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ABSTRACT

In this paper, the foundational rules governing human, economic and financial development in Islam, as understood from the Quran and from the life and traditions of the Prophet Muhammad (pbuh), are summarized. These rules pave the path to development as the basis of institutional structure, which in turn, underpin the path of economic and social progress. The essential elements in the life of a Muslim – the unity of creation, freedom and freedom of choice, economic and human development, economic system and financial practice – are developed.

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Understanding Islam: Development, Economics and Finance

Introduction

Susilo Bambang Yudhoyono, the President of Indonesia, the most populous Muslim country, recently wrote: "The big question for 2010 – and the whole century – is whether the world's civilizations, religions and cultures will finally depart from their persistent patterns of conflict."¹ As the title of his article confirms, the anticipated conflict, real or imagined, is between Islam and the West. Others have asserted that Islam is incompatible with progress – modernization, democracy and the freedom to choose, human freedom, human development, economic development, technological change, gender equality – and insinuate that conflict between the West and those that are labeled as "Muslim" is inevitable.² These prognoses and predictions, and many others like them, are based on an unfounded assumption – the behavior and actions of individuals, societies and countries that are labeled "Muslim" affords an accurate picture of Islam and its teachings. In fact, there is a wide chasm between the vision of the Quran for human development and the results achieved by Muslim societies. Religious sheiks, mullahs and politicians have interpreted their own brand of Islam for the masses – brandings that invariably represent a distorted picture of Islam and its teachings. This is not to say that priests, ministers, preachers and rabbis have not done the same. In a world of mass consumerism, religion has become a consumer product like any other, differentiated and marketed the world over. For the West and Muslim countries to engage each other effectively, it is essential that *both* Muslims and non-Muslims have a better understanding of the teachings and foundation of Islam.

In this paper, the rules governing the Islamic system as understood from the Quran and from the life and traditions of the Prophet (pbuh) are summarized. We endeavor to elaborate how complying with these rules paves the path to development as conventional development theories today consider operative rules as the basis of institutional structure, that in turn, underpins the path of economic and social progress. We hope to clarify the essential elements in the life of a Muslim – the unity of creation, freedom and freedom of choice, economic and human development, economic system and financial practice. Islam should be understood for what it is, not what some would like to have the world believe. More often than not, it is the lack of detailed knowledge

¹ The Economist, *The World in 2010*, "How to Let Islam and the West Live in harmony," Page 66.

² Samuel P. Huntington, *The Clash of Civilizations and the Remaking of World Order*, Simon & Schuster, 1996; Bernard Lewis, *What Went Wrong? The Clash Between Islam and Modernity in the Middle East*, Oxford University Press, 2002.

of the principles and institutional requirements of Islam that has created the gulf between the Islamic vision and actual practice. While the Quran presents clear rules of behavior (institutions) for a balanced, holistic development of the individual and of the collectivity, these have been ignored, or poorly understood, represented and practiced. This is important as non-Muslims and Muslims engage each other to resolve their differences. In the process, it is hoped that Islamic prescriptions in economics and finance will be demystified.

The Unity Of Creation and Freedom of Choice

Islam is a rules-based system, with rules prescribed by Allah for His Worship and for socioeconomic affairs of humankind. The prescriptions ordained by the Law Giver and explained and implemented by His Messenger are also rules. Allah monitors compliance and there are rewards for compliance and reprimands for non-compliance.

There are four fundamental concepts supporting the rule-based system that is Islam. The first is *Walayahh*, the unconditional, dynamic, active, ever-present Love of the Supreme Creator for His Creation manifested through the act of creation and the provision of sufficient resources to sustain life and flourish during their temporary existence on this earth. Humans reciprocate this Love by extending their love to other humans and to the rest of creation. The core activity of *walayahh* is love manifested through knowledge and the upholding of justice. The second is *karamah*, human dignity. The Quran considers humans to be the crowning achievement of the creation for whose individual and collective development everything else has been created. Humans are endowed with intelligence to know their Creator, to recognize and appreciate the universe and everything in it, and to understand the reasons for their own existence. The third is the *meethaq*, the primordial covenant in which all humans are called before their Supreme Creator and asked to testify that they recognize in Him the One and Only Creator and Sustainer of the entire Creation and all other implications flowing from this testimony. The fourth concept is *khilafa*: agency-trusteeship. Jointly, *Walayahh* and *karamah* provide the basis for *khilafa*. The Love of the Creator endows humans with dignity and intelligence so as to manifest *Walayahh* through the instrumentality of *khilafah*. *Khilafah* is the empowerment of humans by their Creator as agent-trustees to extend *walayahh* to one another, materially through the resources provided to them by the Creator, and non-materially through unconditional love for their own kind as well as for the rest of creation. Full understanding of these fundamental concepts manifests itself in operationalization of *walayahh* through rule compliance. The central anchor-rule of the collectivity of rules and a powerful enforcement mechanism is that of actively urging fellow humans to rule compliance and avoidance of rule violation.

A number of verses of the Quran affirm the unity of mankind [1: 4; 13: 49; 28: 31].³ These verses plus those dealing with the availability of resources as well as human endowments are the foundation of the legislative framework of rules (institutions) for the socio-economic-political behavior of humans. Resources are created for all humans. The diversity of humans does not and should not mean their disunity. In the primordial covenant, all humans recognize the Unity of the Creator as well as their own unity. They also have full cognition of their responsibility to maintain the unity, solidarity and integrity of creation through their service to humanity and to the rest of creation, while removing barriers to progress along the axis of *walayahh*. Any attempt at divisiveness is transgression, impeding the progress of humans toward unity. The fundamental idea expressed here is that the ultimate source of all acts of love originates with Allah. The active-dynamic love of nature or of parents for their children, for example, is a manifestation of the *Walayahh* of Allah. Everything good initiates from the *Walayahh* of Allah. If one is asked to transgress against others one must refuse, again out of love and allegiance to Allah. Behaving justly toward one's fellow humans is the manifestation of the recognition of the love of Allah. In contrast, devotion or service to tyrants is in direct conflict with the love of Allah.

The ultimate *walayahh* toward Allah—*úbudíyyah* or adoration of the Creator through service to His Creation—is to be intended for and returned only to Allah. That is, no one or nothing should be associated with the ultimate *walayahh* to Allah. The world is built upon a multitude of *walayahh*-relationships. Since the unity of creation is a corollary of the Unity of the Creator, any act or thought that creates disunity or discord in the creation—for example, the acceptance of factors, such as race, color, creed that compartmentalizes humans for discriminatory treatment—is a reflection of *shirk* (associating partners with Allah). For this reason, the Quran condemns any basis for differentiation (doling out different treatment) between humans.

Walayahh of the Supreme Creator provides the basis for human dignity, which, in turn, empowers humans with the ability to utilize all material resources. Three other non-material faculties allow humans to dynamically respond to *walayahh*: (i) *áql*, empowering reflective reasoning in humans; (ii) a primordial nature (*fitrah*), serving as an ultimate compass imprinted on the essence of humans; and (iii) freedom of choice. These provide support for humans to be fully conscious and aware of the dignity of their human state. Once humanity made the correct choice by entering into a covenant of cognition of the Unity of the Creator and His *Walayahh* and of returning the *Walayahh* of the Creator through the exercise of the gift of freedom of choice, humanity was then appointed as agent-trustee on earth. This, according to the Quran, was a momentous decision that even the angels questioned [172: 7; 30: 2]. The autonomy provided by the freedom of choice is exercised through compliance, or non-compliance, with rules (institutions) specified by the Creator that are necessary for a harmonious existence.

³ Quranic verses are referred to in the text as [verse: chapter].

The most important dimension of the adoration of Allah, *úbudíyyah*, is removing barriers on the path of other humans to empower them to perform their own function of *úbudíyyah*. For example, poverty and destitution are barriers for the poor on their path to reach perfection. Removing these barriers from the path of the poor is an act of *íbadah*, a demonstration of the *walayahh*, the active-dynamic love for one's own kind in adoration of the Creator and in return for His Active-Dynamic Love for His Creation. In politics also, ensuring that no human is deprived of the freedom of choice, sharing the risk of standing up for justice is an act of *íbadah*. Actions taken to ensure the ability of other humans to activate the gifts granted to them by their Creator is an act of adoration of the Creator. The Islamic vision for mankind is to achieve unity.

Human and Economic Development in Islam

The prevailing Western concept of development can be viewed as a return to the traditions of the Scottish Enlightenment, in particular to Adam Smith. In his book, *The Theory of Moral Sentiment*, Smith expressed his insight regarding rules of conduct "as the ultimate foundations of what is just and unjust in human conduct... The regard to those general rules of conduct is what is properly called a sense of duty, a principle of the greatest consequence in human life, and the only principle by which the bulk of mankind are capable of directing their actions... Without this sacred regard to general rules, there is no man whose conduct can be much depended upon. It is this which constitutes the most essential difference between a man of principle and honor and a worthless fellow. . . Upon the tolerable observance of these duties depends the very existence of human society, which would crumble into nothing if mankind were not generally impressed with a reverence for those important rules of conduct. This reverence is still further enhanced by an opinion which is first impressed by nature, and afterward confirmed by reasoning and philosophy, that those important rules of morality are the commands and *Laws* of the Deity, who will finally reward the obedient, and punish the transgressors of their duty. . . The happiness of mankind as well as of all other rational creatures seems to have been the original purpose intended by the Author of Nature when he brought them into existence. No other end seems worthy of that supreme wisdom and benignity which we necessarily ascribe to him;..... But, by acting according to the dictates of our moral faculties, we necessarily pursue the most effectual means for promoting the happiness of mankind, and may therefore be said, in some sense to co-operate with the Deity, and to advance, as far as is in our power, the plan of providence. By acting otherwise, on the contrary, we seem to obstruct, in some measure, the scheme, which the Author of Nature has established for the happiness and perfection of the world, and to declare ourselves, if I may say so, in some measure the enemies of God. Hence we are naturally encouraged to hope for his extraordinary favor and reward in the one case, and to dread his vengeance and punishment in the other. . . When the general rules which determine the merit and demerit of actions comes thus to be regarded as the *Laws* of an all-powerful being, who watches over our conduct, and who, in a life to come, will reward the observance and punish the breach of them – they

necessarily acquire a new sacredness from this consideration. That our regard to the will of the Deity ought to be the supreme rule of our conduct can be doubted of by nobody who believes his existence. The very thought of disobedience appears to involve in it the most shocking impropriety.”⁴

Economists have ignored this Smith and have focused on the champion of self-interest—the basis for utility and profit maximization for the individual consumer and producer, whatever the cost to society, even if it means the impoverishment and exploitation of fellow humans. Smith makes clear that while compliance with the rules prescribed by the Creator is a must, compliance with the market, an instrument for achieving the greatest good, is also a necessity. Smith, as will be seen, clearly shares some of the scaffolding of Islam: belief in the One and Only Creator; belief in the accountability of the Day of Judgment; belief in the necessity of compliance with the rules prescribed by the Creator; and belief that justice is achieved if there is full compliance with the rules. Smith also considers the internalization of the rules, being consciously aware of the ever-presence of the Creator and acting accordingly, as crucial to all human conduct. An important insight of the new institutional economics (NIE) is that rules reduce uncertainty and transaction costs, promote coordination and make collective action possible, and that rule-compliance promotes social solidarity.

During the late 1970s, the intellectual and practical field of development totally changed its focus to human beings, both as the means and the end of the development process. This dramatic change in focus was in large part due to Mahbub ul Haq and his colleagues.⁵ This change culminated with the contributions of Amartya Sen to a paradigm shift in development thinking, by arguing against neoclassical dogma, especially the “narrowing” of Smith’s view by “the believers in, and advocates of, self-interested behavior.”⁶ Support for this view “in Adam Smith is, in fact, hard to find on a wider and less biased reading of Smith. The professor of moral philosophy and the pioneer economist did not, in fact, lead a life of spectacular schizophrenia. Indeed, it is precisely the narrowing of the broad Smithian view of human beings in modern economics that can be seen as one of the major deficiencies of contemporary economic theory. This impoverishment is closely related to the distancing of economics from ethics.”⁷ Sen’s idea of development as freedom assesses wellbeing in terms of what people are capable of being and doing. Sen calls distinct aspects of being and doing, or achieving a specific lifestyle or mode of living, functionings. In assessing human wellbeing in the capability space, Sen suggests that functioning as a point in the capability space represents a specific combination of what a person is able to do. In

⁴ Adam Smith, *The Theory of Moral Sentiments*, New York: Dover Publications, pp.154-146, 2006 (originally published in 1790).

⁵ Mahbub ul Haq, *Reflections on Human Development*, New York: Oxford University, 1995.

⁶ Amartya Sen, *Development as Freedom*, New York: Anchor Books, 1999.

⁷ Vivian Walsh, “Smith After Sen,” *Review of Political Economy* Vol. 12 No. 1, 2000: 5–25.

Sen's framework, capabilities represent the real opportunities individuals have to lead or achieve a certain type of life. Functionings, on the other hand, represent the actual life they lead. Defining development as a process that promotes human wellbeing would mean expansion of capabilities of people to flourish.

The concept of development in Islam has three dimensions: individual self-development called *rushd*, the physical development of the earth called *isti'mar*, and the development of the human collectivity, which includes both. The first specifies a dynamic process in the growth of the individual toward perfection. The second specifies the utilization of natural resources to develop the earth to provide for the material needs of the individual and all of humanity. The third concept refers to the progress of the human collectivity toward full integration and unity. Fundamental to all three is the belief that the Supreme Creator has provided the ways and means to facilitate the achievement of all three dimensions of development.

The process of self-development requires self-purification, which begins with self-awareness, the first sign that the self does not have an independent existence without its Creator and His Creation. This awareness starts an interactive process in which Allah empowers the self along the path to perfection. Progress indicates further advancement in the recognition and knowledge of the Unity of the Creator and His Creation. For example, the degree of sensitivity the person experiences in feeling the pain and suffering of the "other," is an indication of the progress of purification.

With regard to the physical development of the earth, the Islamic view would suggest that the Almighty would not leave humans without sufficient resources to perform the duties expected of them. Indeed, the Quran makes it clear that Allah has created sufficient resources to meet the needs of all humans at any time and He has done so dynamically, meaning that this sufficiency holds regardless of timeframe and population [49: 54; 8: 13; 3: 65; 21: 15]. Consequently, the assumption that at a cosmic, universal, and general level humanity (macro) faces scarcity would be untenable. This, however, may not be the case at the micro level.⁸ As one of the important tests of human experience on this plane of existence, individuals, and groups of humanity experience conditions of plenty as well as conditions of scarcity [15-18: 89; 37-42: 30; 34-36: 34]. The rules prescribed by the Cherisher Lord specify the appropriate response to these tests. The wealthy and the opulent are those who are most susceptible to responding inappropriately. The Islamic view of scarcity is thus in contrast to

8 Asad Zaman, "Toward A New Paradigm for Economics," *Journal of King Abdulaziz University: Islamic Economics*, Vol. 18, No. 2, pp. 49-59, 2005; Asad Zaman, "The Ethical and Political Foundations of Scarcity," Draft Paper, International Institute of Islamic Economics, International Islamic University, Islamabad, Pakistan, September 2005; A. Barrera, *God and the Evil of Scarcity*, Notre-Dame, Indiana: University of Notre Dame, 2005; S. Marglin, "How the Economy is Constructed: On Scarcity and Desire," in *Social Inequality*, Andres Solimano (ed.), Ann Arbor, Michigan: The University of Michigan Press, 1998: 15-27.

conventional economics, where there is never enough to go around. According to Islam, there are sufficient resources if individuals share. With regard to exhaustible resources, Islam teaches that these are the heritage of all generations and current generations must preserve the right of future generations—for every individual in each generation to reap the same benefit. Robert Solow in his examination of exhaustible resources concluded similarly: “The finite pool of resources (I have excluded full recycling) should be used up optimally according to the general rules that govern the optimal use of reproducible assets. In particular, earlier generations are entitled to draw down the pool (optimally, of course!) so long as they add (optimally, of course!) to the stock of reproducible capital.”⁹

When it comes to the development of the human collectivity, the Quran recognizes legitimate authorities in an Islamic society--those who have *Walayahh/walayahh, Rububiyyah/úbudiyyah* relationships and are fully familiar with and adhere to the prescribed rules. The important point is that it is only the rule-compliance of those in authority that legitimizes them to oversee the implementation of the prescribed rules. Believers are the first to recognize the strength of the belief in such people and then by exercise of their free choice to follow and obey them [59: 4]. Even those with legitimate authority have been left with no degree of freedom to rule according to their own judgment. They must rely on Allah and the Messenger as the ultimate authority in judging rule-compliance. The strength of belief of those vested with legitimate authority must surpass that of a representative believer. The highest office of the leadership of the society, *Imamate* or *Khilafat*, is inaugurated by *mubayaa* (from the word *bai'*), which is a contract between the ruler and the community stating that the leader will be rule-compliant in discharging the duties of the office. This provides a strong accountable basis for governance.¹⁰ The term of the contract between the ruler and the ruled is clear: full compliance with the prescribed rules by the legitimate authority. The community and its members commit to following and obeying the legitimate ruler so long as he is rule-compliant. No authority can violate the prescribed rules and retain legitimacy. No community can claim that it has remained a believing community while governed by an authority that is non-compliant. The Prophet warned that non-observance of this duty by individuals and the community will create the conditions that will result in Allah empowering the worst among humans to rule over the community. And if non-compliance by the community and its members continues in the face of injustice by the illegitimate authority, this becomes a rule violation subject to adverse consequences for the whole community. Such a community heads toward destruction, because those in authority will continue to violate rules in the face of silence and inactive rule-compliance of the members of the

9 Solow, Robert M., “Intergenerational Equity and Exhaustible Resources,” *The Review of Economic Studies*, Volume 41, Symposium on the Economics of Exhaustible Resources, 1974, p.41.

10 Al-Hakimi et al. 1989, Vol. 2, 448-459.

community [16: 17].

The process of the physical development of the earth by humans who are aware of themselves, of the responsibilities of trusteeship-agency, and who are ever conscious of their Creator renders sacred all economic activities. There is a command from the Prophet that every activity must begin in the name of Allah, lest it remain incomplete. Profound in its simplicity, this rule is a mechanism of transforming to sacred, as if through an alchemical process, even the most apparently trivial and mundane action. Activities begun and ended with full awareness and consciousness of the Creator follow the rules prescribed for the correct and rightful exploitation of resources, and this, in turn, allows them to flourish as intended by the Creator. The flourishing of these resources removes material barriers on the path to perfection for humans, barriers caused by the paucity of economic resources facing humans individually or in groups. Economic activities undertaken in the Name of the Supreme Creator illuminate the hallowed responsibility of managing resources in accordance with the prescribed rules and the trusteeship-agency of the earth gifted to humans by Allah. Kenneth Cragg marvels: "How duly this delegacy role chimes with the dimensions of the present global scene, its ecological crisis and its political urgency! How decisively it dignifies each selfhood, as never exempt, as always relevant! How in its bearings, it evokes an inter-human mutuality across all frontiers—as, otherwise, frontiers they must be. In 'dominion' the self, without ceasing to be private, becomes a social factor. The world loses a parasite and gains a benison."¹¹ The "otherwise" warning bell, with its variety of "frontiers" created by "selfishness" without the growth and maturation to "selfhood," has already produced desperate human conditions: rising inequality, extreme poverty and hunger amidst plenty, high infant mortality and low life expectancy, the inability to cope with natural disasters because of insufficient investment in infrastructure, and devastating wars and civil conflicts.

It was only in the last three decades of the twentieth century that professionals looked at a broader concept of development, namely, that humans should be the ends, rather than the means of development. Even in the most sophisticated of concepts—Sen's development as freedom—the imperative of self-development as the prerequisite for a comprehension of the substantive meaning of freedom received little attention. If development means freedom and functioning, then what guarantee is there that without self-development, doing what one values will not lead to fully self-centered, selfish outcomes? The Islamic concept places great emphasis on the need to focus human energy on the achievement of social solidarity and unity. Islam's emphasis on the social dimension is so great that there is not one act of adoration and worship that is devoid of societal implications. The success of each human, on this plane of existence and beyond, is made dependent on patient and tolerant interaction and cooperation

¹¹ K. Cragg, *The Quran and The West*, Washington D.C.: Georgetown University, 2006: 27–49.

with other humans [20: 3]. The idea is that mutual support and social solidarity bring about a more tolerant and patient response to individual and collective difficulties. It is the interconnectedness of humanity that calls forth the order from the Supreme Creator for cooperation in good deeds [2: 5]. The fundamental objective of creation is to create a society in which individuals become cognizant of all their capabilities, including the spiritual. When humans are able to actualize these capabilities, it makes possible a life the Quran refers to as *Hayat Tayyibah*, the good life, a life free of anxiety, fear, and regrets; a life of full awareness of the beauty of creation and Creator; a life of solidarity with other humans and the rest of creation; and a life lived in the full Grace of Allah. The final objective of such a society is to ensure the actualization of the capabilities of humans to progress along the path to perfection toward their Creator. This is the common objective of society as well as of individuals. Achieving such an objective is not possible except through the mechanism of love, which grows so strongly that it lights up the inner torch of *taqwa*, the ever-intensive consciousness of the Supreme Creator.

Institutional Economic Structure (Rules of Behavior)

The availability of resources, technology and the efficiency of their utilization determine the level of economic development and the rate of economic growth. Technological progress is encouraged in Islam since this provides the means by which humans can satisfy their material needs and thus remove the economic barriers on the path to their spiritual progress. Moreover, institutions (rules and norms plus their enforcement) have been found to play a crucial role in determining total factor productivity (TFP). The closer the compliance of actions—in production, exchange, distribution, and redistribution—of society with the governing rules, the higher the total factor productivity, the rate of growth, and the level of economic development. We now turn to important Islamic values, such as abstinence from hoarding of wealth, and summarize the rules for: property rights, market behavior, exchange and trade, and contracts and trust.

Being a believer, that is having *iman*, implies a minimum threshold level of inner (heartfelt) rational-experientially validated belief in the three fundamental axioms central to Islam, i.e. the Oneness of the Creator, Prophethood, and the Day of Accountability, as well as a minimum level of conscious awareness, i.e. *taqwa*. In terms of participation in economic activities, this means that rules governing economic behavior in an Islamic economic system, based on the Quran and the life of the Prophet, are held sacred and binding. Such a system can be defined as a collection of institutions—rules of conduct and their enforcement characteristics—designed by the Law Giver to deal with the allocation of resources, the production and exchange of goods and services, and the distribution-redistribution of the resulting income and wealth. The objective of these rules is to achieve justice, to reduce uncertainty for individuals and to allow them to overcome the obstacles presented by their ignorance. Rules specify what kind of conduct is most appropriate for avoiding conflict and

achieving just results. Since everyone knows the rules, the reaction and response of individuals to each situation results in the clarity of the expectations.¹² The effectiveness of rule enforcement is determined by the degree to which the objective of the system, namely, the establishment of justice, is an integral part of the subjective self. It is *iman* that motivates the love of humanity (*walayahh*), which empowers rule-compliance, and *taqwa* assures constancy of behavior in rule-compliance. The sharing of the risks of life is motivated by *walayahh*, which every believer operationalizes through behavior in compliance with the rules. It is the *walayahh* for other humans and for the rest of creation that prompts the believer to want the best for others and to comply with the rule of commending the good and forbidding the transgression of rules. It is love that would call forth full participation in the economic, social, and political life of the community by the believer. It is love that explains why: *You will never achieve righteousness until you spend of what you love the most.* [92: 3]

While there are many biographies of the Prophet, there is much less scholarly research on his economic policies during his tenure as the temporal authority in the society he organized in Medina.¹³ Rules of governance, accountability and transparency; rules regarding property ownership and protection; rules regarding the formation and the structure of the market; rules concerning the role of the state vis-à-vis the market; rules of behavior by market participants; rules regarding distribution and redistribution; rules related to education, technological progress and society's infrastructure; and rules regarding sources of government income and its expenditures were all promulgated during the ten years of the Prophet's life in Medina. The central axis of design and operation of these rules is justice. The Prophet taught the responsibility of the individual and the collectivity. He particularly emphasized the equality of individuals before the law. The first and the most important of the Prophet's efforts was the formation of a society based on Islamic teaching; this he achieved with the assistance of the critical mass of his followers who had migrated with him to Medina. It was first necessary to create peace, social stability, and the means of defending the nascent society from external threats. The social contract with the inhabitants of Medina constituted agreed-upon procedures for administering society as well as procedures for the mutual support and defense. Next, the Prophet clarified rules of property rights over natural resources.

Before looking at rules governing property rights, it may be instructive to get a precise understanding of what property means. It can be defined as a bundle of rights, duties, powers, and liabilities with respect to an asset. In the Western concept, private property is considered the right of an individual to use and dispose of along with the

¹² M.R. Al-Hakimi, M. Al-Hakimi, and Ali Al-Hakimi, *Al-Hayat*, Tehran: Maktab Nashr Al- Thaqafa Al-Islamiyyah, 1989, Vol. 1, 184-186.

¹³ One such scholarly study is S. K. Sadr, *The Economy of the Earliest Islamic Period*, Tehran: Shaheed Beheshti University Publishing, 1996.

right to exclude the access of others. Even in the evolution of Western economies, this is a rather new concept of property that has accompanied the emergence of the present form of free market economies. Before that, however, property rights did not include the right to dispose of an asset or to exclude others from its use. For example, a grant of property rights over a parcel of land, a corporate charter, or a monopoly granted by the state gave its possessor the right to the revenues accruing from those grants but excluded the right of disposing of the asset. It was thought that the free market economy required a revision because the restriction on the ability to dispose of a property was incompatible with a free market economy. In Islam, however, limitations on the disposal of an asset, for example, rules against waste, destruction, and opulent use, are retained without diminishing the role of the market.¹⁴

Property relations are governed by a set of rules regarding rights and obligations. The first rule governing property relations is that everything in creation, including humans, is the property of the Creator. He has created natural resources for the benefit of all of mankind. The second rule asserts the rights of the human collectivity to these resources: *He it is who created for you all that is in the earth* [29: 2]; and: *Do not give your resources that Allah has made you (responsible as) its preserver on to the foolish* [5: 4]. These two verses, and a number of others, establish the right of access to these resources by all humans. The third rule establishes that once the property is accessed and combined with work by individuals, a full right of possession of the resulting product is established for the individual without either the Creator losing His Original Property Right or the collectivity losing its initial right of possession to these resources. The fourth rule recognizes only two ways in which individuals gain legitimate property rights: (i) through their own creative labor, and/or (ii) through transfers—via exchange, contracts, grants, or inheritance—from others who have gained the property rights title to an asset through their own labor. Fundamentally, therefore, work is the basis of the acquisition of right to property. Work, however, is not only performed for the purpose of satisfying one's desires, it is considered a duty and an obligation. The importance of work has been emphasized in over 300 Quranic verses and reflected in the *Sunnah*. An important corollary of the importance of work is a fifth rule that forbids gaining instantaneous property rights without having worked to earn them, with the exception of lawful transfer. This rule prohibits property rights gained through gambling, theft, earning interest on money, bribery, or, generally, from sources considered unlawful [188: 2; 29: 4]. Although Islam prohibits debt-based contracts, it embraces a contract of exchange that allows risk sharing and consumption smoothing [275: 2; 29: 4].

Just as work is a right and obligation of all humans, so is access to and use of natural-physical resources provided by the Creator for producing goods and services. If an individual, for whatever reason, lacks the ability to work, it does not deprive him of

¹⁴Al-Hakimi et al., 1989, Vol. 3, 155-177.

his original right to resources granted to every human. Therefore, the rule of the “immutability of property rights” constitutes the sixth rule of property relations. Before any work is performed on natural-physical resources, all humans have an equal right and opportunity to access these resources. When individuals apply their creative labor to resources, they gain a right to priority in the possession, use and exchange of the resulting product without nullifying the original property rights of the Creator or the rights He granted to all humans in the final product or the proceeds from its sale: This is the justification for the rule of sharing [33: 4; 180: 3; 36-37: 4; 5-11: 92]. The duty of sharing the product or the income and wealth proceeding from its sale constitutes the seventh rule of property relations, which relates to property ownership rights as a trust. This rule is operationalized through the ordained duties imposed on income and wealth, which must be paid to cleanse income and wealth from the rights of others. This is perhaps the reason why the Quran refers to these duties as *zakat*, from the root word meaning cleansing and purification, akin to tree pruning that simultaneously rids the tree of its undesirable parts and allows its further growth. The eighth rule of property relations imposes limitations on the right of disposing of property—a right that is presumably absolute in the Western concept of property rights. In Islam, individuals have a severely mandated obligation not to waste, squander, or destroy (*itlaf* and *israf*), or to use property for opulence (*itraf*) or unlawful (*haram*) purposes, such as bribery. Once the specified property obligations are appropriately discharged, including that of sharing in the prescribed amount and manner, property rights on the remaining part of income, wealth, and assets are held sacred and inviolate and no one can force their appropriation or expropriation. While these eight rules strongly affirm mankind’s natural tendency to possess—particularly products resulting from individual labor—the concomitant property obligations promote interdependence and cohesion among the members of society. Believers are persons in a relationship of reciprocity. Private initiative, choice, and reward are recognized and acknowledged, as legitimate and protected but are not allowed to subvert the obligation of sharing.

The Quran fully acknowledges the important contribution of markets and places great emphasis on contracts of exchange (*bay’*) and trade (*tijarah*). The Prophet implemented a number of policies to enhance the market mechanism and to encourage the expansion of trade. While Medina had its own existing market, the Prophet, with the advice of the leading merchants, selected a location for a new market for Muslims. Unlike in the existing market in Medina, the Prophet prohibited the imposition of taxes on transactions and individual merchants. He also implemented policies to encourage trade among Muslims and non-Muslims by creating incentives for non-Muslim merchants in and outside of Medina. The rules included, inter alia, and in addition to those mentioned above, no restrictions on international or interregional trade (including no taxation of imports and exports); the free spatial movement of resources, goods, and services from one market to another; no barriers to market entry and exit; free and transparent information regarding the price, quality, and quantity of goods, particularly in the case of spot trade; the specification of the exact date for the completion of trade

where trade was to take place over time; the specification of the property and other rights of all participants in every contract; guaranteed contract enforcement by the state and its legal apparatus; the prohibition of the hoarding of commodities and of productive resources for the purpose of pushing up their price; the prohibition of price controls; a ban on sellers or buyers harming the interests of other market participants, for example, by allowing a third party to interrupt negotiations between two parties in order to influence the negotiations to the benefit of one of the parties; and a ban on the shortchanging of buyers, for example, by not giving full weight and measure. Moreover, sellers and buyers were given the right of annulment of a deal: (i) before leaving the location in which it was taking place; (ii) in the case of a buyer who had not seen the commodity and after seeing it found it unacceptable; (iii) if either the seller or the buyer discovered that the product had either been sold for less than, or bought for higher than, it was worth; (iv) if the buyer discovered that the quality of the product was not as expected; (v) if side conditions were specified during the negotiations which were unfulfilled; (vi) if a delivery period was specified but the product was not delivered on time; and (vii) when the subject of the negotiations were pack animals, the buyer had the right to return the animal up to three days after the deal was finalized. These rights of annulment ensured that market participants were protected against a lack of, or faulty, information.

The moral-ethical foundation of market behavior prescribed by the Quran and implemented by the Prophet was designed to minimize the risk for participants and increase the efficiency of exchange. Moreover, rules specified in the Quran regarding faith to the terms of contracts and the knowledge of their enforcement increased certainty and reduced the cost of contracts. From the earliest period of operation of the Medina market, the Prophet appointed market supervisors, whose assignment was to ensure rule-compliance. He ranked honest market participants with prophets, martyrs, and *awlia'* (plural for a *waliyy*) of Allah, because like prophets, they follow the path of justice, like martyrs they fight against heavy odds (satisfy their own greed), and like the truthful Lovers of Allah they are steadfast in their path to perfection. The Prophet would advise the participants to go beyond mere rule-compliance and to treat their fellow humans with beneficence. While justice in the market would be served by rule-compliance, which limits and controls selfish behavior, beneficence rises higher by actually sacrificing one's self-interest for the interests of others.

During his life in Medina, the Prophet laid the foundation for a public treasury. He devised an efficient system not only for collecting prescribed dues, which the Quran had ordained as the rights of members of society in each person's income and wealth, but also for rents and dues on public lands used by private producers and for the per capita dues paid by non-Muslims for benefits derived from public services (paid in lieu of dues paid by Muslims), accruing to the state treasury for redistribution to the needy. He established a means of defense against external threats, an education system, and procedures for the adoption of new technologies and infrastructural investments. He

insisted on the participation of all members of society in its affairs, he encouraged education, he supported the adoption of technologies from neighboring states and people, and he encouraged the expansion of social infrastructure. His emphasis on health and hygiene was so strong that he considered it a religious duty. He emphasized productive work and while he would use the public treasury to alleviate destitution and poverty, he would strongly discourage reliance on handouts to the able-bodied. To encourage work, one of his policies was to enforce risk-reward sharing in production and in trade. He urged his wealthier followers to invest in public infrastructures, for example in water wells, for the benefit of society. He discouraged hoarding of wealth, which is prohibited in the Quran [34: 9].

The Prophet emphasized that it is always the rich, powerful, and the opulent who are exploiters of other humans, who, in order to amass wealth, are the source of the persecution and suffering of the prophets and their followers.¹⁵ The Prophet is constantly reminded in the Quran that the crucial aspect of his own mission, and that of the prophets before him, is to establish justice. In practical terms, the Quran is clear that this means creating a balanced society that avoids extremes of wealth and poverty, a society in which all understand that wealth is a blessing afforded by the Creator for the sole purpose of providing support for the life of all members of society. While the rich consume opulently, the poor suffer from deprivation because their rights in the wealth of the rich are not redeemed.¹⁶ Islam ordains that what is left after one has reached a modest living standard must be returned to the less able members of society as an act of redeeming their rights [7: 57]. Therefore, while Islam ordains hard work, the development of the earth and natural resources provided by the Creator, and the use of proceeds for the satisfaction of the needs of all humans, it prohibits the concentration of output in the hands of a few.¹⁷ Operationally, such an economy can be defined as: the collection of institutions (described above), that is, the rules of conduct and their enforcement characteristics, to deal with the allocation of resources, the production and the exchange of goods and services, and the distribution and redistribution of the resulting income and wealth to establish balance and justice in society.¹⁸

As mentioned earlier, scarcity is not the problem; instead it is selfishness, the misuse of resources, and human greed that cause scarcity, poverty, misery, and destitution. Societies that reject divine law have institutions and power relations that allow significant inequalities, which, in turn, lead to inequality of income and wealth. It is the institutional structure of society that allows a pattern of wealth accumulation, creating abundance for some and scarcity for many. This is what creates social divisions, not natural scarcity. It is the institutional structure of society that determines

¹⁵ Al-Hakimi et al., 1989, Vol. 3, 285-318.

¹⁶ Al-Hakimi et al., 1989, Vol. 3, 211-214; Vol. 4, 203-273.

¹⁷ Al-Hakimi et al., 1989, Vol. 4, 168-179.

¹⁸ Al-Hakimi et al. 1989, Vol. 6, 324-415.

the resource endowments of its members, which, in turn, determine the structure of their preferences and ultimately their economic behavior. Such an institutional structure combined with a poorly functioning process of self-development provides no opportunity for the self to transcend the focus of the self on “me and mine.” Self-development is necessary to transcend selfishness. The Quran clearly states the need for “a revolution in feeling or motivation.” [11: 13] The revolution, as defined comprehensively throughout the Quran, is a change toward compliance with the rules of just conduct for the individual. The “ethos of justice” is created in society by a critical mass of those whose behavior fully complies with the prescribed rules. We now turn to rules covering access to resources, production, exchange, distribution, and redistribution.

Although the Quran acknowledges that in His Wisdom the Lord has created humans with differences, it also emphasizes that these differences are only apparent and that all humans are the same. In a society in which there is poverty amidst plenty, the roots of inequality must be traced to distortions in the pattern of resource endowments, in the workings of the exchange and/or distribution mechanisms and/or in the redistributive framework. The most fundamental among these is the pattern of resource endowment. This pattern determines the formation of individual preferences, which, in turn, determine behavior in the rest of the economy and in society. Individual preferences are not only influenced by the pattern of resource endowment, but also by the “ethos” of society. The ethos of society, in turn, is influenced by individual beliefs. The feedback processes between the pattern of resource entitlement, belief, ethos, and preference formation are complex, and distortions in these processes are highly consequential for the emergence of poverty, economic inefficiencies, and reduced economic growth and development.

Douglas North believes that cognition plays a central role in belief formation, which, in turn, affects preference formation, rational decision-making, and institutions.¹⁹ Institutions (rules) have a reciprocal effect on cognition. Beliefs constitute what North refers to as a “mental model.” However, whereas North believes that institutions “are clearly an extension to the mental constructs the human mind develops to interpret the environment of the individual,” in Islam, rules (institutions) are provided by the Law Giver. For a believer, the “mental model” is formed by these rules (institutions). It is the dense network of rules that reduces uncertainty for individuals and society. When society includes a critical mass of believers, compliance with these rules constitutes the ethos of society. The cognition of the basic structural framework of the belief in Islam forms the “mental model,” which then determines rule-compliance, preference formation, decision-making, and behavior. As Uslaner asserts: “Economic

¹⁹ North, D.C. “Five Propositions About Institutional Change,” in *Explaining Social Institutions*, edited by J. Knight and I. Sened, 15-26, Ann Arbor: The University of Michigan Press, 1995.

equality is the foundation of social solidarity (generalized trust) and trust in government. Generalized trust leads to greater investment in policies that have longer-term payoffs (education spending) as well as more directly leading to economic growth. A weak state with an ineffective legal system cannot enforce contracts; and a government that cannot produce economic growth and the promise of a brighter future will not be legitimate.”²⁰ Moreover, Uslaner suggests: “Unequal wealth leads people to feel less constrained about cheating others and about evading taxes.” And: “Inequality leads to unequal treatment by courts, which leads to less legitimacy for the government.”

Allah has ordained equally free access to resources by all humans and that the resulting income and wealth, which, by implication from the earlier principle, are also His Blessings, must not be hoarded, but must be shared with those who are less able to access the initial resources.²¹ This expenditure is over and above the mandatory portion of net income and wealth collected by the legitimate authority.²² These charges are referred to as *sadaqat* (singular: *sadaqah*) from the root word meaning truthfulness and sincerity. Their faithful discharge indicates the strength of the sincerity of a person’s belief. These expenditures are essentially the repatriation and redemption of the rights of others in one’s income and wealth. It is for the good of the person paying them that they are ordained.²³ Since these expenditures are the repayment of what is the right of those who were unable, or less able, to access the natural-physical resources that the Creator has made available to all humans, it is as repayment of a debt without which one’s wealth would be soiled. Redeeming these rights is a manifestation of one’s belief in the essential axioms of the Oneness of the Creator and His creation. When one is granted the mental-physical capacity by the Creator to access more of these resources, it means others less able or unable to use these resources are in fact one’s partners, whose rights in the final post-production, post-market proceeds have to be redeemed. The Quran affirms that because these are rights to be redeemed rather than charity, extreme care must be taken of the recipient’s human dignity.

As mentioned, Islam recognizes only two legitimate means of acquiring claims to property rights and prohibits transactions that create instantaneous property rights.²⁴ It is possible to distinguish transactions that create legitimate property rights claims from others by reference to a verse in the Quran in which two types of contract are identified: exchange (*al-bai’*) and usury (*al-riba*) [275: 2]. The first is permitted and the second is prohibited. An example of *al-riba* contracts is one in which rent is collected for the use of an amount of money for a set period of time without the transfer of the property rights

²⁰ E.M. Uslaner, *The Moral Foundation of Trust*, Maryland: University of Maryland College Park, 2008.

²¹ Al-Hakimi et al. 1989, Vol. 6, 93-111.

²² Al-Hakimi et al. 1989, Vol. 5, 441-480; Vol. 6, 33-92.

²³ Al-Hakimi et al. 1989, Vol. 6, 66-75.

²⁴ Al-Hakimi et al. 1989, Vol. 5, 371-440.

of the money being transferred to the borrower. Exchange (*bai'*) is a contract, a mutual transaction in which a bundle of property is exchanged for another. Since *al-bai'* is a contract, so must be *al-riba*; except that the latter is forbidden. That *al-riba* covers more transactions than just lending with interest can be gleaned from a saying of the Prophet: "First *fiqh* then trade. Whoever engages in trade without *fiqh* will surely be entangled progressively and drawn in *al-riba*."²⁵ Here the word *fiqh* refers to internalized knowledge of the rules governing exchange and trade. The rule specified here means that before entering the market, participants must know and have internalized the rules of market participation. Compliance with rules is necessary to reduce transaction costs as well as costs to third parties. Dealing with risk tests the resolve to be rule-compliant and is a source of learning and adaptation for humans. Sharing risk is the most important means of reducing volatility in income and consumption. It can arguably be claimed that all rules governing economic behavior in Islam are to promote risk sharing as a means of advancing human solidarity and the drive towards unity of mankind.

It follows from the above that the first rule of exchange and trade is to understand the prescribed precepts governing exchange and trade before entering the market. Most importantly, market participants are commanded to be fully and consciously aware of Allah at all times like *Men whom neither trade nor exchange entice away from remembering Allah* [37: 24]. The second rule governing exchange and trade is mutual satisfaction of both parties to the transaction because the Quran ordains that trade has to be based on mutual satisfaction of the parties [29: 4]. As explained earlier, there are a number of ways in which buyers and sellers are permitted to annul a transaction if they are unhappy, even if the transaction was devoid of all elements – such as cheating, deceiving, over praising or disparaging an item subject of the transaction, not giving full weights and measure – that would automatically render a transaction null and void. Moreover, a corollary of this rule is expressed in the Prophet's words: "Allah (Blessed and Glorified) loves his servants to be easy sellers and easy buyers . . . may Allah bless the person who eases selling and buying."²⁶

The next set of rules to be understood and internalized by individuals are those governing contract and trust. An insight by Polanyi suggests that the development of exchange on the basis of the legal institution of "contractus" rather than "status" was an essential antecedent of the development of markets.²⁷ John McMillan suggests that: "Any successful economy has an array of devices and procedures to enable markets to work smoothly. A workable platform has five elements: information flows smoothly; property rights are protected; people can be trusted to live up to their promises; side

²⁵ Al-Hakimi et al. 1989, Vol. 5, 374.

²⁶ Al-Hakimi et al. 1989, Vol. 5, 379.

²⁷ K. Polanyi, "Primitive Archaic, and Modern Economics," in *Essays of Earl Polanyi*, George Dalton (ed.), Beacon Paperbacks, 1971.

effects on third parties are curtailed; and competitions are fostered.”²⁸ Earlier discussion should confirm that Islam provides a strong “platform” of “devices and procedures to enable markets to work smoothly.” The key to market operation is decision-making autonomy. “Participation in exchange is voluntary; both buyers and sellers are able to veto any deal.” He is, however, quick to add that the choices of buyers and sellers “are not completely free though: they are constrained by the extent of their resources and by the rules of the market place.”²⁹ The collection of devices that organize and support transactions—channels for the flow of information; laws and regulations that define property rights and enforce contracts; and the informal rules, norms, and codes that help markets self regulate—he calls market design. A design that allows markets to keep transaction costs low, he calls “a workable” market design. Appropriately, he argues that high transaction costs render a market dysfunctional.³⁰ Two elements on which McMillan focuses as key to workable market design are the free flow of information and trust, both of which lower transaction costs.³¹

The rules prescribed by the Law Giver and explicated and implemented by the Prophet were intended precisely to reduce transaction costs. As observed in the rules developed for the market of Medina, the Prophet ensured, through the propagation of the rules of market behavior, that there would be no interference with the free flow of information regarding the quantity, quality, and prices of goods and services in the market, and this to the point where he forbade a previous common practice of middlemen meeting trade caravans outside the city and purchasing their supplies before the caravans entered the market. Market supervisors, appointed by the Prophet, ensured that there was no fraud, cheating, withholding of information, or other practices that could lead to the malfunctioning of the price mechanism. Each physical segment of the market was specialized with respect to products. Prices were determined by competition among suppliers and every market was intensely supervised by a person called *Muhtasib*, a practice started by the Prophet. Market supervision was supplemented by guilds of each profession and trade.³² Supervisory devices were based on the rule-enforcement mechanism of commanding the good and forbidding evil. These enforcement devices were fortified by the physical architecture of bazaars, which were constructed such that a grand mosque was located at the center of the bazaar. Every market participant, particularly the sellers, had an opportunity to attend at least two of the five daily prayers in the mosque, noon and afternoon. This

²⁸ John McMillan, *Reinventing the Bazaar: A Natural History of Markets*, London: W.W. Norton, 2002: ix.

²⁹ McMillan 2002, 5.

³⁰ McMillan 2002.

³¹ McMillan 2002, 9.

³² A. Metz, *Islamic Civilization in the Fourth Century of Hijrah*, translated by M. Abdil Hadi, Beirut: 1967: Chapter 26; M.J. Kister, “The Market of the Prophet,” *Journal of the Economic and Social History of the Orient*, January 1965; H. H. Shihata, “Market Competition in Light of Islamic Sharia,” Cairo, Department of Commerce: Al-Azhar University, 1977.

was an opportunity for market participants to be reminded of their Creator, of their obligations to Him and to other humans and of the accountability on the Last Day. Throughout the legal history of Islam, a body of rules, based on the Quran and on the traditions of the Prophet, has constituted a general theory of contracts. This body of rules covering all contracts has established the principle that any agreement not specifically prohibited by law was valid and binding on parties.

In a very important tradition, the Prophet says: "Three (behavioral traits) if found in a person, then he is a hypocrite even if he fasts, prays, performs bigger and small pilgrimages, and says 'I am a Muslim': when he speaks, he lies; when he promises, he breeches; and when trusted, he betrays."³³ There is a strong interdependence between contract and trust; without trust, contracts become difficult to negotiate and conclude, and costly to monitor and enforce. When and where trust is weak, complex and expensive administrative devices are needed to enforce contracts. Moreover, it is well known that complete contracts—ones that foresee all contingencies—do not exist. Thus trust is an important element of a well-designed market. When and where property rights are poorly defined and protected, the cost of gathering and analyzing information is high, and trust is weak, it is difficult to clearly specify the terms of contracts and enforce them. In these cases transaction costs—that is, search and information costs, bargaining and decision costs, contract negotiation and enforcement costs—are high. Where and when transaction costs are high, there is less trade, fewer market participants, less long-term investment, lower productivity, and slower economic growth. As North has pointed out, when and where there is rule-compliance and enforcement, there is an increase in the likelihood that property rights will be protected and contracts honored. Under such conditions, individuals are more willing to specialize, invest in long-term projects, undertake complex transactions, and accumulate and share knowledge.

Keefer and Knack argue that: "In fact, substantial evidence demonstrates that social norms prescribing cooperation or trustworthy behavior have significant impact on whether societies can overcome obstacles to contracting and collective action that would otherwise hinder their development."³⁴ The last decades of the twentieth century sparked considerable interest in the importance of trust and cooperation.³⁵ While trust

³³ Al-Hakimi et al. 1989; Z. Iqbal and A. Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, Singapore: John Wiley and Sons, 2007: 35–38, 244–246, 298–302.

³⁴ S. Knack and P. Keefer, "Does Social Capital Have an Economic Payoff? A Cross-Country Investigation," *The Quarterly Journal of Economics*, November (1997): 1251–1288.

³⁵ E. Lorenz, "Trust, Contract and Economic Cooperation," *Cambridge Journal of Economics*, Vol. 23 (1999): 301–315; E.M. Uslaner, 2008; F. Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity*, New York: Free Press, 1995; A. Alesina and E. La Ferrara, "Who Trusts Others?" *Journal of Public Economics*, Vol. 85 (2002): 207–234; J. Berg, J. Dickaut, and K. McCabe, "Trust, Reciprocity, and Social History," *Games and Economic Behavior*, Vol. 10, 1995: 122–142; Paul Zak and S. Knack, "Trust and Growth," *The Economic Journal*, Vol. III, April 2001: 295–321;

is necessary for the proper functioning of the market, trust is even more essential for social solidarity. In fact, Uslaner equates social solidarity with generalized trust. Among the conclusions Keefer and Knack draw from their empirical cross-country research on trust is that: (i) the levels of trust and trustworthiness vary significantly across countries, and (ii) both trust and trustworthiness “have significant effect on economic outcomes and development.” Moreover, they assert that “social norms that produce trust and trustworthiness can solve the problem of credible commitment,” which, where and when it exists, causes disruption in economic, political, and social interactions among humans. The problem of credible commitment arises when parties to an exchange cannot commit themselves, or believe others cannot commit themselves, to carrying out contractual obligations. Where this problem exists, long-term contracting will not be widespread and parties to exchange will opt for spot-market transactions. Knack and Keefer have found that per capita economic growth increases by nearly one percentage point per year for every ten-percentage point increase in the number of people who express trusting attitudes. They explain: “the larger the fraction of people in a society who share norms prescribing cooperative or trustworthy behavior in collective action setting, the more likely is the society to have overcome problems of credible commitment in the economic, political and social spheres . . . contracting parties can dispense with costly monitoring of performance. . . Individuals have more resources available for innovation and investment, as they can devote fewer resources to protecting themselves—through tax payments, bribes, or private security services and equipment—from unlawful (criminal) violations of their property right. Norms of civic cooperation reduce enforcement costs by leading individuals to internalize the value of laws and regulations even when the probability of detection for violation is negligible . . . Norms prescribing cooperation and trustworthiness enhance governmental effectiveness.” They conclude: “Evidence is fairly clear that income equality and education are linked to trust and other development-promoting norms.”³⁶

While in rule-based societies rule-violation is always an option, it has consequences. On the one hand, if rule-compliance monitoring is effective and the probability of exposure and sanction is high, everyone in society would expect that others will take action-decision “within the set of permitted and required action,” and the social order will be stable. On the other hand, when monitoring is ineffective and the probability of exposure and of being sanctioned is low, rule-compliance will be weak and social order unstable. All the prescribed precepts discussed here are those that are ordained by the Creator. Even if these precepts are not codified as the law of a

A. Mirakhor, “Globalization and Islamic Finance,” Presented at the Sixth International Conference on Islamic Economics and Finance, Jakarta, Indonesia, November 21-24, 2005; H. Askari, Z. Iqbal and A. Mirakhor, *Globalization and Islamic Finance: Convergence, Prospects, and Challenges*, John Wiley and Sons, 2009; E. Fehr, U. Fischbacher, and M. Kosfeld, “Neuroeconomic Foundation of Trust and Social Preferences: Initial Evidence,” *American Economic Association Papers and Proceedings*, Vol. 95 No. 2, 2005.

³⁶ S. Knack and P. Keefer, 1997.

given society and are not enforced, they are commands of the Creator requiring compliance; the non-compliant, both individually and/or collectively, are sanctioned. The rule of “commanding the good and forbidding evil” is perhaps the most important of all enforcement devices within the Islamic framework. The Prophet indicated the dire consequences for society and its members of non-compliance: “Comply with the rules of commanding the good and forbidding evil, for if you do not, the most evil among you gain sovereignty over you. Then you pray (for relief from oppression) and your prayers will not be answered.”³⁷ The only recourse for society is to *change what is in their self* and comply [11: 13].

Throughout the ages, one of the most important questions confronting mankind has been: on what basis should economic resources be distributed? The answer depends on the underlying concept of justice and fairness, which, in turn, depends on the belief system. The concept of justice for humans is simple and unambiguous: justice is obtained when all things are placed where intended by the Creator! How are humans to know where the right (just) place is for everything? The answer is: follow the rules prescribed by the Creator.³⁸ By the instrumentality of His *Walayahh*, the Loving Creator has provided all that is necessary for humans to achieve perfection of the human state. He has also clearly designated the path-to-perfection and has marked it with rules of behavior in all facets of human life. Rule-compliance assures justice, which assures balance for individuals and for society. Compliance with rules, however, does more than create balance, it guarantees that humans draw near to their ultimate objective, namely, their Creator. Morality, therefore, is a result of just behavior.

Given the rules governing property rights, work, production, exchange, markets, distribution, and redistribution, it is reasonable to conclude that in a rule-complying and Allah-conscious society, absolute poverty could not exist. It can be argued that there are no topics more emphasized in Islam than justice and poverty and the responsibility of individuals and society to eradicate poverty. The Prophet said that poverty is near disbelief and that poverty is worse than murder.³⁹ It is almost axiomatic that in any society in which there is poverty, Islamic rules are not being observed. It means that the rich and wealthy have not redeemed the rights of others in their income and wealth and that the state has failed to take corrective action.

Implications for Islamic Economics and Finance

³⁷ See the Prophet’s Saying number 2218 in A. Payandeh, *Nahjul-Fasaha*, Tehran: Sazamane Entesharate Javidan, 1974, pp. 470-471.

³⁸ Al-Hakimi et al. 1989, Vol. 2, 2-25; Vol. 6, 324-451; Seyed Qutb, *Social Justice in Islam*, translated by J.B. Hardie, Lahore, Pakistan, 1953.

³⁹ Al-Hakimi et al. 1989, Vol. 4, 278-468; Seyed Qutb, 1953.

Islamic economics and finance—misunderstood, or at best seen as exotic and of little practical significance—have received little attention in the Western professional literature and have been afforded a narrow interpretation in the popular press.

Islamic Economics: Islamic economics is a set of fundamental rules (institutions) structured on the Unity of Creation, as discussed above, that the Almighty has prescribed for those that choose to follow His Path. The problems facing all economic systems are what goods and services to produce, how to combine factors of production to produce them, and for whom should these be produced? The reason why all economies have to tackle these questions is the assumption that resources are scarce—everything cannot be produced to satisfy the insatiable wants of all members of society. However, as we have mentioned earlier, the Quran states that at the global level the Almighty has provided sufficient resources for humankind, which may not be the case at the local level. Moreover, the Quran does not accept the premise that individual desires for material goods are unlimited; devout Muslims should not be selfish consumers and must limit and control their material desires to support those that are less fortunate. Man needs bread to live, but does not live by bread alone.

In a market-based economy, the underlying assumptions are: consumers are rational individuals who buy goods and services to maximize their individual utility; firms maximize their profit; and with perfect competitive markets the interaction of these different independent agents (consumers and producers) produces an “optimal solution” to the economic questions facing society. Minimal government intervention may be required to address externalities (spillovers from the production and/or consumption of goods and services for which no appropriate compensation is paid, resulting in a divergence between private and social cost) associated with economic activity and other market failures, such as impairment of competition. This optimal solution embodies no judgment on the relative welfare of individual members of society (with abject poverty existing alongside tremendous wealth), does not take into account the welfare of future generations, and essentially assumes perfect mapping from the interest of individuals to that of society. As a result, though consumption and production may be close to their narrowly-defined optimum, a significant segment of society may be destitute, hungry and with little or no economic opportunity, and the welfare of future generations may be compromised. Although the Islamic economic system is a market-based system, an Islamic society cannot depend on the market alone to produce a just solution to the economic dimension of life. An Islamic system integrates into the market system Islamic values, which are the rules (institutions) prescribed by Allah and implemented by his Prophet,.

The central goals of Islam for the society are the welfare of all its members and socioeconomic justice. All members of an Islamic society must be given the same opportunities to advance; in other words, a level playing field, including access to the natural resources provided by Allah. For those for whom there is no work and for those

that cannot work, society must afford the minimum required for a dignified life: shelter, food, healthcare and education. The rights of future generations must be preserved. Thus Islam advocates an environment where behavior is molded to support the goals of an Islamic society: societal welfare and socioeconomic justice, with the goal of making humankind one, confirming the Unity of Allah's creation. It is with the Unity of Creation as the goal that the Quran advocates risk sharing as the foundation of finance (see below) to enhance trust.

Thus, a true Islamic economic system is a market based system, but with entrenched Islamic behavior and goals (objectives/rules/institutions) attributed to consumers, producers and to government (authorities), and with institutions as outlined above. For economic analysis, some of these Islamic values and goals can be introduced into the conventional behavioral functions of consumers and producers and others can be added as constraints in the maximization of consumer utility and producer profit. Based on the Islamic vision elaborated in this paper, we expect the Islamic solution to differ in the following important ways from the conventional: greater degree of justice in all aspects of economic management, higher moral standard, honesty and trust exhibited in the marketplace and in all economic transactions, poverty eradication, a more even distribution of wealth and income, no hoarding of wealth, less opulence in consumption, no exploitive speculation, risk sharing as opposed to debt contracts, better social infrastructure and provision of social services, better treatment of workers, higher education expenditures relative to GDP, higher savings and investment rates, higher trade/GDP, higher foreign aid/GDP, higher degree of environmental preservation, and vigilantly supervised markets. It would be expected that these differences would be reflected in higher quantitative and qualitative economic growth if the Islamic rules and objectives were adopted. One would expect a higher rate of growth as higher investment rate, higher educational expenditures, higher social awareness, better functioning markets, higher level of trust, and institutions that have empirically been shown to be critical for growth.

Islamic Finance: The objective of Islamic finance is to support real economic activities through risk sharing – producing real goods and services and prohibiting the financing of purely financial, speculative and other prohibited activities. The Quran strongly suggests that risk sharing, along with other prescribed behavioral rules, e.g., exhortation on cooperation [5: 2], serves to bring humans closer to unity, which, as discussed throughout this paper, in itself is a corollary of Islam's central axiom: *the Unity of the Creation*. It is a natural consequence of such a system to require risk sharing as an instrument of social integration. This is perhaps why the Quran places more emphasis on rules governing exchange distribution, and redistribution – to affect balanced risk sharing – than on production.

The central proposition of Islamic finance is the prohibition of transactions in which a rent is collected as a percentage of a principal amount loaned for a specific time

period without the transfer of the property rights, thus transferring the entire risk of the transaction to the borrower. The alternative to debt-based contracts is *Al-Bay'*, a mutual exchange, allowing both parties to share production, transportation, and marketing risks. This, in turn, allows specialization and gains from exchange. It further allows both parties to reduce the risk of income of volatility and to allow consumption smoothing, a major outcome of risk sharing.

The emphasis on risk sharing is also evident from one of the most important verses in the Quran in respect of economic behavior. The verse states that: "... *they say that indeed exchange is like usury (Riba). But Allah has permitted exchange and has forbidden usury...*" [275; 2]. This verse can be considered as the cornerstone of the Quran's conception of an economic system since from it flows major implications of how the economy should be organized. One of these implications relates to the nature of these two contracts; hence, it can be understood as the organizing principle of an Islamic economy. Etymologically, the first *Al-Bay'* is a contract of exchange of one commodity for another where the property rights over one good is traded for those of another. In the case of contracts of *Riba*, sum of money is loaned today for a larger sum in the future without the transfer of the property rights over the principle from the lender to the borrower. Not only does the lender retain property rights over the sum lent, but also property rights over the additional sum paid as interest is transferred from the borrower to the lender. The verse renders exchange and trade of commodities (and assets), requiring the freedom of parties to contract, the foundation of economic activity.

It is generally recognized that equity participation provides a first-best instrument of risk sharing. Moreover, there is some evidence that stock market and social interaction are related.⁴⁰ Shiller has recognized the potential benefits of risk sharing for mankind. He points out that "[M]assive risk sharing can carry with it benefits far beyond that of reducing poverty and diminishing income inequality. The reduction of risks on a greater scale would provide substantial impetus to human and economic progress."⁴¹ Arguably, the most meaningful human progress would be achieved when all distinctions among human beings on the basis of race, color, creed, income, and wealth are obliterated to the point where humanity truly views itself as one. Greater risk sharing and financial globalization could well promote the objective of the unity of mankind. Methods and instruments of risk sharing, such as equity participation, venture capital, and direct foreign investment, can explore all risk-return to assets and the real rate of return, leading to greater risk sharing. It can do so across

⁴⁰ H. Hong, J.D. Kubik, and J.C. Stein, "Social Interaction and Stock-Market Participation," *The Journal of Finance*, Vol. 54, No. 1, February 2004, pp. 137-163; Gur Huberman, "Familiarity Breeds Investment," *The Review of Financial Studies*, Vol. 14, No. 3, 2001, pp. 659-680.

⁴¹ Robert Shiller, *The New Financial Order: Risk in the 21st Century*, Princeton, NJ: Princeton University Press, 2003.

geographic, racial, national, religious, cultural, language, and time boundaries. In the process, it can help remove barriers among people and nations.

In regard to banking, an Islamic banking system can have two types of banking activities: safekeeping and payments activity, and investment banking. The first type of activity is similar to 100 percent reserve system, with deposits remaining highly liquid and checking services fully available. This system has to be a fee-based system to cover the cost of safekeeping, and transfers and payments services. The second activity is an investment activity with deposits considered as longer-term savings and allowing banks to engage directly in risk taking in trade, leasing, and productive investment in agriculture, industry, and services, on behalf of the investor. Most important characteristic of this activity is that it is immune to un-backed expansion of credit. An Islamic bank is assumed to match deposits maturities with investment maturities (with no need for asset-liability management). Returns to invested funds arise ex-post from the profits or losses of the operation, and are distributed to depositors as shareholders of equity capital. Since loan default is absent, safekeeping depositors do not face this risk of loss of their assets.

At its core, Islamic finance embodies ethical values which were, in the past, also characteristics of Christianity and Judaism, but which were eroded over time to serve the narrow interests of the wealthy and vested interests at the expense of society at large. While the beneficial and ethical attributes of Islamic finance are evident, most observers have largely ignored the economic benefits. Indeed, in the years between the two great wars, eminent Western economists, such as Keynes, raised serious questions about the stability of conventional finance. More recently, a number of economists are again questioning the stability assumptions of conventional finance, its debt-based characteristic and leveraging. Conventional banks fail to meet inherent stability conditions even in the presence of prudential regulations. Unlike conventional banks, Islamic banks do not create and destroy money. Money is not issued by the stroke of a pen, independently of the production of real goods and services. There can be no bank run or speculation, as the source of credit for speculation, credit multiplication, does not exist. Tangible real assets owned directly by the institution cover liabilities. Risks for Islamic financial institutions are mitigated as they relate essentially to returns from investment operations and not to the capital of these institutions. These features afford Islamic financial system added stability.⁴² While Islamic finance could afford a number of potential benefits if fully developed, no Muslim country has done so, and with a handful doing so in name only. In practice it has been principally used to tap Muslim funds, by both Islamic and Western institutions. Specifically, a number of instruments have been designed to simultaneously mimic the characteristics of conventional

⁴² Hossein Askari, Zamir Iqbal, Nouredine Krichene and Abbas Mirakhor, *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*, Foreword by Sir Andrew Crockett, John Wiley and Sons, January 2010.

instruments and be sanctioned as “*Sharia*-compliant.” Individual financial institutions have formed their own *Sharia* boards to sanction their instruments, affording significant fees to board members, and raising serious conflict of interest issues in the process.

Conclusion

The contour of an Islamic economy is one where everyone who is able works hard, using knowledge to combine with their own labor and the resources provided by the Creator, to produce goods and services for society. Economic, social, and political affairs are conducted with the goal of removing barriers to the progress of all humans and in full compliance with rules, including those governing property rights, market behavior, exchange and trade, and contracts and trust. Knowing that they are responsible and accountable, individually and collectively, they invest allegiance in a legitimate authority to carry out their affairs, with the legitimacy of the authority established by rule-compliance. The rule “commanding the good and forbidding evil,” applicable to individuals and society, assures the full and active participation of all in the affairs of society. Rules stemming from the *Walayahh* of the Creator and reflected in the *walayahh* of the believers for one another and for the rest of humanity and creation, as well as rules prescribing participation in acts of worship that are mostly public, promote human solidarity and unity. The existence of absolute and relative poverty, along with significant income inequality, is *prima facie* evidence of rule-violation and governance failure, for which members of society are, individually and collectively responsible.

These rules and institutions are the foundation of Islamic economics and finance. While conventional economics assumes scarcity of resources, Islam acknowledges scarcity only at the micro level and this due to misdistribution of income and wealth resulting from non-compliance with the rules of conduct; while conventional theory adopts the market and assumes that consumers maximize their own utility and producers maximize profits, the Islamic vision, although embracing the market-based system and proposing rules that enhance its functioning, includes a spiritual and moral foundation that attaches overriding importance to the welfare of society and of each and every individual in this and in future generations. Risk sharing is important in of itself as it promotes trust and brings humankind closer together—in support of the Unity of Allah’s Creation—and affords a number other potential benefits if fully developed, including financial stability.

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