Islam and Mammon

BY TIMUR KURAN

For reasons way too obvious to mention, it is long past time for Westerners to learn how Islam is affecting societies from Asia to the Middle East to Northern Africa to Europe. And few Western scholars are better qualified to help bridge the knowledge gap than Timur Kuran, a professor of law and economics, as well as the King Faisal Professor of Islamic Thought and Culture, at the University of Southern California. We are thus delighted to reprint an excerpt from his latest book, *Islam and Mammon: The Economic Predicaments of Islamism*, which has just been published by Princeton University Press*. ¶ Kuran is no Pollyanna. He coolly compares efforts to create an alternative to free-market capitalism from 1,400-year-old scripture to the utopianism underlying the catastrophic experiments with "scientific" socialism in the past century. At the same time, though, he offers sympathetic insights into the humanism underlying Islamism. And, as important, the USC professor offers a sense of hope that cultures anchored in this ancient religion will find ways to coexist with modern secular societies.

—*Peter Passell*

STEVE RAYMER/NATIONAL GEOGRAPHIC IMAGE COLLECTION

**Copyright Princeton University Press. All rights reserved.*

In 1979 Pakistan took some major steps to give its economy an Islamic character. To satisfy the presumed Qur'anic ban on interest, banks were ordered to offer an interest-free alternative to the conventional savings account and to purge interest from all their operations within five years. Although the wider objective has not yet been met, the interest-bearing savings account is no longer an option for new depositors.

Another highlight of the 1979 program was *zakat*, Islam's tax on wealth and income. Voluntary until then, zakat was made a legal obligation. The Pakistani government now collects zakat from several sources, notably bank deposits and farm output. Every year thousands of local committees distribute the proceeds to designated groups.

Pakistan has not been alone in trying to restructure its economy according to ostensibly Islamic stipulations. Zakat is now compulsory for certain groups in Malaysia, Saudi Arabia and the Sudan. In some other predominantly Muslim countries, the establishment of a state-run zakat system is under consideration.

The impact of Islamization is especially widespread in banking. Banks claiming an Islamic identity are in operation in most countries of North Africa, the Middle East and Asia. In some of these they hold more than 10 percent of the commercial deposits. The leading Islamic banks have also established a presence in countries where Muslims form a small minority. New Zealand now has an Islamic Finance Corporation, and Pasadena, Calif. an Al Baraka Bankcorp.

These developments are not occurring in an intellectual vacuum. A rapidly growing literature known as "Islamic economics" seeks to guide and justify the ongoing reforms. The prescriptions in this literature rest partly on economic logic and partly on the Qur'an and the Sunna – the latter consisting of recollections of the words and deeds of Prophet Muhammad and his companions.

A number of research centers have been established to promote Islamic economics. Some of these, including the International Center for Research in Islamic Economics at King Abdulaziz University in Jeddah, the International Association for Islamic Economics in Leicester, and the Kulliyah of Economics at the International Islamic University in Kuala Lumpur, publish journals devoted to the discipline. There are even several more specialized periodicals, notably the *Journal of Islamic Banking and Finance*, published quarterly in Karachi.

The discipline's exponents, who call themselves "Islamic economists," emphasize that it covers far more than zakat and interest-free banking. The discipline aims, they say, to provide a comprehensive blueprint for all economic activity. A list of suggested research topics published by the International Center for Research in Islamic Economics covers every major category of research recognized by the American Economic Association, including consumer behavior, market structure,

REZA/NATIONAL GEOGRAPHIC IMAGE COLLECTION

central planning, industrial relations, international trade and economic development.

Some Islamic economists are quick to admit that in most of these realms the nascent discipline has yet to make a significant contribution. But they generally agree that the fundamental sources of Islam harbor clear and definitive solutions to every conceivable economic problem. To find these, they suggest, we must turn to the Qur'an and to the wisdom of the earliest Islamic community in 7th century Arabia.

ISLAMIC ECONOMICS AS FUNDAMENTALIST DOCTRINE

The classical sources of Islam contain numerous prescriptions that lend themselves to the construction of economic norms, and the religion's early history offers an array of lessons concerning economic behavior and institutions. But the notion of an economics discipline that is distinctly and self-consciously Islamic is very new.

The origins of Islamic economics really lie in the works of Savyid Abul-Ala Mawdudi (1903-79), a Pakistani social thinker who sought to turn Islam into a "complete way of life." He argued that Islam encompasses all domains of human existence, including education, medicine, art, law, politics and economics. To support this assertion, he laid the foundations of several Islamic disciplines, among them Islamic economics. Other seminal contributions to Islamic economies were made by Sayyid Qutb (1906-66), an Egyptian, and Muhammad Baqir al-Sadr (1931-80), an Iraqi.

Islamic economics applies ancient solutions to perceived problems of the present; where such solutions are lacking, it seeks scriptural justification for favored reforms.

The teachings of these pioneers differ in major respects. Mawdudi is sympathetic to the market process, though he insists that market behavior must be constrained by behavioral norms found in the classical sources of Islam. Generally distrustful of the market, Qutb and al-Sadr favor supplementing norm-guided self-regulation by state-enforced controls. A related difference is that the latter two thinkers are relatively less tolerant of economic inequality.

Whatever its internal divisions, Islamic economics has always presented a united front in justifying its own existence. The dominant economic systems of our time, virtually every major text asserts, are responsible for severe injustices, inefficiencies and moral failures. In capitalism, interest promotes callousness and exploitation; in socialism, the suppression of trade breeds tyranny and monstrous disequilibria. The fundamental sources of Islam prohibit interest, but allow trade. Hence, a properly Islamic economy would possess the virtues of these two systems without their defects.

Typically, this claim is supported by references to Islam's canonical Golden Age – the period 622–61 AD spanning the last decade of Prophet Muhammad's life and the tenure of the "rightly guided" caliphs. During this period, it is suggested, the Islamic code of economic behavior enjoyed widespread adherence, the prevailing spirit being one of brotherly cooperation. Injustices were minimized. Resources were allocated very efficiently, ensuring a rapid rise in living standards. After the Golden Age, so the belief goes, the Muslim community's attachment to Islamic precepts weakened, setting the stage for a painful and protracted decline in Islam's global economic standing.

The case for restructuring economies according to Islamic principles thus rests on two claims. First, the prevailing systems have failed us. Second, the history of early Islam proves the Islamic system's unrivaled superiority over its alternatives.

To put the latter claim in perspective, we must recognize that by modern standards the 7th century economy of the Arabian peninsula was very primitive. It produced only a few commodities, using only simple technologies. Moreover, it featured only the most rudimentary division of labor.

The specific economic injunctions found in the Islamic scriptures – mostly in the Sunna

– are responses to problems that arose in this ancient setting. Some of these injunctions were perceived as eternally valid. But rules and regulations were altered openly and unabashedly in response to new conditions. As a case in point, the scope and rates of zakat underwent many modifications during the Golden Age.

The historical record also calls into question certain virtues attributed to the Golden Age. The notion that the early Islamic community was a paragon of brotherly unity conflicts with evidence that force played an important role in its governance. Significantly, three of the four "rightly guided" caliphs met their ends at the hands of fellow Muslims. Nor was the Golden Age free of the corrupt practices attributed to contemporary capitalism and socialism. Officials of the Islamic state, including the caliphs themselves, were often accused of nepotism and misjudgment.

©2002 THOR SWIFT/THE IMAGE WORKS

Still, the modern literature is replete with calls for the immediate implementation of the holy laws of Islam in the form they ostensibly took almost a millennium and a half ago. In issuing such calls, Islamic economics denies that certain economic problems of the modern age have no counterparts in the past. It also denies that once-beneficial institutions might now be dysfunctional – even harmful. Some of the rhetoric of Islamic economics thus conveys the impression that it seeks to rediscover and restore the economy of a distant past.

At the same time, Islamic economics draws heavily on modern concepts and methods, including many that originated outside the Islamic world. And it pursues such modern objectives as growth, employment creation and efficiency. It would be wrong, therefore, to characterize the doctrine's intense preoccupation with 7th century Arabia as merely a scholastic search for ancient solutions to ancient problems. Islamic economics applies ancient solutions to perceived problems of the present; where such solutions are lacking, it seeks scriptural justification for favored reforms.

Islamic economics is appropriately categorized as a "fundamentalist" doctrine because it claims to be based on a set of immutable principles drawn from the traditional sources of Islam. By no means does its flexibility in practice negate this label's descriptive power. All doctrines labeled "fundamentalist" claim to rest on fundamentals set in stone, yet in application these prove remarkably malleable. Moreover, such doctrines assert a monopoly over knowledge and good judgment, even as they show receptivity to outside influences.

Islamic economics has drawn sharp

criticism from two quarters. A number of scholars (including this writer) have drawn attention to the literature's empirical and logical flaws, arguing that the proposed institutions are either unworkable or inherently inefficient. Others have observed that Islamic economics has invited all this criticism by presenting itself not as a faith or philosophy to be understood on its own terms, but as a positive science that lives up to established scientific standards.

In this view, Islamic economics has been drawn into the game of utilitarian social science, and it is trying to prove its worth by beating the materialistic economic traditions of the West on Western turf. The mission of Islamic economics should be to create a worldview that brings material goals into harmony with spiritual yearnings. It should get on with this mission without offering excuses for pursuing non-utilitarian objectives.

The logic behind this call to self-imposed isolation parallels Mawdudi's apparent motivation for founding the discipline. He wanted to bolster Islam's authority in domains where Muslims had come to rely on the West's guidance. Thus, for Mawdudi, Islamic economics was primarily a vehicle for reasserting the primacy of Islam and secondarily an instrument for radical economic change.

Other supporters of Islamic economics have also subordinated it to wider objectives. The Ayatollah Khomeini made a point of denying that Iran's Islamic Revolution was motivated by economics. The revolution was not fought, he once quipped, to make watermelons more plentiful. Khomeini repeatedly spoke out, of course, against poverty and exploitation. But he always subordinated economic objectives to the general goal of restoring the centrality of Islam in private and public life – even to particular objectives such as eliminating the consumption of alcohol and ensuring feminine modesty.

For some, the attraction of Islamic economics lies in its promise to solve heretofore intractable economic problems. But Islamic economics also serves as an instrument of legitimization and power. In proposing that an Islamic economy will promote harmony, growth and justice simultaneously, Islamic economics enhances the appeal of an Islamic political order.

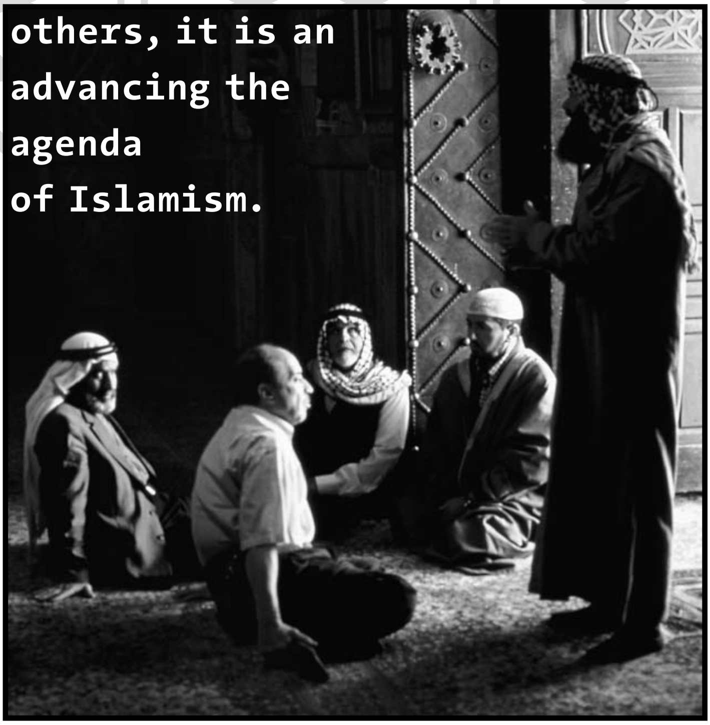
Each of the principal institutions engendered by Islamic economics, zakat and interest-free Islamic banking, provides sources of funding for Islamic causes. Islamic banks channel a portion of their profits into religious education, publishing, networking and other activities that foster the spread of Islam. Likewise, in countries with obligatory zakat, a significant portion of the proceeds are allocated to religious schools dedicated to the dissemination of Islamist views.

Islamic institutions also constitute a channel of upward mobility for Islamists. In Turkey, for example, Islamic banks provide career opportunities to religious youths whose cultural backgrounds might otherwise handicap them in the corporate world.

All this goes to show that Islamic economics owes its support only in part to the real and imagined successes of its applications. The merits of Islamic economics lie for some Islamists primarily in its Islamic character. But for others, the appeal is in the substance. And for still others, it is an instrument for advancing the political agenda of Islamism.

There are vast incongruities, I argue below, between the rhetoric of Islamic economics and its practice. Specifically, the impact of Islamic banking has been anything but revolutionary, the obligatory zakat has nowhere become a significant vehicle for reducing inequality, and, the emphasis on economic morality has had no appreciable effect on

The merits of Islamic economics lie for some Islamists primarily in its Islamic character. But for others, the appeal is in the substance. And for still others, it is an instrument for advancing the political agenda of Islamism.



economic behavior. By its own lofty yardstick, then, Islamic economics is a failure.

BANKING AND FINANCE

Suppose you lend $100 to an industrialist, at 5 percent interest for one year. Since you stand to receive exactly $105 at the end of the year, your return is predetermined. But the industrialist's return depends on the success of his business. If his revenue exceeds $105, he will make a profit. If it falls short of $105, he will incur a loss. An interest-based loan thus places the risk of loss entirely on the borrower. Under one interpretation of Islam, this is prohibited as unfair.

The literature is replete with additional reasons why interest is best avoided. "Interest," writes one Islamic economist, "inculcates love for money and the desire to accumulate wealth for its own sake." Another evil attributed to interest is that it "transfers wealth from the poor to the rich, increasing the inequality in the distribution of wealth." And yet another: it turns people away from productive enterprise.

The purpose of Islamic banking is to prevent such inefficiencies, moral failures and injustices by allowing people to borrow and lend without having to deal in interest. In theory, an Islamic bank accepts only two types of deposits: transaction deposits, which are risk-free but yield no return, and investment deposits, which carry the risk of capital loss for the promise of a variable return. The insured savings CDs of conventional banks are deliberately ruled out because they offer a predetermined return.

An Islamic bank's lending operations are based on the same principle of risk sharing. In lending money to a firm, it agrees to share in the losses of the underwritten business activities in return for a share of any profits.

Since Islamic banks and their depositors are allowed to profit from their monetary assets only by carrying some risk of loss, Islamic

REZA/NATIONAL GEOGRAPHIC IMAGE COLLECTION economics treats the mechanics of profit-and-loss sharing as a topic of paramount importance. Two techniques, each utilized in early Islam and discussed in classical Islamic jurisprudence, receive the bulk of attention: *mudaraba* and *musharaka*.

JAMES L. STANFIELD/NATIONAL GEOGRAPHIC IMAGE COLLECTION

Under mudaraba, investors entrust capital to an entrepreneur, who then returns a prespecified share of the resulting profits along with the principal. If the business fails, the capital loss is borne entirely by the investors – the entrepreneur's loss being his expended labor. Under musharaka, the entrepreneur adds some of his own capital to that supplied by the investors, exposing himself to a shared risk of capital loss.

Mudaraba and musharaka have been likened to the financing techniques used by venture capitalists. In advanced economies the venture capital industry has fostered the rise of many new enterprises, most recently the high-technology sector. Islamic banking, say its proponents, can make an equally significant contribution to the Islamic world's economic development.

The logic of this claim is simple. A banking system that bases its loan decisions on project profitability does not turn down projects with excellent long-term prospects but lengthy gestation periods. Nor does it deny support to entrepreneurs merely for lack of a track record. It thus allocates credit more efficiently than one that insists on demonstrated creditworthiness. And the result is faster development, with everyone benefiting.

The first Islamic bank offering a range of commercial services opened in Dubai in 1975, and Islamic banks are now in operation in more than 60 countries. Knowledgeable observers generally agree, however, that neither mudaraba nor musharaka has ever absorbed a dominant share of the Islamic banks' assets.

According the Central Bank of Iran, mudaraba and musharaka accounted for 38 percent of the assets of Iranian banks in 1986. Two years earlier, when the Islamization of Pakistan's state-owned banking system was ostensibly nearing completion, only 14 percent of that country's bank assets were in mudaraba or musharaka.

Moreover, most of the contracts categorized as mudaraba or musharaka were actually based on thinly disguised interest. The bank would set a target return on its loans, agreeing in advance to reimburse the entrepreneur for any "excess profit." It is widely believed that the share of legitimate mudaraba and musharaka in Pakistan never rose above a few percentage points and that it quickly fell to under 1 percent. In Turkey, where, in contrast to Pakistan and Iran, the banking sector remains heavily dominated by conventional banks, profit-and-loss sharing is similarly unpopular. Privately owned Islamic "finance houses" place, at most, 8 percent of their funds in mudaraba and musharaka.

The most popular financing mode of the Islamic banks is *murabaha.* Here, a borrower itemizes goods that he wishes to purchase – say, a ton of steel. The bank buys the steel, marks up its price as compensation for this service, and transfers ownership to the client. Along with his steel the client receives a bill at the inflated price, to be paid at some future date. What makes this transaction legitimate from an Islamic standpoint is that the bank takes ownership of the steel for some time, exposing itself to risk.

But the risk can be negligible because there is no minimum to the duration of the bank's ownership – a millisecond suffices. From an economic standpoint, of course, an infinitesimal ownership period makes murabaha equivalent to an interest-based loan: the bank bears no risk, and the client pays for the time value of money.

Banks whose declared mission is to stamp out interest are thus making extensive use of a technique that is nothing but interest concealed in Islamic garb. Under murabaha there is no penalty for late payment, as there is under interest. But the Islamic banks have devised an ingenious method for penalizing accounts past due. They simply charge in advance for late payment, offering the client a rebate for payment on time. In implementation, therefore, murabaha differs only cosmetically from the interest-based financing practices of the West.

The second most popular financing instrument is lease financing. The bank rents some asset – say, a truck – to an end-user for a specified period at a rate that reflects the truck's cost as well as the time-value of money. In theory, at least, lease financing satisfies the requirement of risk sharing, since the bank owns the asset for some period. If the truck suffers damage during the leasing period, the resulting loss would be borne by the bank. In practice, however, the bank shifts such risk to others by requiring the user to put up collateral and to pay for insurance.

Murabaha and lease financing are well suited to trade and commodity financing, but neither fits the provision of working capital to finance a firm's day-to-day operations. Nor are these financing instruments of use to a firm with a cash-flow problem; a company facing a pile of unpaid bills needs money, not merchandise. So, in its current form, Islamic banking does not qualify as a full-fledged substitute for conventional banking.

On the whole, the sectoral composition of the Islamic banks' investments does not differ significantly from that of conventional commercial banks. Their clients tend to be established producers and merchants, as opposed to newcomers. They generally favor urban borrowers, as opposed to rural villagers

Banks whose declared mission is to stamp out interest are thus making extensive use of a technique that is nothing but interest concealed in Islamic garb.

who remain dependent on moneylenders charging notoriously high rates.

The banks have shown no inclination to favor labor-intensive firms. Many have invested in real estate, and a few have speculated in international currency and commodity markets. With few exceptions, they have preferred trade finance to project finance. Insofar as they have engaged in project finance, they have favored safe, short-term projects over riskier long-term projects.

interest and profit-and-loss sharing, conventional banks create an "adverse selection" problem for the Islamic banks: entrepreneurs with below-average profit expectations prefer risk sharing in order to minimize their losses in the likely event of failure, while those with above-average expectations prefer interest in order to maximize their gains in the likely event of success.

The upshot is that the Islamic banks receive a disproportionately large share of the

Medieval Islamic civilization produced no organizations that could pool thousands of people's funds, administer them collectively, and survive the death of their managers.

bad risks. Of course, bankers can become reasonably adept at identifying bad deals. But the required skills are in short supply.

Even the Islamic Development Bank, an intergovernmental organization established in 1975 to promote development using Islamic financial instruments, has evolved into an export-import bank. It uses funds at its disposal largely to finance international trade – in particular, oil exports to poor countries of the Islamic world. Revealingly, from 1975 to 1986 the portion of profit-and-loss sharing in the Islamic Development Bank's portfolio fell from 55 percent to 1 percent, while that of murabaha rose from nil to over 80 percent. Lease financing has also increased sharply, although this mode of business is not even mentioned in the bank's charter.

The Resilience of Interest

Why are banks intended to revolutionize finance sticking so closely to conventional techniques? One reason is the ongoing presence of conventional banks in all countries with Islamic banks, except Iran and Pakistan. By allowing entrepreneurs to choose between

To remedy this recognized deficiency, an institute was established in 1982 in Turkish-controlled Northern Cyprus for training personnel to screen projects. But it closed in 1984, leaving the Islamic banking system in the lurch. So the adverse selection problem cannot be the only reason Islamic banks are reluctant to abide by their own principles.

A more fundamental factor is widespread tax fraud. Firms habitually understate their revenues and overstate their costs to conceal profits from the tax collector, generally getting away with it because of inadequate government audits. Under the circumstances, bankers are reluctant to lend on the basis of profit-and-loss sharing, unless they can sit on the recipient's board. By the same token, the typical firm will not let a banker monitor its operations, for fear that information will find its way to the government. In sum, there is a mutual distrust between the providers and users of funds.

Some Islamic economists are beginning to realize that profit-and-loss sharing is unworkable in the presence of rampant dishonesty. They continue to believe, however, that it is possible to lower dishonesty to a level at which borrowers and lenders will happily substitute sharing for interest.

Another reason the practice of Islamic banking conflicts with the underlying theory has to do with the profitability and low risk of trade and commodity finance. In many parts of the Muslim world, certain goods are routinely in short supply due to production controls, import restrictions and price ceilings. Firms that acquire these scarce goods for resale or production tend to profit handsomely, which makes financing their operations quite safe. Understandably, many Islamic banks would rather finance such ventures than sink funds into long-term development projects.

A Historical Perspective

Classical Islamic jurisprudence produced elaborate rules to regulate financial transactions among individuals. Yet, medieval Islamic civilization produced no organizations that could pool thousands of people's funds, administer them collectively, and then survive the death of their managers. The financial rules of Islam remained frozen up to modern times, precluding the formation within Islamic law of durable partnerships involving large numbers of individuals.

The first successful forerunner of Islamic banking was a savings bank established in 1963 in the Egyptian town of Mit Ghamr. This bank was modeled after some of West Germany's local savings banks. It paid no interest on deposits and charged no interest on loans, borrowing and lending on the basis of profit-and-loss sharing. The bank claimed an Islamic identity, partly to distinguish itself from government banks and partly to enhance its attractiveness in the eyes of pious Egyptian peasants.

The Mit Ghamr Savings Bank rapidly gained popularity and made a substantial contribution to the local economy. Nonetheless, it was closed in 1968 by a government hostile to private initiative and suspicious of religion. Significantly, Mit Ghamr was not modeled after some Islamic enterprise of the past. Its essential features were transplanted from a non-Islamic source, with no attempt to disguise this appropriation. By contrast, commercial banks chartered as Islamic organizations since 1975 have all been billed as inherently Islamic creations. Ironically, Mit Ghamr shunned interest and actively promoted long-term development while today's Islamic banks pay and receive interest as a matter of course, and their primary activity is trade finance.

In any case, it is unclear that the Qur'anic prohibition of interest was originally understood to encompass the institution as we know it today. What the Qur'an bans unambiguously is the pre-Islamic Arabian institution of *riba,* whereby a borrower saw his debt double following a default and redouble if he defaulted again.

The purpose of the ban was undoubtedly to forestall communal disharmony by curbing the penalty for default. The Qur'an enjoins lenders to show compassion toward borrowers in distress and to refrain from taking advantage of their misfortunes. The ban on riba may be interpreted, then, as an injunction against kicking a person who is down.

While the broader interpretation eventually gained dominance, it did not deter Muslims from continuing to borrow and lend through various ruses.

A wants to lend $100 to B, at 5 percent interest. So he buys a chair from B in return for $100 and then promptly returns it for $105, payable in one year. The chair's ownership remains unchanged; B receives $100 now, and A stands to receive $105 in a year. Together, the transactions are equivalent to a single transaction whereby A lends $100 to B at 5 percent per annum.

Another common ruse takes the form of redefining as Y what everyone knows to be X. In Iran, for instance, the government has decreed that when a financial transaction between two public agencies takes place at a fixed rate of return, the charge involved is not called interest. So agencies freely borrow from one another at interest, liberated by the twist of a definition.

While Islamic economists are in accord that interest is sinful, there is no agreement on what is meant by an "interest-free" loan. Must loans be indexed to the rate of inflation to protect their purchasing power? Two international conferences on indexation, one in Islamabad in 1986 and the other in Jeddah in 1987, concluded that indexation is incompatible with Islam. Nonetheless, the Islamic banks index their markups, commissions and service charges to inflation.

Many Islamic economists believe that for all their identified shortcomings, the Islamic banks are superior to conventional banks. For one thing, they say, even if Islamic banks lend at interest, they generally avoid paying interest to their depositors. Indeed, the dividends paid to depositors are not predetermined, in that they fluctuate. But the same can be said of the bond funds in operation throughout the Western world. The variability of dividends makes an Islamic bank no more "Islamic" than an ordinary bond fund in South Korea or Switzerland.

The second line of defense hinges on the allegedly superior profitability of Islamic banks. It is not surprising that certain Islamic banks have done very well, because they enjoy some special advantages. The existence of a small but significant group of savers who feel uncomfortable with interest has furnished a ready-made source of deposits. Thus, Turkey's Islamic banks managed to attract about 1 percent of the country's total bank deposits in just a few months.

While Islamic economists are in accord that interest is sinful,

After this initial surge, they found that to expand further they had to open more branches. Still, they could remain more profitable than their conventional rivals because, like many of their counterparts elsewhere, the Turkish Islamic banks enjoy some important legal privileges including tax breaks, lower-than-standard reserve requirements,

JODI COBB/NATIONAL GEOGRAPHIC IMAGE COLLECTION

there is no agreement on what is meant by an "interest-free" loan.

and the right to engage in real estate transactions and foreign trade.

In view of all this, what is surprising is that the older Islamic banks have become less profitable. One major reason: they made careless loans during the oil boom of the 1970s, which are now taking a toll on their profits. The fact that some of these bad loans were made under profit-and-loss sharing helps explain why the Islamic banks are now lending almost exclusively on the basis of interest. It also supports my contention that these banks face a shortage of the skills required to make profit-and-loss sharing viable.

Yet another defense of Islamic banking is that it enhances economic stability. In an interest-based system, macroeconomic shocks may lower bank revenues, thus aggravating the crisis by causing defaults. This source of instability allegedly disappears when returns to depositors are variable.

But there is an implicit assumption here that an Islamic bank whose revenues fall will not lose deposits. In fact, the depositors of Islamic financial intermediaries are just as fickle as their counterparts in conventional banks. In Egypt, news in 1986 that the al-Rayan Islamic investment company lost $100 million speculating in gold provoked massive withdrawals.

Islamic banks losing funds must reduce the credit they supply to their clients. So it is unclear that replacing interest by profit-and-loss sharing enhances stability across the business cycle. The opposite may well be true, and the Iranian and Pakistani governments take this danger seriously. Iran requires all banks to pay the same rate of return, while Pakistan forces rates to stay within a narrow band. Consequently, there is no necessary relationship in either Iran or Pakistan between a depositor's rate of return and the actual profitability of his own bank's operations. Since a common rate of return effectively precludes profit-and-loss sharing, one may infer that the Iranian and Pakistani authorities consider genuinely Islamic banking destabilizing.

REDISTRIBUTION

Like other religions, Islam stands opposed to great inequalities in the distribution of income. From the very beginning, therefore, it has featured instruments aimed at reducing social inequalities. These include an inheritance law that specifies in intricate detail how a person's estate is to be divided among his or her relatives. A more celebrated instrument is zakat, an annual tax on wealth and income. Mentioned explicitly in the Qur'an, zakat is viewed as one of the five pillars of

Zakat recipients apparently include "orphans" with two living parents, "impoverished women" wearing rows of gold bracelets, and "old people" long under the ground.

Islam, along with belief in the unity of God, obligatory prayers, fasting during Ramadan, and pilgrimage to Mecca for those who can afford the trip.

The Qur'an provides only the broadest of guidelines on zakat's coverage, and it leaves open the issue of rates. By tradition, it is levied on agricultural output, livestock, minerals and precious metals – the major sources of income and wealth in 7th century Arabia. The rate varies between 2.5 and 20 percent, depending on the source and conditions of production, although there are various exclusions and exemptions. Wealth held in the form of precious metals is subject to a 2.5 percent levy, whereas mining income is subject to the highest rate, 20 percent.

The rate on agricultural output is 5 percent if the land is irrigated by the owner, 10 percent if it is irrigated naturally. By tradition, the beneficiaries of zakat include the poor, the handicapped, travelers in difficulty, debtors, dependents of prisoners and the zakat collectors themselves.

It has been claimed that the burden of zakat fell disproportionately on the rich. Note, however, that the purpose of zakat was not only to reduce inequality, but also to raise revenue for the Islamic state. The state was empowered to channel funds to "people serving the cause of Islam," which allowed it to spend zakat revenue on public works and territorial expansion.

But whatever the impact in 7th century Arabia, the effect is unlikely to be equalizing in a modern economy. For one thing, the rates are generally lower than those of the prevailing secular taxation systems. For another, the commodities covered by the traditional scheme play a considerably less important role today than they did more than a millennium ago.

Modernists want the sources of collection to include new commodities and activities, and they favor varying the rates according to society's changing needs. They also wish to redefine the categories of expenditure. But there are disagreements on rates, exemption limits and disbursements. Another source of controversy is the 7th century principle that property is not taxable if it is hidden. On this basis, some would exempt bank deposits, equities and other financial assets.

Voluntary Versus Obligatory Zakat

The zakat systems in operation in Pakistan and Saudi Arabia feature major innovations concerning coverage and rates. Whereas traditionally zakat was levied only on individuals, these countries have extended the obligation to companies on the ground that companies are juristic persons. In addition, they have imposed a flat levy on certain types of bank deposits.

Saudi Arabia levies zakat on imports, at rates varying from commodity to commodity. Pakistan allows farmers to deduct their expenses on fertilizers and insecticides. In contrast to Pakistan and Saudi Arabia, Malaysia has in place a collection system that departs minimally from traditional stipulations. Thus, each farmer is granted a fixed exemption, but no deductions are allowed for modern production costs. Another striking aspect of the Malaysian system is that it effectively exempts industrial workers, bureaucrats, businessmen and shopkeepers, along with growers of rubber, coconuts and other tropical cash crops – none of whom are mentioned explicitly in classical texts.

Saudi Arabian figures for the 1970s show that revenue hovered between 0.01 and 0.04 percent of gross domestic product – prima facie evidence of limited coverage and extensive loopholes. In Malaysia, too, extremely restricted coverage and substantial evasion constrain the yield. As of 1988, the rate of compliance was just 8 percent. The zakat burden falls almost exclusively on rice growers, most of whom lie below the country's poverty line. This finding shows that zakat does not necessarily transfer resources to the poor.

It is also significant that, in sharp contrast to Pakistan, the agricultural sector carries a huge share of the burden. Within agriculture, zakat is progressive at the lower end of the income scale because of the traditional exemptions. But it is regressive at the upper end, apparently because wealthy farmers are particularly prone to evasion.

In other Muslim countries, individuals have discretion over whether and how to pay zakat. The Qur'an itself is mute on issues of administration and enforcement. Yet both voluntary and obligatory collection have historical precedents. In the earliest years of Islam, when the Muslim community lived in Mecca, assistance to the poor was unregulated and strictly voluntary. Zakat became a formal and compulsory transfer system shortly after the community's relocation to Medina, at a time when it was expanding very rapidly. Thus, during Prophet Muhammad's last few years, zakat came to be administered by state-appointed agents and enforced, as necessary, by military might.

Barely two decades after his death, however, the Islamic state's ability to administer zakat crumbled in the course of violent leadership struggles. From then on, zakat was up to the individual Muslim's discretion. Thus, for most of the religion's existence, it has been administered in a decentralized manner, the agents of enforcement being peer pressure, fear of God, and the individual's own conscience. And the best evidence suggests that only a fraction of the non-impoverished population pays regularly.

Moreover, the voluntary mode does not treat the needy equitably, passing over the truly destitute, the unemployed and the handicapped. Even in relatively prosperous localities, many desperately poor people receive little, if any, charity. Seen from this perspective the ongoing fundamentalist campaign to recentralize the administration of zakat is understandable.

State-Administered Zakat In Operation

In Pakistan, according to official records, during the 1980-88 period, 58 percent of the zakat funds went as subsistence allowances to people unable to work, including widows, orphans and the handicapped. But the grants were much too small to make a significant difference in living standards. During the 1980s, when an individual needed an estimated \$22 a month just to survive, most zakat payments varied between \$4 and \$8 per individual. Moreover, the system has just one million beneficiaries, about 10 percent of the Pakistanis below the country's poverty line.

The funds set aside for subsistence aid and rehabilitation should have been enough to provide around \$8 per month to every person below the poverty line. In fact, ever since the system's inception, Pakistan has been awash in rumors and newspaper reports of arbitrariness, favoritism, nepotism and embezzlement. Zakat recipients apparently include "orphans" with two living parents, "impoverished women" wearing rows of gold bracelets, and "old people" long under the ground.

Malaysia's federal structure assigns the administration of zakat to offices at the state level. Here is how the zakat office in Alor Setar, the capital of Kedah, allocated its proceeds in 1970: 53 percent went toward "commendable measures" (which generally means religious education), 6 percent to people making a pilgrimage to Mecca, 2 percent to converts, and 22 percent as commissions to the zakat collectors and central administration, leaving a mere 15 percent for the poor.

In Malaysia, helping the poor appears as a pretext for advancing broad Islamic objectives and for lining the pockets of religious officials.

In Malaysia, figures from the early 1980s show that disbursements to the poor ranged between 11 and 13 percent, with zakat officials and various religious causes claiming much of the rest. As in Pakistan, funds collected in one locality are often spent in another. Thus, an impoverished, rice-growing village that contributes to the system will not necessarily receive anything in return.

Decentralized zakat confers value to economic connections, especially ones based on employment; state-administered zakat confers value to political connections, particularly ones touching on religion. Thus, under Malaysia's old decentralized system, the surest way to obtain regular zakat payments was to work loyally for a wealthy landlord; under the current centralized system, it is to enroll in a religious school or to work for the zakat office.

In Pakistan, of course, the religious establishment benefits from the system. But the establishment's stake in zakat has been far greater in Malaysia, where helping the poor appears as a pretext for advancing broad Islamic objectives and for lining the pockets of religious officials.

Malaysia's state-administered zakat system has generated resentment among the peasantry, which tends to view it as just another tax. Ordinary Pakistanis harbor similar feelings. One cause of their resentment is the impression of widespread corruption. As in Malaysia, another factor is that the payer does not see, much less determine, how his contribution is spent. Not only does this deny him the satisfaction of observing his contribution's impact, it facilitates disagreement over spending priorities and decisions.

A significant source of friction in Pakistan has been the Shiite minority's unwillingness to pay zakat to a Sunni-dominated government. In its original form, the zakat law obliged all Muslims to contribute to the government-administered fund. But when the Shiites took to the street in protest, the law was amended to give members of minority sects the option of exemption. Many Shiite depositors have opted to exempt themselves, and a small number of Sunni depositors are passing as Shiites simply to avoid automatic annual deductions.

JOSEF POLEROSS/THE IMAGE WORKS

Evaluation

Zakat has not made a major dent in Muslim poverty or inequality. Touching neither on productive assets, like land and physical capital, nor on consumption goods, like housing and furniture, it allows limited transfers involving a restricted menu of goods and assets. Even in the best of circumstances, the distributional impact of such a scheme would be modest. Poor management has compounded the disappointment.

Similar problems afflict many other official transfer programs. But Islamic economics aspires to vastly superior standards. It promises not that zakat will do as well as other systems of redistribution, but that it will do markedly better.

ECONOMIC DEVELOPMENT: THE ROLE OF ISLAMIC MORALITY

Islamic economists claim that Islamic scripture harbors solutions to every conceivable economic problem. Many problems are to be solved by curbing selfishness through injunctions concerning consumption, production and exchange. If these injunctions are followed, the pace of economic development will allegedly quicken, while taking on a fairer, more balanced and less disruptive form. This assertion turns on its head the longstanding Western suspicion that Islam hinders modernization.

In their most general form, the economic injunctions consist of moral guidelines common to many value systems, both religious and secular. The individual is encouraged to enjoy the bounties of civilization, but to share his possessions with the less fortunate. As a producer or trader, he is free to seek personal profit. But in exercising this freedom he must avoid harming others. Nor must he earn more than his efforts justify; he must pay "fair" wages to his employees and charge "just" prices to his customers. Remaining honest in his economic dealings, he must admit his mistakes and avoid false advertising.

In the early centuries of Islam, these general injunctions were applied to a panoply of situations, generating multitudes of specific injunctions. For example, the requirement to earn no more than one's fair share was taken to imply that Islam prohibits the sale or purchase of a fruit tree in blossom. The logic: since the traders cannot predict the tree's yield with certainty, the selected price could confer an unearned gain to one party while burdening the other with an undeserved loss.

Some Islamic economists believe that ancient interpretations retain validity in the modern world; others call for fresh interpretations. But Islamic economists generally agree that if the moral guidelines of Islam are observed, the economic performance of Muslim societies would improve dramatically. People will readily sacrifice their own material pleasures for society's interests. They will find their daily economic activities more fulfilling. Even their jobs will become more satisfying, as they take on the character of worship.

In accordance with this view, a major, if not the primary, source of the Muslim world's underdevelopment is held to be its moral degeneration. The standard of morality began falling when a string of increasingly corrupt leaders succeeded the "rightly guided" caliphs of the 7th century. But this degeneration has only taken a calamitous form in recent centuries, through the influence of the West. Declining morality, say Islamic economists, has sapped productivity and reduced the effectiveness of government. Moreover, by weakening the ties of Islamic brotherhood, it has made Muslims oblivious to one another's needs.

As a sad consequence, Muslims are divided on key issues and their rivalries are keeping them from cooperating toward common objectives. Low morality is also held responsible for the practical shortcomings of zakat and Islamic banking.

The Islamic morality of self-sacrifice, altruism and brotherhood is expected to work with equal effectiveness in a populous modern nation as among Prophet Muhammad's first group of companions.

The misuse of zakat funds is attributed to the moral deficiencies of local officials. Likewise, the continuing prevalence of interest-based lending is ascribed to rampant dishonesty in business.

No Islamic economist denies that social institutions matter – after all, they attach great importance to zakat. The distinctiveness of their position lies in the primacy it gives to the restructuring of individuals. Throughout the Muslim world, of course, massive efforts have been made since the beginnings of Islam to instill in individuals an Islamic morality. Have these efforts influenced work effort, generosity and market behavior? Islamic economists have undertaken no serious investigation of such matters.

Much of Islamic economics conveys the impression that a communitarian ethic is a prerequisite for economic development. A striking aspect of this emphasis is that it draws no distinction between numerically small and large groups. The Islamic morality of self-sacrifice, altruism and brotherhood is expected to work with equal effectiveness in a populous modern nation as among Prophet Muhammad's first group of companions. The development of a country committed to an Islamic way of life is expected to be driven substantially by Muslims' efforts to meet one another's observable needs and by their mutual cooperation toward commonly perceived goals.

There are two serious flaws in this thinking. First, it implicitly attributes to the individual an infinite ability to receive, store, retrieve and process information. Second, it overlooks the difficulty of generating common goals in a large society.

If economics has taught us anything over the past two centuries, it is that the institution of the market allows traders pursuing different, rather than similar, ends to achieve mutually satisfying outcomes. As an unrivaled economizer of information, the market permits traders to serve the needs of others while pursuing nothing but their own selfish objectives. Prosperity does not require the commonality of all knowledge, nor does it require general conformity to joint objectives.

Friedrich Hayek traced the common misperception that the economic viability of a large society depends on the jointness of both knowledge and purpose to Aristotle's teachings on household management and individual enterprise. Habits of thought do not die easily. Socialism, arguably the most influential social doctrine of the 20th century, promotes the notion that a classless society is possible, even inevitable, where selfish greed has given way to benevolence.

Hayek calls this the "fatal conceit" of our time, the fundamental error that led dozens of countries to appalling inefficiency and tyranny. The supremely efficient, just and harmonious society promised by socialism has existed nowhere but in murals of blissful workers resolutely serving socialism.

Given the pre-eminence of morality in Islamic thinking on economic development, one might expect a consensus on the proper domain of government and the need for central planning. In fact, there is none. Significantly, the term "Islamic" has been juxtaposed both with "socialism" and with "capitalism." And however tolerant or intolerant of market processes, regimes have had no trouble finding an Islamic basis for their policies.

Islamic economics features divisions on numerous other concerns of the field that we call development economics, including trade protection and industrial promotion. Many such issues had no counterparts in early Islam. Indeed, in 7th century Arabia, central planning was not a possibility, industrialization not an issue. As the economy was mostly nonmonetized, there was no monetary policy in the modern sense. It is even doubtful that the notion of economic development was present.

PROGNOSIS

In practice, not to mention doctrine, Islamic economics is hardly as comprehensive as its proponents apparently believe. Not even in Pakistan, which has undertaken the most carefully planned attempt to reorder an economy according to Islamic precepts, has the scope of reform gone much beyond zakat and banking.

Nor have the specific reforms been revolutionary in their consequences. The advent of Islamic banking has altered only the cosmetics of banking and finance, and zakat has nowhere led to a perceptible reduction in poverty or inequality.

In trying to explain why Islamic economics has had no major impact, one identifies several classes of causes. First, its many ambiguities allow the prevailing political forces to give it whatever meaning seems least threatening to the status quo. Second, some elements of the Islamic economic agenda conflict with human nature – thus, Muslims are required to accept financial risk, whereas they prefer security. Third, the Islamic reforms have been impeded by social realities that their promoters have expected religious sentiment to overcome. We saw, for example, how the continuing prevalence of tax evasion has made it imprudent for bankers to engage in profit-and-loss sharing.

Finally, Islamic reforms have suffered from poor organization and a shortage of skills. While there is some demand in every society for profit-and-loss sharing, the Islamic banks do not possess the skills to make this financing method viable. Likewise, the established zakat systems lack effective monitoring.

What does the future hold for Islamic economics? People do not modify their ideologies at the first sign of conflict with reality. Given the initial disparity, new facts that contradict the ideology do not worsen the fit appreciably and are therefore disregarded or else easily rationalized. In any case, even when an individual becomes disillusioned with the prevailing ideology, real or imagined social pressures might make him refrain from publicizing his doubts. Yet, as long as some individuals have the will to voice misgivings, there is reason to expect the eventual mobilization of an organized opposition, even in countries where the wisdom of Islamization is now seldom questioned in public.

How long, then, will it take for the emergence of widespread dissent? One possible scenario is for the ongoing quest for a moral order to become an obsession that makes power holders try earnestly to perfect the individual Muslim. Since there is vast room for disagreement on the nature of moral perfection, a consensus that the human impulses of Muslims need no further organizing would prove elusive. But if the history of socialism is any indication, it could take decades for a broad segment of society to wonder why the desired benevolence is so difficult to elicit. Failures along the way could easily be taken to mean that educational efforts need to be redoubled and non-Islamic influences curbed further. In this vain search for the Islamic utopia the political establishment would become increasingly repressive.

Meanwhile, the discipline of Islamic economics could feed on itself for decades, mistaking apologetics for serious reflection and cosmetics for genuine reform. The 21st century could thus become for Islam what the 20th was for socialism: a period of infinite hope and promise, followed by disappointment, repression, disillusionment and despair. The sequence could end with a flight from Islam into other sources of spiritual and moral inspiration.

An alternative scenario is for Islamic economics, which emerged as a movement to restore idealized economic relationships of the past, to turn into a major innovative force. As R.H. Tawney has documented, Martin Luther and other leaders of the Reformation fought for the restoration of virtues they thought had been abandoned. Paradoxically, their attacks on ecclesiastical corruption weakened Church authority, thereby accelerating the developments they tried to reverse.

Such a scenario could be replayed within the Islamic world. The current preoccupation with economic morality could turn the spotlight on incumbent political establishments, discrediting them further. Progressively delegitimized and weakened, existing regimes could be replaced by Islamist regimes. The new regimes would promise to rid society of its major social and economic problems by restoring properly Islamic values and practices.

Alas, problems do not just yield to fresh policies. Disillusionment sets in, the Islamist regimes split into discordant factions, and the ensuing power struggles force the traditionally interventionist governments of the Islamic world to loosen their controls on private economic activity. By the time central governments regain their lost authority, market institutions are firmly entrenched and private enterprise is very influential.

Just as the rise of European capitalism coincided with the emergence of new social philosophies, so, too, political and economic liberalization in the Islamic world could be accompanied by a complete transformation of Islamic economics. The Islamic banks become genuine venture capital organizations, and zakat evolves into a bona fide social security system. Meanwhile, it becomes commonplace that feelings of altruism and solidarity carry less significance in a large, complex economy than in a small, simple one. And the notion that the Qur'an offers limited help in the realm of economic policy gains increasing recognition.

In a less tumultuous and less circuitous variant of the second scenario, the key players are the practitioners of Islamic economics. Endeavoring to implement Islamic economics, they recognize its unrealism. This stage has already been reached in Islamic banking, where bankers instructed to lend on the basis of profit-and-loss sharing have discovered that this yields more loss than profit. Sensing that it may never be practical to eliminate interest, that zakat requires new thinking to become an effective instrument of redistribution and that the envisaged moral transformation is a mirage, onetime believers in Islamic economics begin chipping away at its edifice.

At first they transform only the practice. Then they begin altering the theory openly – for example, by redefining interest and reformulating the mechanics of zakat. Their endeavors gain the approval of individuals with a stake in common practices, including Islamists who have prospered doing "interest-laden" business. In this scenario the practitioners of Islamic economics serve as hidden agents of secularization, arbiters between the doctrine's goals and the secular practices it still condemns.

The 21st century could thus become for Islam what the 20th was for socialism: a period of infinite hope and promise, followed by disappointment, repression, disillusionment and despair.