CHAPTER - II

MUSLIM CRITICISM OF INTEREST AND PROFIT-SHARING

During the recent years there has emerged a growing interest in the monetary and fiscal economics of Islam. Based on the contemporary debate in western economies on these issues some Muslim apologists are trying to work out the monetary and fiscal policies of their countries which they call 'Islamic Economics'. The two most important pillars of 'Islamic Economics'- the institution of Zakah and the prohibition of riba - are fiscal and monetary measures around which most of the contemporary literatures on 'Islamic economics' revolves. It is claimed that if riba is prohibited, banking and other financial institutions could function efficiently on the basis of profit-sharing. But some Muslim apologists have begun to ask question whether they should carry on their analysis within the framework of the capitalist system or they should depart from the capitalist system and be attached with the ethical value system of Islam. In this connection, the following remarks of a Muslim apologist are

interesting. He says that 'One-dimensional thrust of Western economic thought, which is based on the vision of eighteenth century England, have kept Muslim economists on the straight and narrow path. According to him 'Muslim economists are deeply sunk in the quicksand of western economic paradigm. From the statements of objectives onwards, they have adopted the western economic paradigm in its totality. The major themes of western economics occur again and again in the literature on Islamic economics: 'productivity', 'macro-consumption economics', 'full-employment'; 'economic growth', 'welfare programmes', 'cost-benefit analysis' and 'monetarism'. Because the main frame of reference is the western economic paradigm, its tools, methodologies, issues and institutions are accepted and questions are always asked in relation to them... These metaphysical notions, and the accompanying borrowing of institutions, ideas and tools of the western economic system, are implicitly leading Muslim economists to produce policies that are hardly different from the capitalist and socialist alternatives. In the end they will lead the muslim countries to the same crisis that confronts industrialized societies'.

Questions are being asked as what is Islamic economics? How does it differ from the conventional capitalist and socialist models? What are its axioms and principles? How will Islamic economics replace the dominant economic orders in Muslim societies? It is generally felt that the elimination of interest is not the only condition for the Islamisation of the economy, as it is evident from the fact that a socialistic economy, which is contrary to Islam, also functions on the basis of a zero rate of interest in financial transactions. Thus the abolition of interest is not a necessary first step to attain a truly Islamic state. It is argued that 'a transitional Islamic society will have to shoulder this "necessary evil" till a truly Islamic state is finally established, in which case, of course, there would not be any need for the rate of interest to exist any longer". ³ According to a modern Muslim writer "Islamic economics is not capitalism minus interest plus Zakah or socialism minus state control plus Allah". ⁴ Another Muslim writer explains the rationale behind the prohibition of interest in these words:

"If the Islamic system is equated simply with the abolition of interest and introduction of Zakat, this would amount to some kind

³ S.N.H. Naqvi, Ethics and Economics, Ch.7, p.109.
⁴ This remark is made by Ziauddin Sardar, Op.cit., p.199.
of an over simplification, I agree that abolition of interest and the introduction of Zakah are the most important pillars on which we have to base new structure of society and economy, but they do not go to make up the whole structure ... Abolition of interest is one of our primary targets. Establishment of Zakah is a priority of objective in our scheme. But they do not constitute the be-all and end-all of the Islamic economics .... our target is a fundamental change in the economy and society: a change that affects people's attitudes and motives, their consumption and production relationships, society's institutions and structures, individual life styles and collective policies at all levels.5

The rationale of the prohibition of interest is looked rather with doubt. A numbers of points are raised. Regarding the traditional view that business partners face the risk of a possible loss whereas the lenders face no risk at all as the reason for prohibiting interest, Homa Katouzian, says there is nothing in the Qur'an and tradition to say that riba is prohibited because it does not involve the lender in the risk taking. He further says that the rate of return on capital bears a relationship to the degree of risk involved in various types of investment

5 Khurshid Ahmad made this remark on opening speech in Ariff (ed.) Monetary and Fiscal Economics of Islam (Jeddah: Internal Centre for Research In Islamic Economics, King Abdul Aziz University, 1982).
The higher the risk, the higher the rate of return. A borrower would normally expect a lower rate of interest than rate of profit he would have earned on his capital had he entered a partnership with borrower. In this way, they each take different degree of risk and expect different rate of return. He also thinks that there are various degrees of risk and rates of return associated with different types of business activity. In some partnership, the partner may face higher risk, and even higher profits, than others. But Muslim economist does not maintain that business involving higher risks are superior to those facing lower risk. As it can be seen however, there is no genuinely risk-free decision of any kind, and, in any case, the degree of risk is related to the rate of return.  

The emphasis of the Muslim ideologue is that the Islamic economic system is a part of the total Islamic way of life. For a balanced economic growth 'curbing conspicuous consumption, both private and public, and guaranteeing a minimum level of consumption to all, accompanied by fiscal discipline ensuring the channelisation of the additional incomes generated to capital formation', are essential.  

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'Islamic economics' as it has been already mentioned have still not faced a testing ground. That is why Islamic economic theories cannot be justified merely on the ground, as they claim, that other prevailing systems have proved a failure. Not only the concept of interest, but important aspects like the Zakah and Islamic financial systems still remain obscure. They discuss Islamic fiscal policy within the framework of Islamic distributive justice. Zakah dominates the whole discussion, as if distributive justice is concerned only with transfer payments and as if Zakah is the only instrument available. Islamic thinkers have expressed differences of opinion with respect to Zakah base. One view is that Zakah is a form of wealth tax and therefore, it is not permissible to include income in the Zakah base. Another view is that Zakah must be paid on a Zakah-able asset regardless of whether it is owned by private individual or by government, it is because Zakah is earmarked by certain purposes as spelled out in the Qur'an, whereas Government revenues are not. One writer rejects this point and says that commercial exploitation of mineral resources can be undertaken only by the state and not by individuals. He even goes so far as to suggest that revenues from such state-owned mines are similar to Zakah, regardless of whether these are used to benefit the poor or society as a whole.7 The question is generally raised: what will

7 Mohammad Ariff (ed.) Monetary and Fiscal Economics of Islam., p.16
happen if interest is abolished in an Islamic economy? It is claimed that the profit-loss sharing system is superior to interest-based debt-financing on grounds of efficiency. The prevalence of debt-financing in the world is explained by the high information cost of profit-sharing system. Islam, as it is believed, is neither opposed to competitive effort nor is averse to the operation of market forces. But monopoly, hoarding, speculation and other unIslamic practices have been banned. Islam, like capitalism, permits private ownership of property including the means of production and grants freedom of enterprise. It holds trade and therefore production in high esteem.


9 The Qur'an condemn the hoarding of wealth in following words: "And let not those who hoard up that which Allah hath bestowed upon them of His bounty think that it is better for them. Nay, it is worse for them. That which they hoard will be their collar on the Day of Resurrection. Allah's is the heritage of the heavens and the earth, and Allah is informed of what ye do (111:180).

Even Prophet is reported to have said: "Fear God and be moderate in your pursuit of wealth, take only that which is allowed and leave that which is forbidden". Ibn. Majah, vol.2, p. 725:2144.

Interest and Islamic Economy

Keeping in view the function of interest in the capitalistic system, it is argued that interest cannot be abolished instantly from the "Islamic economy", for if it is done so there are chances that economy will collapse. Because a capital scarce economy in transition to an Islamic economy will need a rate of interest which performs certain desirable functions, and in the absence of interest it cannot achieve its goals. Thus interest rate would be required to allocate scarce resources optimally among various sectors of the economy. Moreover, in a dynamic economy's positive rate of interest is desired to account for the positive social rate of time preference, for the social cost of capital consumption resulting from its use, and for the declining real value of saving over time'. 11 Hence for an economy in transition to the Islamic state, a positive rate of interest cannot be substituted by the

11 Even in the socialistic system the price of capital is counted. Recent studies shows that planners in the Soviet Union are anxious not to be denounced as apologists for capitalism; yet they need some form of interest rate (or "discount rate", or "payoff period") for making efficient investment calculations. See, Paul A. Samuelson., Op.cit., p.669.
Islamic concept of profit-sharing. For an economy in transition to the Islamic state, a positive rate of time preference can move towards zero only by extensive cut back on consumption, which means that public saving will take the upper hand and less reliance would be placed on private saving. While abolishing interest in the transition period, government interference will be necessary in creating saving, cut back in consumption loan, increase in real investment and so on. In short, the presence of the interest rate is a "necessary evil" in a capital scarce economy during its transitional phase to full-fledged Islamic economy. If the rate of interest is at all to be abolished, then it will lead to gross inefficiencies.

An important function of the rate of interest is that it is essential for the efficient allocation of scarce investment resources. Interest is a device that serves two functions in the economy. It provides an incentive for people to save and accumulate wealth. But the interest rate is also a rationing device; it allows society to select only those investment projects with the highest rates of return. Interest rate play a major role in determining the market value of asset. When the interest rate drops from a high to low level, there follows a rise in the present value of existing machines, land, bonds, stocks, yielding a stream of future return. The rate of interest also performs the functions of safeguarding the real value of private saving. Besides this interest income provides the reserve funds to finance monetary escalation of money expenditure on depreciation and new investment.

S.N.H. Naqvi, 'Interest Rate and Intertemporal Allocative Efficiency in an Islamic Economy, in Ariff (ed.) Op. cit., p.43
Replacement of interest by profit-sharing is the basic "reform", that has been advocated by Muslim economists. The reason behind it is that the 'investor faces an uncertain world in which the result of his enterprise cannot be foreseen with certainty. 14

What is this 'partnership and profit-sharing' ? and how much it is different from the concept of interest ? and can this be substituted in place of the functioning of interest without doing any harm to the economy ? Muslim scholars are at pains to prove the efficiency of profit-sharing system, but not without much complexities that are associated with this.

There is a general consensus among the Muslims that profit-sharing is legitimate in Islam, and an alternative to interest. What makes profit sharing permissible in Islam, while interest is not, is the fact that it is the profit-sharing ratio and not the rate of return which is predetermined. It is because, the

14 Almost every Muslim scholar has emphasised this point. For a comprehensive account on this use. See M.N. Siddiqi, Muslim Economic Thinking., Ch., 4.
owners of capital have no priority over others in the form of a fixed rate of return.

As for the complexities are concerned, it is said that the substitution of interest with profit-sharing would lead to monopolies, allocative inefficiency and economic instability and so on. It is also felt that inflation might exist in the profit-sharing system. The reason is given that some possible factors may contribute the inflation like excess demand, shortage of supply, market rigidities and unbalanced resource allocation between luxuries and necessities, specially those which can artificially be created.15

Definition

'Shirkah means participation of two or more persons in a certain business with defined amounts of capital according to a contract for jointly carrying out a business and for sharing profits and loss in specified proportions.

'Mudarabah means that one party provides capital and the other utilises it for business under the agreement that

15 Ariff (ed,) Monetary and Fiscal Economics of Islam,. p.260.
profit from the business will be shared according to a specified proportion. Thus, the most accepted solution for interest is the application of the principles of shirkah (partnership) and mudarabah (profit-sharing) as the medieval Muslim jurists have accepted that as legal. Now the main concern is that how the profit-sharing works in an interest-less Islamic economy. The main economic arguments are given as follows:

The Islamic jurists have worked out the details about shirkah and mudarabah on the basis of the Qur'an and sunnah. A deeper analysis of the concept of mudarabah reveals that it is essentially an investment-management agreement. The sahib al-mal (capital contributor or investor) is basically not the lender but the owner of the business to the extent of his shares.


Also, under Mudarabah, the party that provides the merchandise and the party that engages in business may each comprise many persons, i.e., the capital may be provided by several persons and the business may be carried out by several other persons. Alternatively, capital may belong to one person and the party that utilizes it in business may be many or several persons may pool their capital while one person uses if for carrying on business.
in the total financing of the business. The mudarib, (manager or entrepreneur) manages the investment fund placed at his disposal by the sahib al-mal in accordance with the mudarabah agreement. Mudarabah is a form of equity which is temporary in nature and is liquidated as soon as the objectives are realized. In accordance with the rationale behind the prohibition of riba, the manager of Mudarabah funds is not entitled to a fixed return for his management services irrespective of what happens to the business. If there is a profit, he shares the profit in an agreed proportion as a reward for his managerial and entrepreneurial services. If there is a loss, he gets no reward, and his loss amounts to the opportunity cost of his services. However, he shares the loss if he has a share in the equity of the business, but only to the extent of his shares because losses according to the fusha constitute erosion of equity. This fits perfectly into the rationale of the Islamic model of Riba-free economy and implies that the spirit of business relationship preferred by the Shari'ah is "investment management" and not "borrowing-lending", taking into account the modern connotation of these terms.

Equity financing in place of loan-financing will help eliminate the possibility of a large superstructure of finance being raised on a narrow equity base. It would help bring
about a wide dispersal of ownership of business and contribute substantially to the realization of the goal of equitable distribution of income and wealth. It is said that expected rate of profit in the economy will play the allocative role which is supposedly played by the rate of interest in the modern economies. Accordingly capital as a scarce factor of production, will have a price, not in the form of a pre-determined rate of interest, but in the form of a probable rate of return thrown up by the profit-sharing system. Savers will have the expected rate of returns to bank deposits on the incentives to save and deposit their saving in bank investment accounts. The profit-sharing arrangement would result in a just and equitable sharing of social surplus. The system based on interest is unjust because it guarantees a definite positive return to the financier whereas the value productivity of investment is uncertain. Thus, it is claimed that profit-sharing system is not only feasible, it is also more efficient than the system based on interest.


18 M.N. Siddiqi, Issues in Islamic Banking., p.125.
This profit-sharing, which include also the risk sharing is considered the only alternative for interest. Muslim apologists believe that principle of profit-sharing will ensure mobilisation of saving, its channelling to productive enterprise, and its allocation in accordance with social preference will be achieved by the rate of profit. This rate of profit, according to them, will be more efficient mechanism for allocation of resources than interest. 'The rate of interest tends to be a "perverted" price and reflects price determination in favour of the rich, the more "creditworthy" the borrower, the lower the rate of interest and vice versa. The result is that "big" business is able to get more funds at a lower price because of its "higher" credit rating. Thus those who are most able to bear the burden, because of their bigness claimed "higher" productivity, bear the least burden.' In this system if there is a profit, the entrepreneur shares the profit in an agreed proportion as a reward for his managerial services. If there is a loss he gets no reward. However, he shares the loss if he has a share in the equity of the business. It is further argued that; a wholly equity-based system,

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with the rate of profit not fluctuating as erratically as the rate of interest and the distribution of the total return (profit + Interest) between the entrepreneur and the financier determined more equitably, should on the contrary tend to have the effect of reducing rather than accentuating economic instability. As regards the differences between profit and interest it is said that Islam has recognized the profit only in a restricted sense. Because unrestricted and 'abnormal profit' which a capitalist earns is a clear case of exploitation. While Islam recognizes normal profit, it prohibits interest. Unlike interest, profit is the result of productive efforts. In the case of interest, productive effort is not at all made by the lender, but in the case of profit that element remains throughout the process of production and marketing. Thus profit is the reward of progress. In the case of interest, the element of loss is altogether missing because it is fixed and certain, whereas profit is a payment for the assumption of risk by the entrepreneurs.

It is entrepreneur's income which is uncertain and unknown. Because of these vast differences, it is claimed Islam has allowed profit and condemned interest.

Muslim economists, in recent decades, have started to work out different models of Islamic banking, based on profit-sharing instead of interest. Thus profit-sharing is considered as true ideal of Islam.

The proposed 'Islamic bank', it is argued, will work "as a financial intermediary mobilising savings from the public on the basis of mudarabah, and advancing capital to entrepreneurs on the capital advanced by the banks are shared by the banks according to a mutually agreed percentage. The bank also provides a number of familiar banking services against a fee or a commission. The bank's own share capital also goes into its business of offering banking services and advancing capital on a profit-sharing basis. Making allowance for administrative costs, the net revenue on all these counts constitutes business profits, to be distributed over the entire capital involved: public deposits on the bank's share capital. The percentage profits so worked out are then shared with depositors according to a proportion announced in advance. Profits received by the depositors in mudarabah accounts are, therefore, a percentage part of banking profits which mainly
accure to the bank as a percentage part of the profits of enterprises financed by it.\textsuperscript{21}

Thus, in mudarabah system, instead of interest which is unjust, profit will play the allocative role. The advantage of this system is that the banks as suppliers of investable funds examine the projects presented to them and supply investable funds only when they are fully satisfied that the project will result in the production of a value larger than that invested, since the bank's own returns depend on it.\textsuperscript{22} "In the interest based system supply of investable funds by banks involves creation of new money. This applies to the profit-sharing system also. But the creation of new money in profit-sharing system is effectively linked with the genuine possibilities of creating additional value. It may not be so in the interest-based system where credit worthiness of the borrower is more important than the prospective productivity of the project".


\textsuperscript{22} M.N. Siddiqi, \textit{Issues in Islamic Banking}, Ch.5., p.127.
Mudarabah: An Analysis

The claim that profit-sharing applied to Islamic banking system has the unique advantage of not being prone to inflation has been challenged by many economists. It is argued that profit-sharing system offers no solution for inflation. The reasoning is that "in an Islamic economy, where interest is replaced by profit-sharing, the higher the profit share ratio, the lower the demand for liquidity and the greater the velocity of circulation." As the mudarabah partnership depends on profit-sharing the profit and interest cannot duplicate each other's role, because in a perfectly competitive markets all profits are normal profits and are, therefore, inadequate to perform the functions of a positive rate of interest. Moreover, profit maximisation under the mudarabah will lead to the growth of monopolies and monopolistic market would create economically inefficient allocation of resources both in a static and dynamic market situation. The argument runs thus:

"Interest rate cannot be abolished just by an administrative fiat, without making alternative arrangements, financial and real

to ensure the effective performance of these functions ... since a zero rate of interest is a property of an Islamic economic system and not of capitalism, thus, if interest rate is abolished by an administrative fiat while leaving all other capitalistic institutions intact, the Islamic 'reform' may end up by pushing the economy away from the Islamic ideal. To put this argument formally, while a zero rate of interest is a necessary condition for an Islamic economic order, it is by no means a sufficient condition in that this step, all by itself, need not usher in an Islamic society, based on al-Adl".24

The above proposition that elimination of interest will not be a sufficient condition for an ideal Islamic economy, deserves to be considered carefully. He may be right or wrong, but it is fact that there is not any established Islamic economic model available in the Islamic world for empirical studies. Even those "economists" who are full of praise for the mudarabah system, cannot justify their claim merely on scholastic ground. As a matter of fact it has yet to prove its potentiality.