

**AN AGENDA
FOR
ISLAMIC ECONOMIC REFORM**

**THE REPORT OF THE COMMITTEE ON ISLAMIZATION
APPOINTED BY
THE FINANCE MINISTER, GOVERNMENT OF PAKISTAN**

MAY 1989

**PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS
ISLAMABAD**

First Printing 1980

Second Printing 1982

Third Printing 1983

Fourth Printing 1989

All rights reserved. No part of this publication may be reproduced, stored, in a retrieval system or transmitted in any form or by any means – electronic, mechanical, photocopying, recording or otherwise – without the prior permission of the authors and the Pakistan Institute of Development Economics.

©Pakistan Institute of Development
Economics 1989

بِسْمِ اللّٰهِ الرَّحْمٰنِ الرَّحِیْمِ

وَاللّٰهُ مِیْرَاثُ السَّمٰوٰتِ وَالْاَرْضِ ط

(آل عمران . آیت ۱۸۰)

*“Allah’s is the heritage of the
heavens and the earth . . .”*

(al-Qur’an, 3:180)

List of Contents

	<i>Page</i>
Foreword	iii
Chapter 1: Introduction	1
Chapter 2: The Character of An Islamic Economic System	3
(i) Property Relations	3
(ii) Kinds of Economic Freedoms	4
(iii) The Character of the Incentive System	5
(iv-v) The Resource-Allocating Mechanism and the Location of Decision-making	6
Chapter 3: The Objectives of An Islamic Economy	7
(i) Social Justice	8
(ii) Universal Education	8
(iii) Economic Growth	9
(iv) Maximum Employment Generation	9
(v) Improving the Quality of Life	9
Chapter 4: The Choice of An Appropriate Policy Package	10
SUMMARY	12
Chapter 5: The Islamic Policy Package-I	13
(i) Private Property	13
(ii) Universal Education	15
(iii) Employment Generation and Economic Growth	15
(iv) Social Security and Anti-Poverty Programme	16
SUMMARY	17
Chapter 6: The Islamic Policy Package-II	19
The Introduction of <i>Zakat</i>	20
Abolition of <i>Riba</i>	20

	<i>Page</i>
In Search of Viable Alternatives	21
(i) Interest-Free Loans	22
(ii) Indexing Time Deposits and Bank Advances	22
(iii) Investment Auctioning System	23
(iv) Investment Companies	24
(v) The Long-Run Solution	25
SUMMARY	27

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

FOREWORD

The Islamic world, including Pakistan, is passing through the pangs of a rebirth. Not a pursuit of something new, the Islamic resurgence is the process of *rediscovering* the truth of the Islamic Message in the modern world, which is by no means very receptive to this historic 'event'. It is not only an opportunity to 'realign' ourselves – both as individuals and as nation – with the reality of Islam. This is also a challenge to the ingenuity of the Muslim philosophers and social scientists: for while the truth of the Divine Message is immaculate and immutable, ways and means must be found to 'accommodate' it within the straitjacket of pre-existing institutions. True, the institutions will also change under the impact of Islamic Reform, but that takes time. A beginning has to be made and at this stage the institutional constraints are binding. The 'point of contact' of the Islamization process will be the present socio-economic set-up, which, being a hard 'reality', cannot be ignored.

Fully cognizant of the immensity of the task, we have gone about our job in a systematic fashion. The *leitmotiv* of this Report is delineation of the basic features of the Islamic economic system, with emphasis on its 'totality'. An important implication of this 'fact', not always clearly recognized in popular discussions, is that bits and pieces of the Islamic reform are fully meaningful only within the matrix of the Islamic economic system. However, this does not mean that there is no other way to Islamize the economy than to introduce the Islamic economic system *in toto*. That would be a meaningless statement because no blueprint exists – and we have not attempted to provide one – of the total Islamic economic system. It does mean, however, that when introducing elements of the Islamic reform, we must constantly keep in mind that our ultimate aim is to introduce the total Islamic economic system.

In spelling out the central features of the Islamic economic system, the Committee has been guided by the unambiguous Qur'anic Commandment: "Lo! Allah enjoineeth Justice and Kindness [*al-Adl wal-Ahsan*]" (16:90). Translated onto the economic plane, while *al-Adl* requires a delicate and just balance among production, consumption and distribution relationships in the economy, *al-Ahsan* enjoins a special concern for the economically down-trodden in the society. Hence the basic objective of the Islamic economic philosophy is the eradication of absolute poverty, illiteracy, gross inequalities of income and wealth, widespread unemployment and disease. To maintain intergenerational equity, such a philosophy also dictates a specific policy to regulate the rate, form and strategy of economic growth. Such measures, favouring the poor and the oppressed in the society, will have to take precedence over everything else in order to evolve an Islamic societal framework. That this is what Allah requires us to do is made quite explicit in the Holy Qur'an: "And We desired to show favour unto those who were oppressed in the earth, And to make them examples and make them the inheritors, and to establish them on earth..." (28:5-6). Since, according to the Holy Qur'an, the poor in the land have a right to the wealth of the rich – "And in their wealth the beggar and the outcast had due share" (al-Qur'an, 51:19) – any Islamic policy package must contain a set of strong redistributive measures to diffuse the ownership of wealth in the society. For, in the Islamic perspective, all wealth belongs to Allah. Hence any institutions or policies that set up the monopoly of a few on Allah's bounties is un-Islamic. The Holy Qur'an holds out a warning against such tendencies: "[let] it (i.e. wealth) become not a commodity between the rich among you" (59:7).

These 'facts' about the Islamic economic philosophy led the Committee to lay the greatest emphasis in its recommendation on the redistribution of income and wealth – more of wealth than of income – to provide a firm basis for a complete societal reordering according to the precepts of Islam. In this connection, special attention has been given in the Report to the phenomenon of intergenerational snowballing of wealth within the same families. A broader view has been taken of the Islamic Law of Inheritance, which, contrary to widespread misconceptions, does permit a wider distribution of wealth of the deceased outside the closed circle of a few families. Such a redistribution of wealth, rural and urban, will provide the basic force for social change. To reinforce this process, and to add to the quality of life, the need for universal education, particularly at the primary level, has

also been emphasized in the Report as an essential building block of an Islamic society. Furthermore, an ambitious social security and anti-poverty programme has been recommended as a vital element of the Islamic policy package.

It is from the vantage point of such a comprehensive political, social and economic framework that the existing Islamization attempts focusing *exclusively* on the abolition of interest and the introduction of *Zakat* have been analysed in the Report. This Committee has forcefully argued against an undue obsession with *only* these two elements of the Islamic reform. True, Islam rejects interest. What should then be done? Charge forth, in a Quixotic fashion, to strike down *riba* at all cost, keep capitalism intact and live happily ever after! This Committee rejects such an advice as scientifically naive and socially counter-productive. In its view, the Islamic rejection of interest is in effect a rejection of the entire capitalistic system: an interest-free economy is in fact an exploitation-free economy. There is absolutely no doubt in our minds that a full-fledged Islamic economic system will have no use for interest and that *Zakat* will be one of the elements of fiscal policy in it. However, it is essential to understand that the elements of the Islamic system cannot always be transplanted into non-Islamic economic system with impunity. Any unqualified recommendation to replace an interest-based economy by a profit-based economy within the capitalistic framework need not even be Islamically legitimate *if* the result of this 'reform' is a rise in the overall level of economic exploitation of the poor by the rich. And the grail may recede even further from the grasp of those who chose this route to the Islamic Ideal. In the same vein, the Committee, while supporting the proposal to introduce *Zakat* into Pakistan's fiscal system, has also highlighted that it is not *Zakat per se* but the objectives that it is supposed to achieve which should receive the primary emphasis for *Zakat* is *only* one element of the comprehensive and revolutionary Islamic concept of *infaq*. Since the primary emphasis of the Islamic Reform should be to eliminate *zulm* (the antithesis of *al-Adl wal-Ahsan*) in the society, the *adequacy* of this single step must be seen in that context.

This is then the basic message of this Report: The totality of the Islamic system is what should count most with the policy-makers; its elements must be seen in relation to this totality. Since the 'point of contact' of the Islamic reform will inevitably be the capitalistic system existing

in Pakistan, this 'fact' cannot be ignored in formulating the Islamic policy package. Interest is an integral part of a financial system in which saving and investment decisions are made independently by economic agents whose behaviour is controlled *indirectly* through monetary (and fiscal) policy. As long as the financial and the real sectors are interconnected – through the money market – in this fashion, not much progress can be made towards the goal of a total abolition of interest. That being the case, the Committee, while not excluding the possibility of taking partial steps in this direction, has rejected the view that the *total* abolition of interest is the *first* step towards the establishment of an Islamic society. That would be putting the cart before the horse! Instead, it takes the view that the abolition of interest is part of a fundamental restructuring of the whole spectrum of production, consumption and distribution relationships on the Islamic lines. However, the search for such a system must be gradual to let the interaction between theory and practice of Islamic economic philosophy produce an economic system which corresponds to the overall vision of an Islamic economic system – a system based on *al-Adl wal-Ahsan*.

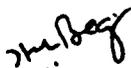
A possible criticism against this Report may be: what is new about these proposals? However, this is no objection at all. The fact that an equitable distribution of wealth, universal education, social security and anti-poverty programmes are an integral part of *any* just economic system does *not* disqualify these aspects of social reform from being a part of the Islamic policy package. Formal similarities among economic systems are inevitable because they all face the common problems of want, poverty, disease and economic deprivation. The important fact is that *these recommendations follow directly from Islam's distinctive economic philosophy*. It is the demonstration of this fact that constitutes the basic contribution of this Report.

The main merit of the approach of this Report, which focuses on the 'totality' of the Islamic system, is that it draws attention to the *political* aspects of the Islamization process as well. This is important, because no attempts at Islamization can strike roots unless people feel the beneficial effects of such a fundamental social transformation in their daily lives. The still-prevalent squalor, hunger, disease and abject poverty are major 'pollutants' of the socio-economic landscape in to-day's world. People should be convinced that the Islamic system does not tolerate this state of affairs –

as it is contrary to its absolute commitment to *al-Adl wal-Ahsan* – and that it offers an integrated programme of social amelioration. And something more: within the unitary perspective of Islamic economic philosophy steps taken to relieve human misery also point the way to Man's spiritual salvation. The act of 'giving', being the quintessence of a societal ordering enjoined by Islam, achieves both these aspects of Man's life, the material and the spiritual, within the framework of a comprehensive vision of Islamic social reform. "Ah, what will convey unto thee what the Ascent is! (It is) to free a slave, And to feed in the day of hunger; An orphan near of kin, or some poor wretch in misery..." (al-Qur'an, 90:12 – 16). A message so humane, and yet so revolutionary, touches the human heart and arouses the deepest emotions in Man. A system which can offer so much more than *the existing non-Islamic systems* is bound to command the support of the people. This is exactly what the attempts at Islamization must aim at: to enlist active, voluntary cooperation of the common man. *The Islamic economic system must become for the Muslims the medium through which to channelize their enthusiasm for social change.*



(Syed Nawab Haider Naqvi)



(H. U. Beg)



(Rafiq Ahmed)



(Mian M. Nazcer)

Chapter 1

INTRODUCTION

There is a consensus among Muslim scholars that Islam's is a 'complete' system. Its clear perception of the Unity of all life processes – social, economic and religious – is Islam's original contribution to civilization, and offers the best hope to the Muslims to reorder their socio-economic affairs according to the tenets of Islam. All this is clear enough. However, the full implications of the unitary Islamic philosophy are not always so clearly understood. Specific recommendations to "Islamize" existing economic systems tend to ignore inherent incompatibilities between the Islamic and other economic systems. For instance, profit-sharing in business transactions, which properly belongs to an Islamic system, has been proposed to replace interest *within the framework of a capitalistic economic system* – a system built upon the limited-liability principle which interest represents. That such a transplantation may, in fact, aggravate the worst characteristic of Capitalism – viz. economic exploitation of the poor by the rich – does not seem to have occurred to the proponents of such ideas.

This is just one instance of a general principle that social and economic systems are 'complete' entities, with a set of distinctive value premises and the logical consequences of those premises. Hence, elements of one economic system cannot be moved at will across different economic systems. It is therefore essential that the Islamic system be viewed in its "totality". Furthermore, in introducing the Islamic system, specific elements of the reform should be looked at in relation to this "totality". However, it should be noted that when the "totality" of the Islamic system is emphasized, it does *not* necessarily mean that isolated steps to implement the Islamic reform should not be taken. However, what it does mean is that

- (i) these isolated steps should directly contribute to the ultimate realization of the total Islamic system; and
- (ii) such steps should be appropriately "ordered", singling out those which contribute the most to achieving the basic objectives of the Islamic economy. An important consideration in this context is the fact that, *to begin with*, the existing (non-Islamic) economic systems will have to be taken as the natural starting point from where to move towards the Islamic Ideal.

It is, therefore, essential that the priority list of the elements of Islamic reform be drawn up with a view to minimizing the evils of the *existing* economic system. For instance, a highly skewed distribution of income and wealth, high levels of open unemployment and disguised unemployment, socially unacceptable levels of literacy rates, allocative inefficiency, low level of business and public morality, etc., are the major 'pollutants' of the economic environment in developing countries like Pakistan. True, public policy under any economic system must squarely meet these problems but that does not mean that the Islamic system should not face up to them. The distinctive character of the Islamic system which sets it apart from existing non-Islamic economic systems lies in its outlook on these problems, and in the way that it seeks to meet them. In fact, the presumption is that the Islamic system will succeed where other systems have failed, together with the belief that it will provide a unified framework within which the successful pursuit of the above-mentioned objectives will also contribute to spiritual salvation.

Chapter 2

THE CHARACTER OF AN ISLAMIC ECONOMIC SYSTEM

If the assertion is made, as we have made in this Report, that the Islamic system should be seen in its "totality", then the next question is: what is the Islamic economic system? Exact definition of systems is quite often a treacherous territory: such definitions can be made broad enough to accommodate "everything under the sun", or they may be much too restrictive. Definitions of the former type are meaningless as analytical devices, while those of the latter type have little explanatory power. However, like an elephant which can be fairly accurately described though not defined, economic systems can also be identified and compared in terms of certain basic properties. As recent work on comparative systems analysis has shown, the attitude on the following matters locates the distinctive character of an economic system fairly accurately:

- (i) Property relations;
- (ii) Kinds of economic freedoms;
- (iii) The character of the incentive system;
- (iv) The character of the coordinating or the resource-allocating mechanism; and
- (v) Location and system of decision-making.

(i) Property Relations

The basic characteristic of an Islamic system is its attitude towards private property. In the Islamic perspective, all wealth belongs to Allah: "Unto Allah belongeth whatever is in the heaven and whatsoever is in the earth" (al-Qur'an, 3:129). Accordingly, Man is only a trustee of whatever he has and *not* its owner: "and spend whereof He hath made you trustees" (al-Qur'an, 57:7). This Islamic position is unique and can easily be distinguished from the position of Capitalism where the private ownership of wealth is a sacred institution to be preserved at all cost as well as from the position of Socialism where all wealth belongs to the State. It should be clear that, because of the concept of trusteeship, the right to private property in Islam gets vastly qualified, limiting severely the sphere of ownership itself. There is a complete unanimity among Muslim scholars that such things as grazing lands, natural forests and water resources, mines, roads, graveyards and places

of congregational prayers cannot be privately owned. As for land, ownership rights are liable to be lost if such land lies unreclaimed or is not used for three consecutive years.

A more difficult matter is that of inherited wealth. Does an individual have an unrestricted right to whatever wealth he inherits from his parents? Again, can the State do nothing to take into public custody a part or the whole of what a person inherits? There is a view that since the individual is a legal owner of inherited property, the State cannot impose death duties, nor can it take away any part of it. This may be so, but does it follow that the State can take no measures whatsoever to ensure an Islamically just redistribution of all property? To hold such a position on the basis of the specious argument that the law of inheritance is *sufficient* to redistribute wealth equitably, in the sense of preempting all distributive initiative of the State, is really to miss the whole point about the heavily egalitarian economic philosophy of Islam.

There is the unequivocal Qur'anic commandment: "Whoso is rich let him abstain generously, and whoso is poor let him take thereof in reason" (al-Qur'an, 4:6). It follows that even though, to begin with, there may be such a thing as the coexistence of the rich and the poor, it need not persist — at least the gulf between the two should not widen over time — after the redistribution of wealth ordained by Islam has taken hold. The argument for adopting measures to redistribute private property more widely gains further strength from the fact that we are living in a non-Islamic economic system, marked with gross inequities in the ownership of wealth, of which land is a very substantial element. Hence, in order to make a decisive move towards the Islamic Ideal it is essential that, *to begin with*, the total private property in the community, both rural and urban, is redistributed in a more just fashion. To maintain that nothing can be done about redistributing private property more widely in the society, so that it remains locked within certain families through inheritance, would really amount to taking the absurd position that the existing distribution of wealth is in accordance with the Islamic precepts!

(ii) Kinds of Economic Freedoms

The principle of consumer sovereignty, held so dear in capitalistic societies, and its total suppression as practised in socialistic societies, are anathe-

matical to the 'moderate' egalitarian philosophy of Islam. In Islam, individual freedom has been appropriately balanced by social responsibility, as contained in its ethical principles. The Islamic view is founded on an explicit realization of the 'fact' that Man is greedy and selfish by nature. If left to himself, he would not do much for others in the society. The Holy Qur'an attests to this aspect of Man's nature: "Say if you possessed the treasures of the Lord's mercy, yet would you hold them back for fear of expending and Man is ever niggardly" (17:100). On the other hand, it is the 'intention' of God that everybody should be provided with a minimum of sustenance: "There is no moving creature on earth but its sustenance is upon God" (al-Qur'an, 9:6). Thus the existence of hunger and abject poverty is entirely man-made and a direct result of an unjust economic system. The Islamic system, with its heavy emphasis on the act of 'giving' as the essence of a just socio-economic ordering, must, to reflect God's intention, devise ways and means of checking individual greed, so that all members of the society get a minimum of sustenance.

Hence, to introduce Islamic reform in a society like Pakistan, the structure of which has been raised on the capitalistic principles, it will be essential for the State to take up increasing responsibilities to ensure the satisfaction of the society's demand for such 'basic needs' as health, education and housing. In doing so, the consumer sovereignty will have to be sharply curtailed, though not entirely eliminated, so that enough resources are released for financing an elaborate public sector programme to fight poverty, hunger and widespread economic deprivation.

(iii) The Character of the Incentive System

Another important factor distinguishing one economic system from another is the kind of economic incentives that keep the system going. In particular, the place accorded to price incentives – viz. profits, interest, rents and wages as sources of income – in a given economic system determines its character. For instance, in a 'pure' capitalistic setting, profits and rents tend to grow at a rate faster than that of wages to allow the investible surplus to accumulate. In Pakistan, such a strategy did in fact operate during the Sixties, when government policies consciously let profits multiply while increases in wages were restricted to maximize the flow of investible surplus in the corporate sector. Such a strategy was based on an explicit acceptance of income and wealth differentials, which were allowed to grow even further, as

a means of achieving rapid growth rates. In socialistic societies, where profits accrue to the State, disproportionate amounts are reinvested into the production of capital goods industries. Thus consumption is restrained and capital formation accelerated, causing economic hardships on the common man. Islam would reject both of these extremist economic strategies. *It would not – as it cannot – use widening income differentials as a policy instrument to promote capital formation and economic growth by virtue of its commitment to al-Adl wal-Ahsan.*

(iv & v) The Resource-Allocating Mechanism and
the Location of Decision-Making

The observations just made have a direct bearing on the character of the resource-allocating mechanism and the economic decision-making process in an Islamic economy. As pointed out above, while the private sector will have a due place in it, the public sector will be called upon in an Islamic economy to assume, among other things, a predominant role as a producer of 'wage goods'. For social welfare requires not only a transfer of financial resources from the rich to the poor, but a diversion of *real* resources to the production of the basic necessities of life – and away from non-essential and luxury production. In other words, the very composition of the 'consumer-goods basket' in an Islamic economy will require the State to play a tangible role in it. The matter is too important to be left to the 'invisible hand' of the market forces.

Chapter 3

THE OBJECTIVES OF AN ISLAMIC ECONOMY

All the 'indicators' of the Islamic economic system specified above unmistakably point to the humane economic philosophy of Islam, whose kingpin is *al-Adl wal-Ahsan*. The Holy Qur'an is explicit on what the individual and the society should be doing: "Lo! Allah enjoineth Justice and Kindness [*al-Adl wal-Ahsan*]" (16:90). These two basic attributes of Islam translate into an economic system which explicitly aims at re-establishing a delicate balance between social and economic forces, *with a clear 'bias' in favour of the poor and the economically weak*. The Holy Qur'an explicitly lays down the ultimate requirement that Islamic economic policy must meet: "And We desired to show favour unto those who were oppressed in the earth, And to make them examples and make them the inheritors, and to establish them on earth ..." (28:5-6). In fact, according to the Holy Qur'an, the poor of the society have a *right* to the wealth of the rich: "And in their wealth the beggar and the outcast [i.e. destitute] had due share" (51:19). The implementation of this Divine commandment on the economic plane would require a heavy redistribution of income and wealth from the rich to the poor.

Two points should therefore be crystal clear about an Islamic economic system:

- (i) It must enforce a balance – 'equilibrium' – among the consumption, production and distribution relations in the society. This must come about by virtue of God's commandment to establish *al-Adl*; and
- (ii) The second part of God's commandment – i.e. *al Ahsan* – requires that economic policies in Islamic economy have a distinct tilt towards the poor. Not only that: the process of pushing up the poor along the scale of social hierarchy must continue until the 'oppressed' in the land finally attain a 'respectable' status in the society.

These overriding Islamic requirements can be met if economic policy is geared to the attainment of the following objectives:

- (i) Social Justice;
- (ii) Universal Education;
- (iii) Economic Growth;
- (iv) Maximum Employment Generation; and
- (v) Improving the Quality of Life.

True, these are the objectives of any economic system; but that does not disqualify them from being the objectives of the Islamic economic system as well, *particularly as they follow directly from Islam's own distinctive economic philosophy*, and the reasons for the avowal of these policy objectives are not the same as in other economic systems.

(i) Social Justice

Social justice follows from *al-Adl*, since there can be no justice without a delicate balance among various social and economic forces. In fact, *al-Adl* requires that social justice must obtain in every walk of life so that Divine unity can be realized on the plane of social existence. Man has been commanded again and again to realize and maintain the quality of justice under all circumstances. In particular, in financial transactions the observance of this principle is absolutely essential for an orderly society: "Give full measure and full weight, and wrong not people in respect of their goods" (al-Qur'an, 11:85). Furthermore, Man has been warned against concentration of wealth: "[let] it (i.e. wealth) become not a commodity between the rich among you" (al-Qur'an, 59:7). Thus if *al-Adl* prevails in the society, an equitable distribution of wealth will result – which is what social justice is all about.

(ii) Universal Education

Universal education, particularly at the primary level, is a very strong means of establishing *al-Adl* in the society. It not only is a powerful redistributive mechanism but is also required to equalize opportunities in order to bring out the best in Man. It is for this reason that Islam declares the acquisition of knowledge to be the most sacred pursuit of Man, who has been advised to pray constantly: "My Lord! increase me in knowledge" (al-Qur'an, 20:114).

(iii) Economic Growth

Economic growth in the Islamic perspective is required to attain *dynamic* social justice. Equity must hold not only within a generation but between generations as well. As such, economic growth cannot violate the requirement of *al-Adl*: the scarce resources of the society can neither be squandered away on the consumption of the present generation, nor stored away for posterity beyond a certain point. In other words, the flow of consumption must be optimized not only at a given point in time but also over time. Such a strategy will rule out both a profligate spending behaviour, which lowers domestic savings below the optimal level, and an excessive abstention from present consumption, which forces saving to be above this level. It should, therefore, be obvious that the quality of *al-Adl* defines both the lower and the upper limits on the socially desirable rate of economic growth.

(iv) Maximum Employment Generation

Economic growth must also maximize employment generation in order to make the greatest contribution to human happiness. However, for this to be an economically efficient process it is essential that capital/labour ratios correspond to the resource endowment of the country. In a labour-abundant economy like Pakistan's, the capital/labour ratio must be low enough for economic growth to generate maximum employment opportunities. This would, in turn, require an appropriate choice of techniques, which, in the long run, can be promoted only by making heavy investments in human capital formation.

(v) Improving the Quality of Life

The requirement of *al-Ahsan* will generally reinforce the process of securing *al-Adl*, because social justice requires the poor to be moved up and the rich to be moved down the scale of social hierarchy in line with the clear Qur'anic commandment, quoted above: "Whoso is rich let him abstain generously, and whoso is poor let him take thereof in reason" (4:6). In the context of an economy like Pakistan's, it will take considerable social effort to improve the quality of life not only in financial terms but also in real terms. A diversion of real resources from the rich to the poor, without demanding any *quid pro quo* from the latter, will be necessary if abject poverty is to be eradicated and the opportunities for social advancement are made accessible to all.

Chapter 4

THE CHOICE OF AN APPROPRIATE POLICY PACKAGE

The choice of an appropriate policy package aiming at the Islamic Ideal must be governed by a clear realization of the fact that its *immediate* "point of contact" will be the existing economic system. Hence, the success or otherwise of the Islamic Reform in the short run – i.e. during the 'transition' from the existing to the Islamic economic system – will be judged by its capacity to handle the problems we face to-day – e.g. absolute and relative poverty, low literacy levels and high levels of open and disguised unemployment, etc. A satisfactory solution to these problems should also lead the society to the Islamic Ideal; for *al-Adl wal-Ahsan* cannot come about in a society plagued by these problems.

For the Islamic reform to take effect, it will be essential to move towards the Islamic Ideal gradually, encompassing all or most of the essential aspects of the social and economic life. *In fact, the requirement that the Islamic reform be carried out in its essential multi-dimensionality will slow down considerably the pace of the Islamization process*, for the experience at each step of the implementation of the Islamic reform will have to be carefully analysed to permit a maximum of "feedback effect". It is only through a prolonged two-way interaction between the theory and the practice of Islamic economic philosophy that a systematic body of thought can emerge to provide reliable guidelines to the Muslim policy-makers.

What at present passes for the grandiose title of Islamic Economics is nothing more than a smattering of broad and vague ideas about the introduction of *Zakat* and the abolition of *riba*, giving the impression that Islamic Economics can be reduced to just these two elements. Such a claim is false because no complete economic system, such as Islam's, can be described merely in terms of one or two of its policy *instruments*. Furthermore, *even* if this could be done, the real meaning of these two important elements of the Islamic reform must be understood. It can easily be shown that the Islamic rejection of *riba* is, in fact, a rejection of the entire capitalistic system, which condones the exploitation of the poor by the rich to achieve high rates of economic growth. The institution of *Zakat* is really sympto-

matic of Islam's highly egalitarian economic philosophy. Now, to maintain that *riba* can fully account for capitalistic exploitation or that a mere 2½-per cent tax on wealth will be sufficient to solve the problem of want and poverty and to bridge the yawning gap between the rich and the poor is to betray gross ignorance of the nature and magnitude of these problems in the present-day societies.

In fact, there is a real danger that if the abolition of *riba* and the introduction of *Zakat* are overemphasized as *initiators* of the process of Islamization, setting a two- or three-year time limit on their implementation, then policy-making will concentrate on just these two elements to the exclusion of all else. Attempts will be made to achieve these 'targets' by one means or another irrespective of their effects on the economy. And once they are achieved, it may give everybody a false sense of accomplishment, as if all that was needed to be done had been done! Nothing could be more dangerous. After all, don't we have countries where gross social injustice prevails in violation of the requirement of *al-Adl wal-Ahsan* even though *Zakat* is the *only* form of taxation there and *riba* has been abolished. In capital-scarce and poor societies, where economic exploitation is rife, such tendencies will be still greater: the profit-sharing system (replacing *riba*) may lead to a gross exploitation of the poor by the rich, and the 2½-per cent *Zakat* tax will prove to be insufficient to end economic injustice in the society. What is worse, nothing can be done about this state of affairs to the extent that the failure to end exploitation *results* from the reforms introduced in the name of Islam. One must never confuse ends with the means!

Another important point which has a direct bearing on the choice of an appropriate Islamic policy package is that specific elements of the package cannot be rejected just because they bear superficial *resemblance* to the policies pursued in non-Islamic economic systems. For instance, if Islam's emphasis on Man's (limited) economic freedom translates into a definite, though limited, role for private enterprise, then this is *not* Capitalism. By the same token, if Islam's commitment to *al-Adl wal-Ahsan* requires far-reaching land reforms and the nationalization of banks and public-goods industries, then such recommendations cannot be rejected simply because they smack of communistic collectivizing philosophy. These are just two examples

of a general principle that formal similarities among some of the elements of different economic systems will always exist, because all economic systems directly or indirectly grapple with the problems of scarcity, want and poverty. However, these similarities do not deprive any economic system of its 'originality' or its distinctive character. The important thing is that, in each economic system, policy instruments should bear a direct relationship to its basic policy objectives and that the former should logically follow from the latter.

SUMMARY

The discussion so far of the principal considerations governing the choice of a policy package to *initiate* the Islamization process can be summarized into five broad 'rules':

- (i) The Islamic policy package must *minimize* the element of *zulm* – i.e. the lack of *al-Adl wal-Ahsan* – in the existing economic systems.
- (ii) It must also move the society towards an Islamic system characterized by *al-Adl wal-Ahsan*.
- (iii) The elements of the Islamic reform must be looked at in relation to its "totality" – i.e. the 'fact' that Islam's is a complete socio-economic system.
- (iv) Specific elements of the Islamic reform – e.g. land reforms, nationalization, etc. – should not be rejected just because they bear a superficial resemblance to other economic systems.
- (v) The pace of the Islamization process must be slow enough to allow the *existing* economic system to change on a broad front and to maximize the flow of knowledge about how the Islamic system operates in practice.

Chapter 5

THE ISLAMIC POLICY PACKAGE – I

It should be clear by now that the most important, and relevant, elements of the Islamic policy package must be those which, *consistent with the overall Islamic requirement of al-Adl wal-Ahsan*, minimize the element of *zulm* in the *existing* society – viz. absolute poverty, excessive income and wealth differentials, low literacy levels and a high rate of unemployment. What can be done about these problems? The most important element of the policy package that suggests itself is a programme for ‘Islamizing’ the institution of private property, *which has been built upon feudalistic – capitalistic foundations*. Other elements of the policy package are vigorous programmes of universal education, particularly at the primary level, and those providing social security in order to relieve absolute poverty. Measures designed to increase the employment ‘content’ of the economic development process through an appropriate choice of techniques and those meant to regulate the rate of economic growth to preserve intergenerational equity should also compete for the attention of the policy-makers. A brief explanation of these proposals is given below.

(i) Private Property

According to some rough estimates, private property accounts for about one-third of the GNP in most of the capitalistic countries. Similar estimates are not available for Pakistan, but it can be safely asserted that privately-held wealth – urban and rural property, including land, houses, jewellery, etc. – accounts for a large part of the inter-class income differentials. It follows that no programme of income redistribution can make much sense unless the distribution of wealth in the society is made equitable, *to begin with*. The most important element of wealth is landed property, which is not only the source of inequity but also of social tensions and moral degeneration in the society. It is, therefore, essential that steps are immediately taken to regulate this institution in a manner which conforms to the Islamic concept of trusteeship rather than that of ownership. The crucial question is: what form should (and can) State intervention take, particularly during the “transition” period – the transition from the present non-Islamic to the Islamic system – to translate the idea of trusteeship into a set of

meaningful socio-economic relationships. The central issue to decide in this context is the extent to which the Islamic Law of Inheritance allows a wider distribution of landed property *outside the small circle of legal heirs* to prevent intergenerational snowballing of wealth – i.e. each generation adding to the inherited wealth, which keeps on growing within the same family? With wealth come political power, privileges and social influence and it should clearly be the concern of the State to prevent, and to destroy if it is already in place, the system of family oligarchy, which tends to be the strongest anti-reform, reactionary force in the society. Hence, for anyone to take the extreme position that the Islamic Law of Inheritance effectively pre-empts any redistributive initiative of the State is really to condone a highly exploitative economic system. Such a position, whatever the cover of legality it may claim from the Law of Inheritance, is clearly against the spirit of *al-Adl wal-Ahsan*: indeed, it is also against the spirit of the Islamic Law of Inheritance.

This Committee rejects such a narrow view of the matter and takes the position that there is considerable room for social reform in this vital area. While legal heirs of the deceased should be protected against any arbitrary action tending to deprive them of their rightful share in the wealth of their parents, the intergenerational snowballing of wealth must be regulated to redistribute wealth among non-family needy members of the society and to prevent the growth of family oligarchies. It is proposed that every time wealth passes from one generation to another when its legal owner dies, each legal heir must be made to pay a registration fee up to a *maximum* of 30 per cent of the total value of wealth inherited by him or her. The percentage can be varied in the light of the financial conditions of the heir, the value of inheritance and the state of encumbrance of the property inherited.

In addition to this, land reforms should be introduced to reduce the size of the *family holdings* of land. Steps should also be taken to promote the Islamic system of partnership tenancy in place of the widespread practice of hiring out bare land for fixed rent, which, according to some *fuqaha* (theologians), is formally equivalent to *riba*. Furthermore, there is the explicit Islamic position that land not cultivated for three consecutive years should be taken away by the State, without paying any compensation to its owners, and given to those who can cultivate it. These measures should also lead to a more intensive and economic level of cultivation. To

ensure rural-urban equity in line with the Islamic commitment to *al-Adl*, it will be essential to take similar steps to regulate the size of urban land holdings and other property. And in line with clear Islamic injunctions, all grazing lands, mines, natural springs and forests must be owned by the State. Also, the un-Islamic practice of granting to individuals lands reclaimed through State-financed irrigation works must be discontinued.

(ii) Universal Education

As pointed out in Chapter 3, universal education, *at least* at the primary level, must form an integral part of the Islamic policy package both as a mechanism for redistributing income more equitably and as a measure for improving the quality of life. However, it should be kept in mind that education can have the maximum equalizing effect only within the matrix of an economic system which distributes wealth more equitably. It is not enough that opportunities for education are made available: the financial capacity of all members of the society must also be improved to allow them to take advantage of those opportunities.

(iii) Employment Generation and Economic Growth

There can be no two opinions about a highly positive attitude of an Islamic society towards economic growth. However, it will place certain restrictions on the *rate* and the *form* of economic growth as well as on the *policy mix* designed to achieve a pre-assigned growth rate.

As pointed out in Chapter 3, the aim of public policy in an Islamic economy is to make economic growth contribute to the maintenance of *al-Adl* intergenerationally: the cost of economic growth borne by each generation should have some relationship to the benefits accruing to that generation. It follows that what public policy must be aiming at is *optimal* saving and not *maximal* saving. Such a 'balanced' policy will also require a proper mix of consumer goods and capital goods obtained through domestic production and/or foreign trade.

The second dimension of the problem concerns the *form* of economic growth. It is common knowledge that economic growth in most of the developing countries, including Pakistan, has been immiserizing – i.e. economic growth is adding to, instead of subtracting from, economic misery in the

society – mainly because of a capital/labour ratio that is far too high in relation to their resource endowments: in labour-abundant countries a ‘high’ capital/labour ratio makes growing unemployment consistent with economic growth. This state of affairs should be unacceptable to any economic system, the Islamic system being no exception. However, it should be noted that the problem is one of the choice of inappropriate techniques, in part due to bad planning. However, the prevalence of uneconomically high capital/labour ratios in labour-abundant developing countries like Pakistan is mostly due to the failure of such countries to evolve capital-saving methods of production. In other words, the problem is one of promoting appropriate technological change, which in turn depends on the supply of relevant technical education.

The third aspect of economic growth, which needs to be regulated to reflect Islamic intentions, is the exact strategy pursued to promote high rates of economic growth. In ‘mixed’ capitalist economies, such as Pakistan’s, economic growth has often been promoted by encouraging considerable investment through the private corporate sector. However, such a strategy has had very undesirable effects on the distribution of income and wealth. It should be clear that a strategy which uses widening income differentials to finance high growth rates must be rejected as contrary to the Islamic commitment to *al-Adl wal-Ahsan*. It also follows that the role of the public sector must increase in an Islamic economy to promote capital accumulation. Not only that: the public sector must also be called upon to produce, through State enterprises, wage goods consumed by the poorer sections of the society.

(iv) Social Security and Anti-Poverty Programme

The Qur’anic verse, “In their wealth, the beggar and the outcast (destitute) had due share” *clearly points to an economic system wherein an individual’s consumption level is not necessarily proportional to his income.* The difference between these two magnitudes – viz. individual income and level of consumption – has to be made up by a social security programme which *guarantees* a minimum consumption level to the poor, the sick and the old in the society, and subsidizes the process of skill formation, particularly among those who live below the poverty line. This programme will also provide general medicare and “rehabilitative medicine” – i.e. artificial limbs, hearing aids, etc.

SUMMARY

The Committee's recommendations in this chapter can now be summarized.

- (i) The Government should take immediate steps to curtail substantially the private ownership of property with a view to promoting a wider distribution of income and wealth outside the closed circle of individual families. In this connection, it is absolutely essential that the Islamic Law of Inheritance be implemented in its full multidimensionality, particularly in respect of that aspect of it which emphasizes the share of the non-family members of the society in national wealth. A registration fee, up to a maximum of 30 per cent of the total value of the wealth inherited by each heir, is recommended to prevent intergenerational snowballing of wealth within few families. Furthermore, land reforms should be carried out on the basis of the size of land held by the family and *not by individuals*. Corresponding steps must also be taken to regulate the size of urban property. Furthermore, all lands which have remained uncultivated for three consecutive years should be taken over by the State without paying any compensation to their owners. Also, grazing lands, mines, natural forests, springs and lands reclaimed through State-financed irrigation should all be owned by the State and cultivated on its behalf.
- (ii) The government should actively promote free and *universal* education, particularly at the primary level.
- (iii) The rate and form of economic growth as well as the strategy of growth must be carefully reviewed to reflect Islamic economic philosophy. The rate of growth must be consistent with the requirement of intergenerational equity. The role of public sector in promoting capital accumulation and producing wage goods must also increase as a part of the Islamic reform. Heavy reliance on the private corporate sector to generate investible surplus *must* be discarded as a policy instrument.
- (iv) The government should take steps to promote the growth of an economically efficient labour-intensive technology in order to increase the employment-generating content of the development programme. In this connection, emphasis should be given to the promotion of technical education.
- (v) An elaborate social security and anti-poverty programme should be mounted to ensure a minimum consumption standard to the

poor and to subsidize the process of skill formation among those living below the poverty line. The government should also take steps to supply medical care, including rehabilitative medicine, to the poor, particularly those residing in rural areas and urban slums.

Chapter 6

THE ISLAMIC POLICY PACKAGE – II

Popular discussions of the Islamization process have singled out the abolition of *riba* (which is held to denote interest in all its modern manifestations) and introduction of *Zakat* to be the centre-pieces of the Islamic Reform. There is no denying the fact that in the *Islamic* economic system there is no place for *riba* and that *Zakat* will be an essential *element* of the Islamic fiscal policy. However, it is crucial to understand that what holds for an Islamic system may not be valid within the context of a capitalistic economy. As is well-known, the capitalistic system is based on the principle of limited liability because individuals have only limited knowledge about the working of big financial institutions and production units. It is entirely reasonable that limited knowledge should entail only limited risk. *It follows that the institution of interest, symbolizing the limited-liability principle, is entirely reasonable and fair within the matrix of the capitalistic system.*

However, Islam rejects interest as unjust. What should then be done? The popular view asserts that the Islamic principle, being divine, would work in every economic system perfectly. Not only that. According to this view, Capitalism itself will be “purified” and work more efficiently if only *riba* were abolished and replaced by the not-so-divine principle of profit-sharing. The Committee rejects such views as both naive and harmful.

The Islamic injunction against *riba* constitutes a rejection of the entire capitalistic system. It is, in fact, a signal for a complete restructuring of the entire economic system along Islamic lines: the Islamic principle of *al-Adl wal-Ahsan* must be reflected in the basic consumption, production and distribution relationships. The abolition of *riba* will come about *only* as a part of this fundamental readjustment of the economy. To think of abolishing *riba* without reference to the “totality” of the Islamic economic system is to put the cart before the horse. In fact, there is a real danger that the abolition of *riba* and its replacement by the profit-sharing system will increase the level of economic exploitation of the poor by the rich, thereby negating the basic Islamic principle of *al-Adl wal-Ahsan*.

The following paragraphs will clarify the Committee's stand-point both on the question of *Zakat* and on the abolition of *riba*. A few proposals will be given on how to deal with the latter problem.

THE INTRODUCTION OF ZAKAT

The Committee fully supports the Government's decision to introduce *Zakat* as a part of its bid to introduce Islamic values into the Pakistani society. However, it will be a gross confusion to consider *Zakat* to be an end in itself and to hold the naive view that once this is done the economic problem will more or less be solved. It is the Committee's opinion that such emotionalism must be avoided. Things must be seen in their proper perspective and not exaggerated out of all proportions. It is important to look at *Zakat* as a *limited* step to raise resources to finance the elaborate social security and anti-poverty programmes which will be essential elements of an Islamic economic system (see Chapter 5). The basic thing is to offer an Islamic solution to the problem of poverty and of an uneven distribution of wealth in the society. In that perspective, *Zakat* is only *one* of the policy instruments to achieve the objective of an Islamic economy.

It is essential to realize that the imposition of *Zakat* does not preclude the imposition of other taxes – not only on income but also on wealth. The comprehensive and revolutionary Islamic conception of *infaq* – “And they ask thee what they ought to spend. Say: That which is superfluous” (al-Qur'an, 2:219) – should be the focal point of our thinking on how much resources should be transferred from the rich to the poor. It was this conception which led Hazrat Abu Dharr, the distinguished companion of the Holy Prophet (peace be upon him), to his revolutionary view that *absolute* equality must hold in the distribution of income and wealth.

ABOLITION OF RIBA

The Committee is strongly of the opinion that popular discussion on *riba* does not show a full understanding of the complex nature of the problem. Firstly, it will be an exaggeration to maintain that the *zulm* (social injustice) in the society can be entirely explained in terms of the existence of a positive rate of interest. In fact, it is profit that is by far the most important source of economic exploitation in a capitalistic society. Hence, while means must be found to abolish *riba*, albeit in very easy steps, any proposal to replace it by profits will not necessarily be a step towards the Islamic Ideal in so far as it negates the objective of *al-Adl wal-Ahsan*.

Secondly, as noted above, an *economy-wide* abolition of *riba* can come about *only* within the context of far-reaching readjustments in both the 'real' sector – consumption, production and distribution relations – and the financial sector of the economy. Thus, to maintain that the abolition of *riba* is the *first* step towards, or even the necessary precondition of, an Islamic economy is a gross inversion of "priorities" in the realm of policy-making.

Thirdly, in a capital-scarce economy, like Pakistan's, it is meaningless to even talk of a zero rate of interest. The real question is not how to abolish interest rate, or even how to lower it: the problem is how to replace it with a system which reflects more accurately the opportunity cost of capital. It may be noted parenthetically that the interest rate in Pakistan has *not* performed this function adequately: the 'real' rate of interest in Pakistan has mostly been negative! However, this is *not* an argument for abolishing interest, but for raising it to an appropriate level. The problem has assumed greater importance in the context of the severe bouts of inflation Pakistan has experienced since 1971. Inflation has not only tended to discourage saving, it has also encouraged investment (in nominal terms), thereby widening the gap between investment and saving.

In Search of Viable Alternatives

The Committee, after taking account of these and other considerations, set out towards the end of this chapter, has rejected the widely held opinion that the profit-sharing system can completely replace interest *within the matrix of the economic system in operation at present*. Instead, it proposes:

- (i) A limited scheme for giving interest-free loans as a subsidy;
- (ii) For the banking sector, a comprehensive non-automatic system of indexing which will be symmetrical with respect to bank deposits and bank advances;
- (iii) A system of Investment Auctioning for long-run advances by financial institutions, including banks;
- (iv) An investment company which invests in risky ventures on behalf of the banks on the basis of profit-sharing; and

- (v) A long-run solution to the problem which relates the abolition of *riba* directly to the process of restructuring the real and the financial sectors of the economy along Islamic lines.

(i) *Interest-Free Loans*

Since capital commands a scarcity price in Pakistan, interest-free loans will constitute a net subsidy to the borrower, the size of the subsidy depending on the level of the 'real' rate of interest in the economy.

As noted in Chapters 4 and 5, the government may have to subsidize the production of wage goods. To the extent the private sector undertakes the production of such goods, interest-free loans may be extended to it. However, the subsidy given in this form would partly or wholly preclude the fiscal subsidies normally given to the private sector. In fact, it is possible to generalize this system to 'cover' most of the private sector. It should be noted that the subsidy given in this form will be in the nature of a *permanent* subsidy – i.e. once it is extended as a part of the Islamization package, *it cannot be withdrawn*. Hence, it will be essential to impose additional taxes on those industries for which the subsidy is no longer needed.

Interest-free loans may also be given to those sectors which require *permanent* subsidization by the government. The construction of small houses, particularly those built in rural areas or urban slums, need to be subsidized. Furthermore, local initiative in the construction of hospitals, nursing homes, modest schools and small-scale industries in the rural areas should be encouraged through this policy.

(ii) *Indexing Time Deposits and Bank Advances*

As pointed out above, in the persistent inflationary situation that the world (and Pakistan) will have to live with for quite some time in the future, it is essential that steps are taken to encourage saving and promote a most economical use of investment resources. Inflation cuts both ways – it discourages saving and favours borrowing for investment. The longer the period for which savings are kept or borrowing sought for, given the rate of inflation, – or the higher the rate of inflation, given the period for which saving and borrowing are done – the greater will be the disequilibrium between investment and saving. It is for this reason that periods of high inflation are

associated with rising rates of interest. Any proposals to abolish the institution of interest from the banking system must keep these considerations in view together with the fact that the return on saving, or the cost of borrowing, *must not be fixed in advance*, for that would be *riba*.

The proposal to index time deposits and bank advances to the rate of change of the price level satisfies all these requirements. Each year the State Bank may decide the percentage by which the nominal value of bank deposits (i.e. time deposits) and bank advances should be escalated. The indexing need not be automatic; nor does it need to be one hundred percent. All that is being proposed is that the indexing be some *multiple* of the rate of inflation: it could be less or more than, or equal to, one hundred percent, depending on the size of the required return (cost) of saving (borrowing). The rate of indexing can also vary with the period for which saving (borrowing) is being done.

The proposed system is Islamically legitimate because indexing will be some percentage of the *rate of change* of the price level – a variable quantity. On a limited scale, it will also be economically viable and a perfect alternative to the interest-bearing option. In fact, there is a decisive advantage in the proposed system over the existing interest-based system: it makes inflation-conscious all those who stand to gain most by inflation, namely the bankers and the borrowers. Since there is a definite cost attached to it, everyone will have a 'vested interest' in controlling the rate of inflation. The proposal is also administratively simple – a decisive advantage over the administrative nightmare that the proposed profit/loss-sharing system will inflict on the policy-makers.

(iii) *Investment-Auctioning System*

The proposal is designed to provide a mechanism to regulate the terms on which long-term lending is done by financial institutions and takes into account, as far as possible, considerations of social profitability in private investment decisions. The proposed system can be operated as an alternative to, or in conjunction with, the system of indexing loans to changes in the price level. Under this system, the financing institutions will periodically auction investment authorizations to investors through the market mechanism. This procedure will make it possible for the investors to take into account the scarcity price of capital, which will be high and positive in a capital-

scarce economy, in making investment decisions. In order to prevent an unnecessary 'cornering' of investment authorizations by a few bidders and also to reflect social investment priorities, the auctions will take place periodically according to the following scheme.

The Government, in consultation with the Planning Commission and other responsible authorities, will parcel out total investment resources into several categories of investment to be specified in an investment schedule. Each broad category of investment in the investment schedule would be assigned a maximum monetary limit. Auctioning will stop in a particular category once the monetary limit assigned to it is reached.

This system will achieve both of the objectives stated above and will ensure that total investment resources are not all forced into those uses which are considered to be the most profitable from the point of view of individual investors. It will also prevent overcapitalization and excess capacity, and will not allow the capital-labour ratio to go too far out of line with the resource-endowment pattern of the country.

It may be asked whether this system has an element of *riba* built into it. The answer is in the negative. All that is envisaged in the scheme is that the investors will be allowed possession of scarce investment resources only at a price, which will correspond to the prevalent scarcity of capital resources. *The scarcity price will not be fixed in advance; instead, it will be determined by the supply of and demand for investible funds.*

(iv) *Investment Companies*

The profit-sharing arrangement, while unfeasible as a substitute for *riba* on an economy-wide basis, can be usefully employed to promote interest-free investment *on a limited scale*. However, two basic amendments have to be made to this arrangement before it can work in practice: (i) The profit-sharing system must somehow incorporate the principle of limited liability without which no economic system based on capitalistic principle can work; and (ii) This arrangement will operate within the overall interest-based system, so that it is only one option among many available to the investors.

These general principles can be incorporated through investment companies, which, being more *knowledgeable* about the working of the financial

system, can minimize risk under condition of uncertainty. Since they will be managing an investment portfolio, they will not bear any loss but will charge a commission for their services. Under this system, banks will be investing through these companies the funds made available to them by *those depositors who wish to take risk*. This is not only Islamically legitimate but makes economic sense as well because the risk will be borne by those who are not risk-aversers, this latter class still having the option of risk-free, interest-bearing investment.

It may be objected that the proposed arrangement is not Islamically legitimate because, according to it, the individual liability to risk is limited. This may be so, but, as pointed out above, the profit-sharing system can work *within the capitalistic system* only on the basis of limited liability. And in making a transition to the Islamic system there is no option available to the policy maker but to accept the present financial structure as the natural starting point for introducing bits and pieces of the Islamic reform. The problems of the transition period, when we have to work with non-Islamic system, will be inevitably different from those faced in a full-fledged Islamic economic system. *During this period only 'second-best', or even 'third-best', solutions will be available.*

(v) *The Long-Run Solution*

How far can we go down the road leading to the economy-wide abolition of *riba* with the help of the above-mentioned measures? Not very far. As far as the banking sector is concerned, the proposals will 'cover' only time deposits on the 'liabilities side' and bank advances on the 'assets side' of the commercial banks' "T-Accounts". *These proposals will not in any way change the status of the interest-bearing securities.* This is because the interest-bearing government securities in Pakistan account for all the "secondary reserves" of the commercial banks and for about 73 percent of their total reserves, which form the basis of money creation through the banking system. Hence, if these are abolished, the 'monetary base' will shrink by about three-quarters, causing a sharp fall in the money supply. These securities also offer an outlet for short-term, riskless investment of their "excess reserves" by commercial banks because the risk of loss on sale is zero on securities — a feature that makes them both highly liquid and marketable. It is for this reason that the money market, of which the banking system is an important part, uses interest-bearing government securities to perform

effectively their risk-minimization function – i.e. the function of keeping a proper balance between securities and equities, and among equities of differing maturities.

The spread of risk, ranging between the zero risk and the high-risk investment options, is called the “interest-rate structure”. This range is the continuum through which monetary policy makes an impact on the ‘real sector’ of the economy. This holds not only for those policy instruments which formally involve manipulation of the interest rate – e.g. the Bank Rate and the Open Market Operations – but also for those which do not carry a similar involvement – e.g. variations in the cash reserve requirements. *In terms of their effect on the financial and real sectors of the economy, all these instruments are equivalent because they all operate on the same “interest-rate structure”.* Interest-bearing government securities also form the most important source of the non-inflationary and inflationary finance to the government. By issuing long-term securities, the government raises non-inflationary loans from the public, while inflationary finance requires the issuance of short-term deposit receipts, against which the State Bank prints new money. It is thus clear that interest-bearing securities form the hub of the entire monetary structure, which would collapse if they are abolished: monetary policy, in the traditional sense, will cease to be operational, while government will have no way of raising non-inflationary, non-tax finance.

It follows that so long as the capitalistic structure of the economy continues unchanged, there is a definite limit beyond which the process of abolishing interest can not go. The Islamic reform, aiming at the abolition of *riba* must therefore remain ‘partial’, ‘covering’ only a small part of the economy. What should then be done? Can’t we ever abolish *riba* on an economy-wide basis? *Not if we persist with the capitalistic economic system,* where the financial and real sectors of the economy are linked together through the money market and where investment and saving decisions are made independently by atomistic “economic agents”. An economy which operates on a limited-liability basis can never completely do away with *riba* if only because a large class of small savers are risk averters. *All this must change if the ultimate goal is the abolition of riba.*

There is no way to abolish *riba* on an economy-wide basis unless the process of monetary creation is *directly* linked with the process of produc-

tion *and* both the saving and investment activities are perfectly coordinated. This, in effect, means that the public sector must become not only the saver and investor but also the producer. Furthermore, the entire banking system will have to be effectively nationalized (as has already been done in Pakistan) and then operated *only* as a means of providing finances *directly* – and *not* through the money market which will cease to be – to meet the liquidity requirements of the real sector of the economy.

But can we do all this? Is it not Socialism that we are advocating? Not at all! As has been shown, this solution follows directly from the logic of the Islamic Reform. We don't have to step outside of the Islamic system to reach a stage the basic features of which have been delineated in this section. As pointed out in Chapter 4, we do not reject a solution just because it resembles the one offered by Socialism. For if we were to use this logic consistently we will also not be able to advocate an economy run mainly on the basis of profits – which is the linchpin of Capitalism. If we can't have a private sector because it reminds us of Capitalism and a public sector because it smacks of Socialism, what else shall we have for the Islamic system? A complete answer to this question can be given only when an Islamic economy, based on *al-Adl wal-Ahsan* has become fully operational. Only then, through the process of learning-by-doing, shall we come to recognize an Islamic economy just as we recognize Capitalism and Socialism. Till that time, we must move slowly and steadily towards the ultimate goal, concentrating first on those aspects of the Islamic solution which come to grips with the problem of poverty, want and economic deprivation.

SUMMARY

Now to summarize the main recommendations of this chapter.

- (i) The proposal to substitute profit-sharing within the existing economic system for the interest-based system should be rejected. Any such attempt, besides being incompatible with the basic conception of a capitalistic economy like Pakistan's, will make it impossible for the State Bank to conduct monetary policy in the traditional sense
- (ii) *No attempt should be made to replace interest-bearing government securities by equities.* For such a step would: (a) deprive the government of any means for inflationary or non-inflationary borrowing; (b) knock out the secondary reserves of the commer-

cial banks, thereby putting severe constraints on money creation; and (c) make the money market ineffective in its main task of risk minimization.

- (iii) On the limited plane of the commercial banking operations, interest-bearing deposits and advances to the private sector may be indexed to the changes in the price level. The indexing percentages will be announced at the end of each year by the State Bank as a certain *multiple* of the rate of change of the price level.
- (iv) Long-run loan-financing by the financial institutions may be done through a system of investment-auctioning.
- (v) Interest-free loans may be given as a subsidy to small-scale industries, modest construction activity, etc.
- (vi) *As one of the options* for profitable investment, it is being proposed to establish investment companies which invest on behalf of the commercial banks on the basis of profit-sharing. These companies will not share any losses but will work for a commission. The profits and losses will be passed on to the banks, which will distribute them among those who deposit their money in a special interest-free bank account.
- (vii) *However, in the long-run, riba can be wholly abolished only if the economy is completely restructured in a way that renders the institution of interest redundant.* This will involve a complete dovetailing of the process of money creation and the productive activity in the 'real' sector of the economy. The process of money creation, instead of being conducted indirectly through the money market, will have to be linked directly to the real sector.