powers, "Inheritance System", p. 14. In Sumatra and Negeri Sambilan, Malays of Minangkabau decent practice *adat perpatih*, whereby daughters become the only rightful heirs to all the property of the deceased. Rosly, *Critical Issues*, p. 511. This is based upon the view that women do not possess the capacity to create wealth while men, who are stronger, do.

²⁴ Powers, "Inheritance System," p. 21. This is confirmed by Canan, who has shown that although subject to debate, unequal gift giving among the offsprings has been approved by some of the greatest classical scholars (Abu Hanife, al-Shafi'i, Ahmad, Abu Yusuf and Imam Mohammad). See; Canan, *Kütüb-i Sitte*, vol. 16, p. 254.

gift. But the underlying condition to this is that transfer of the gift must occur before the death of the donor, otherwise it becomes a bequest and be subjected to the general rules. Thus, if the recipient does not take possession of the gift before the donor dies then the gift becomes void but if the gift is taken into possession before the donor's death, then it is valid according to the Hanafi, Shafi'i and Hanbali *fikh*. The Maliki school merely states that a gift made during death sickness is inoperative and is silent about a gift made during health.²⁵

Another way of exercising primogeniture or preferring one of the offspring was the following: a proprietor who wants to favour one of his children over the others could make a bequest for the benefit of his minor grandchild, the child of the person he wants to favour. As a minor, the child's property would be administered by his father – the desired heir. If the proprietor did not have a grand child at the time that he wrote down his testament, he could leave a legacy for “the first child born to my son” or to “all children who will be born to my son”. In this manner the unborn child's father could gain control of the property upon the testator's death. Thus a far sighted proprietor, who wanted to exercise greater control over the way his property is transmitted to the next

²⁵ Hussain, *Succession*, p. 410.

generation could certainly do so providing he made a testament while still in good health.²⁶

It was also always possible to reach an agreement with the sisters to continue the family firm. This is what the Ibn Yagmur brothers did in seventeenth century Cairo. When their father died without making a will and the assets were divided among all the children, the sons reached an agreement with their sisters to pool and recombine the capital of the family firm. In this agreement the sisters most probably became passive partners of the active brothers.²⁷ In short, Kuran's argument that "the Islamic inheritance system created incentives for keeping partnerships small", is also not entirely convincing because it was possible to avoid the excessive divisiveness of the law by making gifts *inter vivos* or by establishing family waqfs with sufficiently flexible endowment deeds and entrusting the management of the trust to the preferred offspring.

Thus, it is clear that, at least theoretically, it was possible to transfer wealth to a preferred child and avoid excessive fragmentation of property through the law of inheritance. But to what extent these theoretical possibilities were actually practiced needs to be searched thoroughly in the Islamic court registers. For the time being some evidence confirming the above has already appeared. Indeed,

²⁶ Powers, "Inheritance System", p. 21.

²⁷ Hanna, *Big Money*, p. 41.

according to Hudson in late Ottoman Damascus gift giving and endowments prevailed. There is strong evidence that people who controlled significant resources fought the restrictions by gift giving and establishing family endowments. Properties, particularly houses, were given as gifts. Also waqfs were endowed with the condition that the revenues to be generated were to be distributed among the beneficiaries determined by the founder.²⁸

Third, Kuran's argument that the third parties "avoided providing services or loans beyond the financial capacity of the particular partner they were dealing with" ignores the popular contract form the *wujuh* or the *sharikat al-mafalis* also known as the "credit partnership" or the "partnership of the penniless". As the name suggests, this was a partnership formed by bankrupt merchants, who had lost everything except their good reputation. It was customary practice for merchants to help their colleagues by supplying them with commodities for sale even though the value of these commodities may have been way above their means. The goods would be purchased on deferred payment and re-sold to third parties on cash. After repeating this a few times, the profits would be partially used to make the deferred payment. The essence of this partnership was to provide finance to colleagues with good reputation so as to enable them to re-enter the market.

²⁸ Hudson, *Cultural Capital*, pp. 49-57.

Naturally, the mere existence of this particular partnership in classical law books does not necessarily prove that it was actually used in practice. But documents found in the Ottoman archives have demonstrated that it was used frequently among the merchants.²⁹ Thus, I reject Kuran's argument that due to the lack of the corporate form Muslim merchants provided finance to their colleagues only up to the amount each could carry. Islamic law as well as economic history demonstrate that this was simply not the case. On the contrary, it was established custom to advance credits to colleagues with good reputation. This custom was so wide-spread that the law provided special partnership forms precisely for this purpose. Indeed, if the provision of finance even to the bankrupt was possible, wide-spread and well organized, the argument that "the third parties avoided providing services or loans beyond the financial capacity of the particular partner they were dealing with" appears to be totally unconvincing.

Kuran's argument that due to the lack of judicial personality litigation costs were much higher because each partner had to be litigated separately, is also not convincing. This is because, in *Mufawada* partnerships concerning "the rights and obligations arising from any purchase or sale in connection with their joint enterprise, the *mufawada* partners are, from the point of view of third parties, like one individual. The price of a purchase made by one of them is collectable

²⁹ Çizakça, *Comparative Evolution*, pp. 82-83.

from the other”.³⁰ Thus if, in order to obtain credit, merchants felt the need to provide their creditors unlimited liability for the actions of their partners, it was certainly possible to do so by entering into a *mufawada* partnership. Moreover, in such a situation the upper limit to the credit would be determined not by the financial capacity of a single partner but by the aggregate capacity of all the *mufawada* partners. Most importantly, in case of conflict it would not be necessary, as Kuran suggests, to litigate each and every partner separately. But a single litigation against any of the *mufawada* partners would suffice since “the *mufawada* partners are, from the point of view of third parties, like one individual. The price of a purchase made by one of them is collectable from the other”.³¹ Thus, for all practical purposes, the *mufawada* would fulfil the basic advantages of the corporation and eliminate the need for separate litigation against each and every *mufawada* partner.

Finally, recent research has revealed that Islamic law does recognize the concept of judicial personality. Indeed, it has been argued that a doctrine called *dhimma* constituted a nearly perfect substitute for it.³² The *dhimma*, very much like the corporation, is assumed to be an imaginary repository that contains all

³⁰ Udovitch, *Partnership and Profit*, p. 109.

³¹ *Ibid.*, p. 109.

³² Zahraa, “Legal Personality”, p. 202.

the rights and obligations relating to a person in the present and the future. Most recently, it has been reported that the concept can be found in the classical sources of Islamic jurisprudence. It would be appropriate to quote Mustafa Zarqa`s forceful comment here:

“When we referred to the original texts and sources of the *Shari`ah*, we found in it legal provisions which in substance propound the concept of juristic person and its legal status. And also, we found the legal provisions, which personify the juristic person with all its principles and characteristics, which are attributed to it by the latest (western) law...the legal position of the juristic person is found in the *Shari`ah* in the most perfect form in the shape of treasury, waqf and the state...”³³

An Alternative Explanation:

If we are rejecting Kuran`s argument on the grounds that the Islamic jurisprudence did not impede corporations or primogeniture, why indeed then did partnerships or firms remain so small in the Islamic world? This is a crucially important question. Because, failure to create long lasting and powerful companies proved to be disastrous in the long run. Industrialization could not be achieved without powerful firms with large capital and when the time came for railways to be built, telegraph lines to be laid, in short, modernization projects so crucial for the survival of a nation had to be financed,

³³ In Sanusi, “The Concept”, forthcoming.

Islamic empires of the nineteenth century had to turn to foreign banks and that led to financial imperialism.³⁴

It will be argued here that neither the supposedly immediate dissolution of the partnership upon the death of one of the partners nor the multitude of heirs caused by the Islamic law of inheritance, nor the alleged absence of judicial personality can account for the absence of the corporate form in the world of Islam. There was, however, one powerful reason: the corporate form was simply not needed and true to the spirit of the Coase theorem,³⁵ because it was not needed, the corporation simply did not emerge in the Islamic world until well into the nineteenth century.³⁶ Let us now examine why this important institution was not needed in the pre-industrial Islamic world.

The Geographical Factor:

³⁴ For the original version of this argument made for China see; Faure, *China and Capitalism*, p. 25.

³⁵ Coase Theorem as interpreted by Kindleberger: “institutions respond to supply and demand, or to economic necessity. They always spring into being to perform necessary economic tasks”, in Kindleberger, *A Financial History*, pp. 3-4, 44, 74, 206.

³⁶ Currently corporations have been completely accepted in the Islamic world. Even the modern Islamic banks have been established as corporations.

To start with, known ever since the late eleventh century, the corporation was adopted by the European business community with a huge lag of half a millennium. This is not to say that the European business community was not aware of the corporate form. Indeed, as early as the eleventh century Flemish merchants had organized themselves within incorporated guilds. The thirteenth century *Hanses* were also organized as corporations.³⁷ But neither the guilds nor the *Hanses* were firms. It is not accidental that the emergence of incorporated firms by and large had to wait until the sixteenth century, because that was when the need surfaced in Europe. First came the Papal bull of 1494, known as the Treaty of Tordesillas, which divided the New World between the Spanish and the Portuguese and kept out all other European nations from the spice trade. Then came the unification of the Spanish and the Portuguese crowns in 1580. This was soon followed by the closure of the port of Lisbon to the Dutch and the English, thus effectively depriving these nations even from the re-export trade of the eastern spices.³⁸ Both of these nations were at war with the now united Iberian crown and they decided that they had to reach the spice islands on their own. First the North-East and then the North-West routes were tried and when both ended disastrously, it was decided that the ships had to sail along

³⁷ Çizakça, “Cross-Cultural Borrowing”, p. 689.

³⁸ That is to say, re-exporting the spices brought by the Portuguese and Spanish ships from the Far East, to the rest of Europe.

the known routes, across two oceans, the Atlantic and the Indian and, if necessary, fight the Iberians all the way to the Far East. For this, powerful and well-armed ships had to be built – a very expensive undertaking. Hence the need for corporation, which not only facilitated the pooling of large capital but also assured longevity for the firm. Both the English and the Dutch East India companies were incorporated joint-stock companies.³⁹

By contrast, Muslims had easy access to the spice islands. Indeed, when an Arab ship sailed off from Basra or the Hadramouth to India, it had already covered some four-fifth of the way a Dutch ship sailing off from Amsterdam had to cover. For the Arabs to sail to India was not so difficult because the routes and the sailing methods had been known and perfected centuries ago. Moreover, the Indian Ocean was a free trade zone, *mare liberum*, and Muslim shipping there was based upon small ships owned by just a few partners. There is evidence that Mediterranean ships were in general considerably larger than the Indian Ocean ships despite the fact that the former was a mere inland sea. It seems what determined the relative size of the ships was not so much the elements but rather the need to equip them for combat. Moreover, prevailing technology also played a role. While it was possible to make holes for cannons in the outer skin of the European ships, this was not possible for local Indian Ocean ships. Thus, to the extent that large ships existed in the Muslim Indian

³⁹ Van Dillen, *Van Rijkdom en Regenten*; Keay, *The Honorable Company. passim*.

Ocean shipping, these ships were designed to carry large numbers of pilgrims and cargo, but not cannons.⁴⁰ In short, geography and politics made it imperative for the Europeans to incorporate, while this was not the case for the Muslims.

Property Rights:

Another important reason why Islamic firms remained ephemeral and small, was the concept of property rights. According to Douglass C. North, there is a direct relationship between property rights and firm size, with insecure property rights leading to small firm size.⁴¹ If so, it would be appropriate here to investigate the prevailing property rights in the Islamic world with the hypothesis that small firm size may well have been caused by imperfect property rights.

Since the corporate form was applied to European business primarily during the fifteenth – sixteenth centuries, we must investigate the status of property rights in the Islamic world for the corresponding period. During this particular period, the Islamic world was dominated by three great empires. These were from the West to the East; the Ottoman, the Safewid and the Mughal empires.

Unfortunately, a detailed analysis of property rights can only be made for the

⁴⁰ Utku, *Kızıldeniz'de*, pp. 241, 244.

⁴¹ North, *Institutions*, p. 65.

Ottoman Empire. This is because, Safewid and Mughal archives have been destroyed to a large extent. By contrast, surviving Ottoman archives contain more than four hundred million documents. So, the question boils down to the extent of the Ottoman property rights during the fifteenth-sixteenth centuries.

As in most societies, in the Ottoman Empire also, the mercantile class had the greatest potential for advancement. Within the Ottoman command economy, however, the mercantile class was effectively prevented from advancing its status. The Ottoman economic system aimed at the preservation of harmony between the classes. To preserve this harmony, the state applied pressure upon the mercantile class and ended up choking it. Recently, Stoianovich as well as Inalcık and Quataert have also described the Ottoman economy during the period 1300-1800, in similar fashion, as a “command economy”.⁴²

Actually, in order to maintain harmony between the classes not only the mercantile class but even the military/ruling class, *askerî*, was prevented from advancing too far. While in power, some members of this class could earn massive salaries and other income related to their positions. But this income could be earned only as long as the person remained employed and his tenure

⁴² Stoianovich, “Cities”; Inalcık and Quataert, *Economic and Social History*, pp. 1, 45-47.

continued. When the person retired or fell from favour, his income was either confiscated or reduced to one percent of what it was.⁴³

Being appointed as *celepkeşan* was another way accumulated wealth could be encroached upon. *Celepkeşan* were the unfortunate wealthy individuals, usually merchants or usurers, who were appointed as *celeps* to purchase large numbers of sheep in the Balkans at market prices and then sell these in Istanbul at the prevailing state imposed *narh* prices, which were less than the purchase prices.⁴⁴ Consequently, being appointed a *celep* almost always meant financial ruin. The system lasted from the late fifteenth century to 1597. It can be stated without any reservation that while it lasted, that is, for at least a century, the system must have impeded capital accumulation significantly. Indeed, the *celepkeşan* system targeted the accumulated wealth of the rich and distributed it to the masses. It goes without saying that such policies contrast sharply with the principles of classical Islamic capitalism. How the Islamic economic thought evolved from the latter to the former remains an important area of research.⁴⁵

⁴³ When Şeyhülislam Feyzullah Efendi fell from favor, he was cruelly tortured to make him reveal the whereabouts of his hidden treasure. I owe this point to Erol Özvar. Also see on this; Abou-el-Haj, *The 1703 Rebellion*, p. 80.

⁴⁴ Greenwood, *Meat Provisioning*, p. 279.

⁴⁵ For more on this see; Çizakça, *Islamic Capitalism*, forthcoming.

Actually, the Ottoman *celepkeşan*, should be considered as a special form of the much more important, long lasting and more general institution of confiscation. Indeed, while the *celepkeşan* lasted for merely a century, confiscation can be traced to the very beginnings of Islam. There are several *ahadith* reporting that when informed about some embezzlements committed by an official, the Prophet became very angry and declared: “misappropriation by an official of even the smallest item is betrayal and theft”. Probably based upon this *hadith*, Caliph Omar (d. 644) began to apply systematic confiscation of corrupt officials. At that period the usual practice was to confiscate half of the property of the official in question.⁴⁶ Under the Umayyads (661-750) not only confiscations increased in frequency and became an instrument of threat and revenge, but they were also institutionalized with the establishment of a special office of confiscations, *Dar al-istihraj*. When the Abbasids came to power in 750 A.D., they not only executed members of the Umayyad dynasty but also confiscated their wealth. Abbasids established a special court of confiscation, known as the *Divan al-mezalim*. Under the Abbasids confiscations were also extended to the properties of the companions’ and the relatives’ of the corrupt official. Between the years 908-946 thirty and in the period 946-991, ten confiscations have been recorded.⁴⁷ Extension of confiscations to the wealth of

⁴⁶ Tomar, “Müsadere”, *passim*.

⁴⁷ *ibid.* p. 65.

the civilians seems to have occurred for the first time, again, under the Abbasids. In Egypt, members of the Tulunid dynasty (868-905) also could not escape confiscation when they fell from power. Confiscation of the wealth of the officials as well as innocent civilians continued under the Fatimids (909-1171). It is well known, for instance, that Caliph Muiz had his *vizier* collect 390.000 dinars from the peoples of Fustat and Tinnis.⁴⁸ But members of the Fatimid dynasty and their officials also faced the same faith when the Ayyubids confiscated their wealth. In Egypt, the most extensive application of confiscations occurred under the Mamluks. This is because, Mamluks were not organized as a dynasty and any one of their members could assume power. So, the ruling elite resorted to the confiscation of their potential rivals ruthlessly. Thus, for the Mamluk ruling elite, confiscation was an instrument of eliminating the rivals. In central Asia, Ghaznavids and in Iran Selcukids also applied confiscations extensively.

Under the Ottomans, confiscations had to wait until the concentration of power at the hands of the dynasty. When Musa Çelebi attempted to resort to confiscations prematurely, he lost the throne to his brother Çelebi Mehmet. The first major well known Ottoman confiscation occurred during the reign of Mehmed II in the second half of the fifteenth century. Following the centralization of power in this period, confiscations were extended to all

⁴⁸ *ibid.* p. 66

important officials regardless of their guilt or failure. This is because, all wealth accumulated by a government official was regarded as originally belonging to the state and therefore considered liable to confiscation. Legitimised in this way, confiscations were normally limited to the members of the military/ruling class. But as the Empire began to fight wars on three fronts with European powers, plus Iran, defeats began to occur by the late seventeenth and eighteenth centuries, and confiscations were extended to non-military class individuals as well. Moreover, confiscations did not remain limited to the capital but were extended to the provinces. Lower level provincial officers also began to confiscate the properties not only of their rivals but of the innocent wealthy as well. During the 1768-1774 war with Russia, even the modest properties of small scale craftsmen were confiscated. In the early nineteenth century Mahmud II resorted to confiscations to wipe out the power of the provincial *ayans*. This same sultan did not hesitate to confiscate even the *waqf* properties of the abolished *janissary* corps.⁴⁹

One case from the eighteenth century Diyarbakır, a remote province, is particularly revealing. We are informed by Mehmet Genç that when a major merchant died in Diyarbakır, his wealth was confiscated. Normally, according to Islamic law, the state is not permitted to do this to the rightfully earned

⁴⁹ Ögün, “Müsadere; Osmanlılarda”, pp. 67-68. Confiscations became illegal in the Ottoman empire as late as the year 1839.

property of a free Muslim. Indeed, protection of property, *hifz al-mal*, is considered to be one of the tenets, even a *raison d'être* of Islamic law.⁵⁰ But the argument put forward by the officials to legitimize this confiscation, in itself, was most revealing. Indeed, it had been argued that a fortune of this magnitude could not have been accumulated by trade. It could only have been accumulated by tax-farming. Since tax-farmers were members of the ruling class, the *askerî*, the deceased could be considered a member of the military/ruling class. Therefore, his wealth could be confiscated!⁵¹

This case reveals a number of important points. First, beginning with the disastrous second siege of Vienna in 1683, the state was forced to take extraordinary steps. One of them was extending confiscations to civilians despite the fact that fortunes collected by the private sector were considerably less. Indeed, the wealth of this merchant was about one-half or even one-fourth of the fortune of an average member of a military/ruling class person.⁵² Second, the argument

⁵⁰ Çizakça, "Democracy", *passim*.

⁵¹ Genç, *Devlet ve Ekonomi*, p. 75.

⁵² Genç, *ibid.* p. 75. In some extreme cases, fortunes collected by high level military class members could reach to staggering proportions. When the failed commander in charge of the second siege of Vienna, Merzifonlu Kara Mustafa Paşa, was executed, his confiscated wealth stood at the staggering figure of 225.000.000 akçes. This was about 20% of the revenue of the Central Treasury for that year. Özvar, *Malikâne Uygulaması*, p. 16-17.

used for this unusual step reveals that merchants' profits must have been somehow controlled, because it is taken for granted that trade does not enable a person to accumulate much wealth. Third, the argument that substantial wealth can only be accumulated by tax-farming suggests that there must have been different rates of profits associated with different sectors in the economy. It is indeed clear from the text of the document that profits in tax-farming must have been allowed to be higher, probably significantly higher, than in other sectors.⁵³ This suggests the existence of a massive crowding-out effect in the Ottoman economy leading to a flow of investable funds from all sectors to tax-farming, where higher profits were permitted. Put differently, the bulk of the savings of the private sector available for private investment must have been sucked in by the state sector through tax-farming, leaving little for private investment.⁵⁴ This is indirectly confirmed by Nelly Hanna,⁵⁵ who has documented that the famous

⁵³ During a conference convened in Artvin, Turkey in June 2009, Genç has pointed out to the possibility that profits even in tax-farming were controlled. But the text of the document leaves no room for doubt that still tax-farming profits must have been significantly higher than those prevailing in commerce.

⁵⁴ This, in itself, must have been very harmful for the economy. Because funds were withdrawn from the most productive sector of the economy, the private sector, into the least productive one, the state sector.

⁵⁵ Hanna, *Big Money*, p. 41.

merchants of the seventeenth century Egypt, the Abu Taqiyyas, shifted their investments from trade to tax-farming indicating the prevalence of higher profits in that sector- a clear case of the state sector crowding-out the private sector.⁵⁶

The essence of above arguments is the existence of different rates of profit permitted in the economy. This needs to be examined further. Based upon a decree dated 1501, Ömer Lütfi Barkan informed us long ago that, possibly from the middle of the fifteenth century but, definitively from the beginning of the sixteenth until the second half of the nineteenth centuries, the Ottoman state controlled prices and through prices, the profits. Moreover, artisans were normally not permitted to earn profits of more than 10 percent. Genç confirms this and reports that throughout this period, the Ottoman state constrained the profit rates for merchants and artisans to between 5 and 15 percent, the exact rate depending upon the nature of the activity.

Since these maximum profit rates were sustained for more than three hundred years and observed operating in such diverse places as Istanbul, Bursa (Turkey), Salonica (Greece) and Cairo (Egypt), we can reach the conclusion that limiting profit rates of merchants and artisans by controlling prices was a general

⁵⁶ Tax-farming was privatized tax collection. Though primarily a private sector activity, it is still considered as a state sector activity since the collection process was institutionalized by the state and the taxes thus collected were channeled to it.

Ottoman policy.⁵⁷ These low profit rates are definitively confirmed by a law from the reign of Mehmed IV, dated 1680, which promulgated clearly that the urban grocers and merchants were to be permitted to earn 10 percent. If the activity was considered to be particularly difficult and labour intensive, a 20 percent profit rate could be permitted. The law, tellingly, states that all commodities can be imposed maximum prices, the *narh*.⁵⁸ But this law dated

⁵⁷ Barkan, “Bazı Büyük Şehirlerde”, p. 340; Genç, “Osmanlılar”, p. 528. Şevket Pamuk, however, has warned that the Ottoman state applied a maximum price policy, *narh*, only during extra-ordinary times. See; his *500 Years of Prices*, pp. 164-69. While this may be true, Pamuk’s own data reveals that *narh* orders have been issued for 163 years out of a total of 319 years between 1520-1839, i.e., roughly once every two years. Naturally, as Pamuk argues, *narh* imposition was clustered around difficult years. Moreover, this does not take into consideration the multiple *narh* orders issued in a single year. Thus at least half of the period in question has witnessed *narh* imposition. Since *narh* imposition implies low profits, we are not surprised that low profit rates have been confirmed by the Islamic court registers as well. Consider the following cases found in the Ottoman Court Registers in 1672 (4.5 percent - silk trade), 1801 (8 percent - grocery) and 1803 (6 percent - stone masons) see; Çizakça, *Comparative Evolution*, pp. 71-81.

⁵⁸ “Bilcümle şehir içinde bey’ u şira eden ehl-i hirefe nezaret olunub her kişinin harcını, sermayesini zahmetini görüb ve onu onbir üzere narh verile. Meğer gayet zahmetli ve emekli iş ola. Ol vakit onu oniki kâide konup tecâvüz olunmaya. *Ve hiçbir nesne olmaya ki kadı ve muhtesib mârifetiyle narh verilmeye*”, Ergin, *Mecelle*, vol. 1, p. 390. That the generally

1680, essentially repeats the same profit rates promulgated by the 1501 one reported by Barkan. Such constantly low profit margins imposed by the state over the very long run confirm the insensitivity of the state to the needs of the merchants. In another law known as the *Tevkiû Abdurrahman Paşa Kanunnâmesi*, it is stated that unless a pertinent *ferman* is issued, prices cannot be increased or decreased. Indeed, *narh* did not always entail an increase in prices. Sometimes it involved a *decrease*, occasionally even substantially.⁵⁹

Moreover, since all production, from the raw material to the final product, was organised by the guilds, each guild tried to control the prices of the other, whose final product it consumed as its input. Thus input-output relations along the production process organized by the guilds, was another factor that helped control the maximum profit rates imposed by the state. The strictly guild and *narh* controlled production process appears to have functioned as a zero sum game, with any guild able to increase its profit rate only at the expense of that of another further along the production process. Consequently, the guilds controlled each other, both in terms of prices charged and profits earned. When

approved profit rate was 10 percent and for exceptionally difficult production processes upto 20 percent, is also confirmed by Barkan, “Bazı Büyük Şehirlerde”, p. 340.

⁵⁹ In reality, *narh* prices were determined and administered by *Kadı*s supported by government officials. Occasionally the Sultans, themselves, ordered the imposition of *narh*. See, Kütükoğlu, *Narh Müessesesi*, p. 7, 12.

in case of conflict, a guild appealed to a court, the latter always ruled according to the rates and prices promulgated by the law. The mechanism of *narh* controlled prices continued, not only in Istanbul but also in the provincial cities, until the middle of the nineteenth century.⁶⁰

Under these conditions of limited profits, restricted property rights and controlled prices, it is no wonder that capital accumulation remained limited among the Ottoman merchants and artisans. Indeed, this is confirmed by various analyses of estates. Haim Gerber has shown that in the period 1600-1630 the artisans of Bursa on average left estates worth 66,163 akçes. This is not a high figure if we consider the fact that Gerber considers 20,000 akçes as the borderline of poverty. The average estate left by a merchant in the same period was worth 133,395 akçes, about 6.5 times the poverty line, again not a huge fortune. Moreover, 68 percent of the merchants left estates worth below 100,000 akçes and only 5 percent had serious capital between 500,000 and 1,000,000 akçes.⁶¹ Inalcık, in an article designed to demonstrate capital formation in the Ottoman economy, had to concede that even the richest guildsmen did not possess large capital sums.⁶² Research covering the period seventeenth-

⁶⁰ Kütükoğlu, *ibid.*, p. 8, 18.

⁶¹ Gerber, *Economy and Society*, pp. 21-29.

⁶² İnalcık, "Capital Formation", p. 135.

eighteenth centuries in Damascus (Syria) and Cairo (Egypt) has revealed that estates left by hundreds of craftsmen ranged between 400-1,000 gruş and by merchants between 1,500-4,000 gruş.⁶³

Profit controls imposed by the state, do not constitute the only impediment to the accumulation of mercantile capital. Another equally important factor is the relationship between profit rates and the prevailing rate of interest.⁶⁴ Adam Smith has argued that an important condition for capital accumulation is that the interest rate (marginal cost of capital) should be about half as much as the “ordinary rate of clear profit”. In the Ottoman Empire roughly the reverse was true. Indeed, according to Smith’s condition, for Ottoman merchants to accumulate capital, the interest rate should have been about 2.5 to 10 percent, that is, half as much as the average rate of permitted profit of 5 to 20 percent. But the prevailing rates of interest in the unofficial Ottoman capital markets were between 15 to 25 percent.⁶⁵ Thus merchants could have access to capital

⁶³ Genç, “Osmanlılar”, p. 528.

⁶⁴ Despite the interest prohibition, unofficial yet *de facto* interest prevailed in the Ottoman capital market.

⁶⁵ Genç, *Devlet ve Ekonomi*, p. 51. Cash *waqfs* (charitable foundations established with cash) lent at around 11 to 12 percent “economic interest”, a situation, which naturally led to the emergence of a secondary capital market. Indeed, it has been shown that some trustees borrowed money from the very *waqfs* they managed in Bursa, only to lend it with a margin to

only at interest rates well in excess of the permitted profit rates, a situation certainly not conducive to capital accumulation. Among the contemporaries, it was Montesquieu, who noticed the higher rates of interest prevailing in Islamic countries. He attributed this to the prohibition of interest and the consequent increase in transaction costs associated with trying to evade the Islamic law.⁶⁶

Whatever the causes of these relatively high rates of interest may have been, the real impediment to capital accumulation was the considerably lower rates of permitted profitability *vis a vis* the prevailing very high rates of interest.

Public finance constitutes an interesting exception to the generally much lower rates of profit prevailing in the economy. This indicates that this sector was given preferential treatment. In order to enhance the flow of private capital to the public sector, the *sarrafs*, who financed most public finance transactions, were allowed to pay up to 15 percent for deposits in order to allow them to attract capital to finance tax-farming. When they loaned to tax-farmers they were permitted to charge 20-25 percent interest.⁶⁷ Once again, these very high rates of interest were clearly beyond the means of merchants whose profit rates were kept well below 20 percent.

the money dealers in Istanbul. Çizakça, *Philanthropic Foundations*, p. 49. This has been confirmed most recently by Deguilhem, *Wakf*, p. 89.

⁶⁶ Smith, *The Wealth of Nations*, pp. 96-97.

⁶⁷ Genç, "Osmanlı Ekonomisi", forthcoming.

Conclusion:

To sum up, it was the Ottoman economic policy which impeded accumulation of capital. Under these circumstances of geography, price and profit controls, high interest rates, property rights restrictions, wide-spread confiscations and sustained crowding-out effect, the corporate form was simply not needed.

Indeed, forming a corporation and accumulating large fortunes would have invited instant confiscation. Thus we conclude, it was the peculiar characteristics of the Ottoman command economy rather than the alleged rigidity of *Shari'a* which was responsible for the lack of the corporate form, the short life span and lack of capital accumulation in the Islamic world.⁶⁸

⁶⁸ This conclusion can only be vindicated by a comparative study of the history of property rights in the world of Islam and the West – a task well beyond the present confines of this work. It should suffice here to say that some European countries like England and the Netherlands, where mercants had more political influence, enjoyed better property rights. In England, the turning point came with the Glorious Revolution in 1688. Absolutist monarchies, like Spain and France did not provide such extensive property rights. The result was reflected in relative growth rates as well as real wages. See; North and Thomas, *The Rise*; North and Weingast, “Constitutions and Commitment”, pp. 803-32. On real wages see; Pamuk and Özmucur, “*Real Wages*”, pp. 293-321, 312-14. See also; Broadberry and Gupta “*Great Divergence*” pp. 2-31. Most recently, Dincecco was able to demonstrate that regimes where executive discretion was well controlled achieved much higher levels of revenue and

Furthermore, it will be argued here that all legal systems, Islamic included, sooner or later respond to the needs of the society. Thus, had the need surfaced, Muslim jurists would have responded and sanctioned the corporation. Indeed, from the waqf with perpetual life span to the corporation with judicial personality, it would have been but a small step. Actually, some jurists are convinced that Islamic law has always recognized judicial personality.⁶⁹ Therefore, the problem was not the rigidity of the Islamic law but a lack of need for the corporate form. But this lack of need was not caused, as Kuran has argued, by the rigidity of the *Shari'a* and the Islamic law of inheritance but because of the restricted property rights, price/profit controls and confiscations observed in all Islamic empires, policies which culminated in the Ottoman command economy. Indeed, it was not the *Shari'a* but the Ottoman economic doctrine, which remained constant.⁷⁰

therefore power. See, Dincecco, "Fiscal Centralization", pp. 48-104.

⁶⁹ Hatemi, *Medeni Hukuk*, pp. 35-53; Zahraa, "Legal Personality", pp. 193-206; Sanusi, "The Concept", forthcoming.

⁷⁰ The relative flexibility of *Shari'ah* was infact confirmed by recent research, which demonstrated that notwithstanding the claims of some orientalist, the "Gate of Ijtihad" was in fact never closed. Therefore, Muslim jurists could have, indeed, easily created the corporation had it been needed. See, Ali-Karamali and Dunne, "The Ijtihad Controversy", pp. 238-57. Approval of the cash waqfs after a long debate in 1586 also confirms this flexibility.

Admittedly, the evidence presented here primarily pertains to the Ottoman empire, which covered for four centuries about one-fourth to one-third of the Islamic world. This evidence therefore has provided only a partial refutation of Timur Kuran's arguments. A more definitive test can only be provided if economic historians of Iran, central Asia, the Indian sub-continent and the Malay world also join the debate. It is therefore hoped that this article will serve as an invitation to these colleagues.

For further details on this see; Demir, *Ebussuud Efendi*, p. 164. Indeed, it has been argued that the Ottoman economic doctrine remained constant from its early beginnings in the fourteenth century to the nineteenth. It is for this reason that Genç has identified these five hundred years as "the classical age" of the Ottoman empire. See; Genç, *Devlet ve Ekonomi*, pp. 92-93.

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