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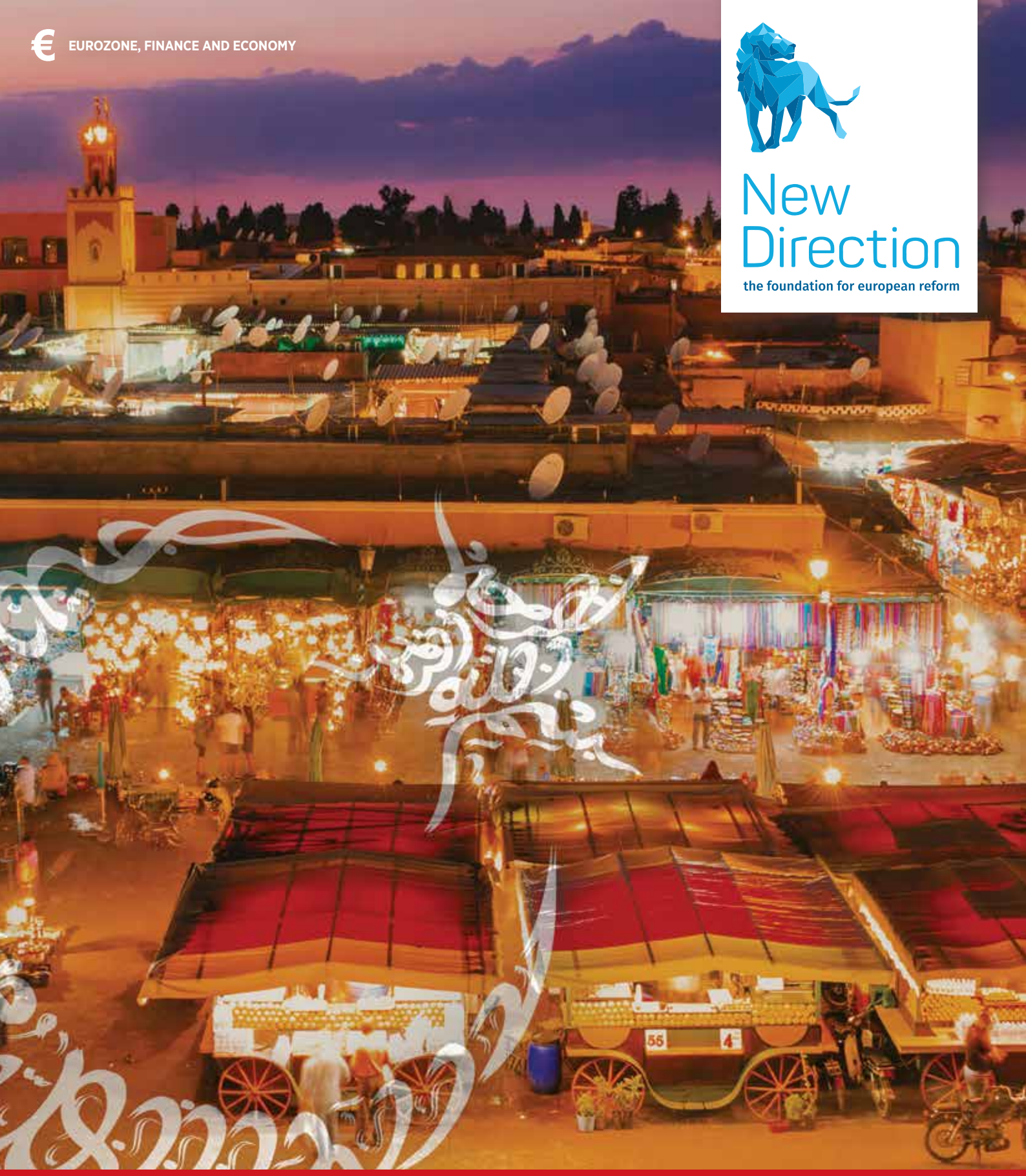

REDISCOVERING THE CAPITALIST TRADITION OF ISLAM

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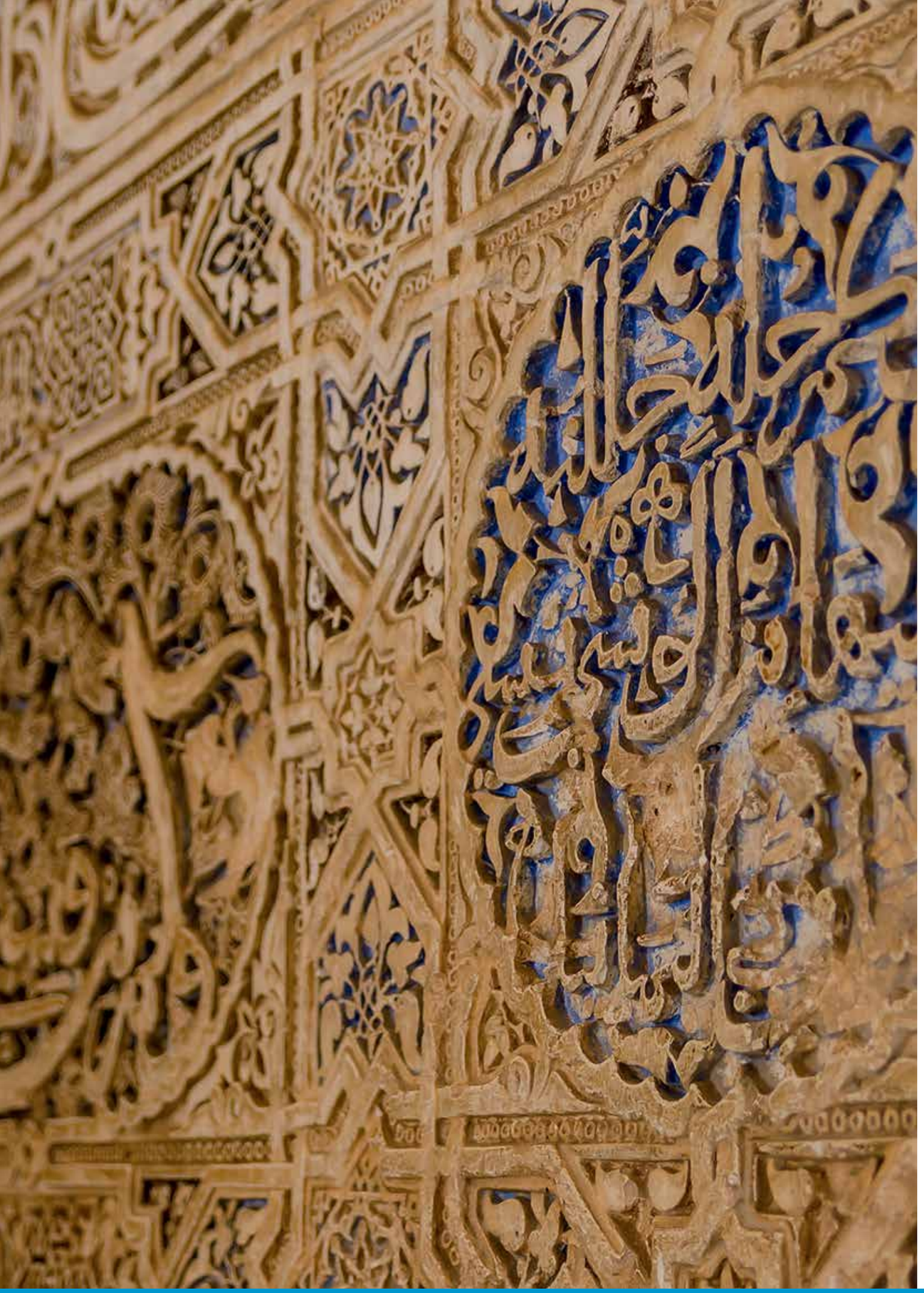

INTRODUCTION

by Aminah Koshul
Researcher at Arab Center for Scientific Research and Humane Studies

This brochure serves to establish a connection between Islam and capitalism by methodically refuting the claims behind their incompatibility. The following collection of articles draws on analyses of religious texts as well as sayings from the Prophet's life (hadith) to prove that the teachings of Islam call for an economic environment conducive to capitalism. Historically, the relationship between Islam and capitalism has eluded thorough analysis due to the absence of overlap between disciplines, such as religion and economics. Since economists and scholars of religion can rarely claim mastery of each other's fields, research on the Muslim world is largely based on the premise of an existing link between Islam and underdevelopment (Quran, 1997).

To begin with, the current state of global affairs has necessitated an exploration of the potential for violence allowed by religion. In the turbulent political atmosphere following 9/11, mainstream academia constantly produced literature on Islam inspecting its connection to terrorism. At the same time, Western media's portrayal of the Muslim world grossly misrepresented the role of religion in the War on Terror without giving consideration to political, economic and historical factors. The Middle East and North Africa have effectively been rendered synonymous with cultural backwardness and civil unrest, in which Islam is considered complicit. Such misrepresentation inevitably results in an incomplete surface-level analysis of the economic situation of Muslim majority countries, in which underdevelopment has been attributed to religion in an intellectually dishonest fashion. Ultimately it is erroneously assumed that the robust economic growth associated with the West cannot be replicated in the Muslim world because religion is responsible for creating a regressive environment that severely debilitates economic potential.

The connection between Islam and underdevelopment has been disproved numerous times throughout this brochure by the readily available examples of early Islamic civilization and the Golden Age of Islam.

It is the Golden Age, dating from the 8th to 13th centuries, that makes the strongest case for Islam's compatibility with capitalism. This time period witnessed a previously unprecedented level of economic, scientific and social development that helped form a basis for Europe's renaissance roughly one century later.

Developments made in the Golden Age occurred against the backdrop of a strong and dynamic civilization, whose progressive interpretation of religion created a cohesive social structure that defended markets. Islam, as a system of beliefs brought about moral societal change that resulted in the strengthening of social trust and facilitated the establishment of strong, equitable institutions (Quran, 1997).

Historian Maria Menocal in her renowned book *The Ornament of the World* describes culture in Andalusia as 'rooted in pluralism and shaped by religious tolerance'. Openness to cultural exchange promoted the pursuit of knowledge and resulted in sweeping scientific and technological innovations. Cross-cultural contributions to scholarship were only made possible in an atmosphere that raised the social status of religious minorities. Muslim Spain, by capitalizing on its diverse population managed to achieve the collective social advancement of civil society.

Accordingly, it is no coincidence that the height of Islamic civilization witnessed the creation of an expansive commercial empire. It was characterized by a period of increased economic globalization that promoted Islamic influence through extensive trade networks. However, the economic power afforded by the Golden Age began to disintegrate in the face of political decline.

One of the primary reasons for the fall of the Islamic Empire lies in the suppression of free thought. While Islamic law is derived from the Quran and hadith, issues that are not covered by these two traditional sources require *ijtihad,* or independent reasoning to realize God's law. In employing independent reasoning, jurists during the Golden Age remained receptive to change and created an atmosphere in which hermeneutic thinking was encouraged rather than suppressed. At a societal level, *ijtihad* maintained the intellectual stimulation necessary to contribute to the widespread innovation and discoveries that defined the Golden Age.

The gates of *ijtihad* closed, however, upon the agreement that all possible eventualities had been discussed and independent reasoning was no longer needed to deduce solutions. Instead society adopted the uninspired approach of practicing what was prescribed, the results of which are seen today (Quran, 1997). The intellectualism that had once served as a catalyst for rapid growth is no longer present, as is seen from the struggling education systems of many Muslim majority countries.

Once free thought was suppressed, social trust weakened and reputable institutions were eroded, giving rise to corruption and political mismanagement that hastened the downfall of the Islamic Empire. Algerian thinker Malek Bennabi introduces the concept of coloniability in saying 'we were colonized because we were colonizable' to explain how the internal problems of Muslim countries increased their susceptibility to intervention from imperialistic Western powers (Bilgrami, 2016).

Upon closer historical analysis, it is revealed that anti-Western sentiment translated into a rejection of capitalism in an increasingly anti-colonial atmosphere fraught with calls for self-rule. Subsequently socialism gained ground as an ideology in the Middle East and North Africa post World War II. In *Capitalism and Class in the Gulf Arab States,* Hanieh writes 'in many cases, the anticolonial movements allied with the USSR or China as a means to maneuver against the major capitalist powers' (Hanieh, 2011).The embracement of socialism by Arab states, as a politically motivated process, was a direct result of the bipolar global order that characterized the Cold War.

A multi-disciplinary approach, such as the one used above, is necessary in order to contextualize the current state of Muslim majority countries. It is necessary to discern the root causes of weak state economies so that an effective solution can be proposed without misdiagnosing the problem. Accordingly, the breakdown of social trust, vulnerability to colonial powers and repression of current regimes must be taken into account instead of isolating Islam as the sole cause for underdevelopment.

To begin with institutional reform is desperately needed in order to strengthen the economy and reinvigorate entrepreneurial spirit.

This can be achieved through a reconnection with the roots of Islamic intellectual tradition that promotes free thought and the pursuit of knowledge, as seen throughout the Golden Age. Economic anxiety, which has far-reaching consequences ranging from political instability to social discontent, must be assuaged to stave off internal conflict and bring about stability.

A stable political climate is necessary for the healthy growth of a capitalist economy. From the onset, however, it must be recognized that there is an embedded moral component to capitalism when practiced within the framework of religion. Therefore, Islam does not allow for the crony capitalism commonly practiced today, but it calls for an ethically sound form guided by Islamic values.

The most commonly cited grievance against crony capitalism is the creation of income inequality that confines wealth to the business and political elite of a country. However, the third pillar of Islam, *zakat* (purification) plays a unique role as a built-in religious mechanism that oversees the redistribution of wealth with little to no government intervention. It requires Muslims to donate 2.5% of accumulated wealth to the poor, and in doing so it upholds the idea that wealth is entrusted to humans by God as a blessing and must be used to serve Him and His religion

Zakat serves as a mechanism of solidarity that performs the dual function of strengthening community ties while mitigating economic hardship. Its decentralized nature decreases opportunities for governmental corruption since it's required to be distributed in the community that donated it. In *Poverty and Charity in Middle Eastern Contexts*, Bonner cites the Prophet's interaction with his governor Mu'adh ibn Jabal to explain how wealth was required to be collected from the rich in any given area and offered to their poor without being transferred elsewhere (Bonner, 2003).

By mandating the local redistribution of funds, *zakat* manages to temper destabilizing inequalities with minimal governmental intervention. In doing so, it consolidates the sense of unity necessary to establish institutional trust and conduct business in a healthy free-market economy. Since redistribution of wealth is seen as a religious or moral obligation rather than a governmental one, the wealth gap is decreased without de-incentivizing hard work and competition. In this sense Islamic capitalism manages to negate arguments about the unfairness of a mandated redistribution of hard-earned wealth to poor sectors of society.

While it is difficult to isolate causes behind the rise and fall of civilizations due to the complicated nature of human development, it is safe to say that Islam cannot be faulted with the increasingly delayed adoption of capitalism by Muslim majority countries. As this brochure intends to assert through a comprehensive examination of religion and ensuing economic practices during early Islamic civilization, Islam undoubtedly supports capitalistic practices on a spiritual as well as practical level.

AUTHORS' CONTRIBUTIONS

The following articles adopt a multifaceted approach in making the case for Islam's compatibility with capitalism. The authors come from diverse backgrounds and present a wide range of viewpoints that dismantle various arguments about the illiberal nature of economics mandated by religion. The first three articles make their case by referencing religious text or the body of literature known as hadith. The authors assert that Islam is compatible with capitalism, as evidenced by scripture.

The opening article begins by introducing capitalism on a moral ground; it frames the creation of wealth as a means of serving God. The author Salman, explains Islam's teachings about the treatment of the poor and contends that in order to help the less fortunate it is essential to be in a position of economic strength. This can be achieved by accumulating wealth, which capitalism facilitates by espousing necessary conditions such as individual freedom and property rights. Ultimately this article presents a strong moral argument about the use of capitalism leading to higher standards of living for all members of society.

In his second article, Salman cites hadiths and quotes from the Quran to prove that Islam advocates for a market-friendly economy with limited government intervention. He specifically brings up the topics of exchange, inequality, property rights, free trade, price controls and profit to verify that sharia does indeed call for economic freedom in every sense of the term. He explains that throughout the 20th century, Islamic economics in practice have been socialist-leaning, but they are libertarian in theory. Historical forces in the post-colonial Muslim world created a nationalist political climate that effectively resulted in a plan-

based economy. However, Salman argues that such an economy is not supported by Islamic law, which in reality supports economic freedom while recognizing the need for social justice.

The third article written by Mustafa Akyol distinguishes between the enforcement of Islam as a legal or moral code. Akyol argues that since there is no compulsion in religion, Islam is only morally enforceable so modern states such as Saudi Arabia are flawed in their execution of religion. A state that strictly polices the behavior of its citizens cannot be said to be practicing Islam. He draws on religious tradition to clarify the meaning of Sharia and contend that it is meant to protect the values of religion, life, property, intellect and lineage.

The next two articles make their argument by analyzing the economic practices of early Islamic civilization. The author, Sorman mentions that the Prophet and his wife were proponents of international trade and participants in the economic creation of globalization. He asserts that the entrepreneurial spirit of Arab Muslims created a commercial empire and that free trade and capitalism can find their roots in Islamic theory and early practice. In addition Sorman suggests that the Arab Spring was primarily caused by economic anxiety that can be assuaged if Muslim countries reconnect with their entrepreneurial traditions and embrace popular capitalism.

The following articles adopt a historical approach in establishing a connection between Islam and capitalism. The author Ghazanfar examines trade in the Arab World and Ottoman Empire, describing how merchants adopted capitalistic principles while conducting business. He explains that trading across boarders created the need to establish advanced financial institutions conducive to capitalism.

The next author Moussaoui cites the success of Islam during its Golden Age (between the 8th and 13th centuries) with facilitating international trade. The decline of Islamic civilization, he argues, was due to the deterioration of institutions necessary for entrepreneurship and not Islam itself. Moussaoui also explains how religious teachings, such as submission to the will of God, and the influence of collectivist cultures in Muslim majority countries do not negate free will or hinder independent acts of entrepreneurship. In fact, similar to the first author Salman, he contends that the lawful creation of wealth is a form of worship. Moussaoui concludes by saying that meaningful institutional change is needed to create a culture of entrepreneurship. In turn, this will play an instrumental role in strengthening the economies of Arab countries.

The last article, also written by Moussaoui, follows a similar trajectory. He first outlines the reasons behind the decline of a free-market economy in MENA. A lack of social trust combined with weak institutions hindered the establishment of the widespread societal networks that are compulsory for a flourishing market economy. Moussaoui points to sociopolitical factors for debilitating the economy and, therefore, he manages to refute the claim that Islam is the reason behind socialist governments in Muslim majority countries. He cites crony capitalism and cosmetic changes at the government level as causes for institutional mistrust but suggests reforms like limiting state intervention, consolidating the rule of law and encouraging competition to strengthen economies.
The above articles primarily employ two strategies in their case for capitalism: they either refer to religious teachings or Islamic history which practices those teachings. By adopting this dual-pronged approach, the authors cover broad topics that present exhaustive analyses and reject single cause explanations. While Islam is often viewed as an outdated religion, they argue that its practices can be implemented in modern-day societies without precluding the possibility for a functioning free-market economy.

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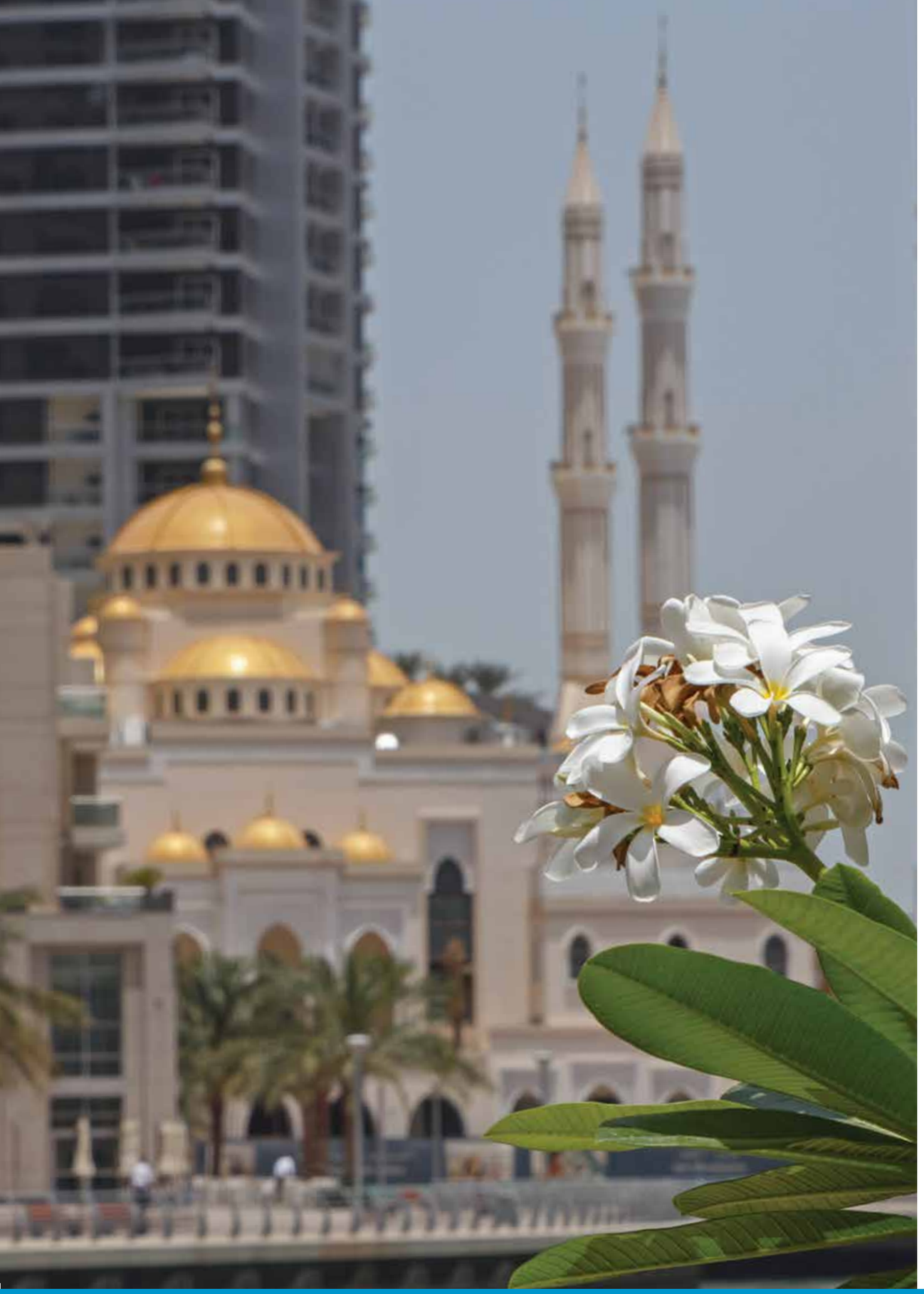
New Direction is particularly grateful for the great work and contribution of these scholars in the field of Islamic studies.



1

MORALITY OF CAPITALISM – IN THE CONTEXT OF A MUSLIM MINDSET

by Ali Salman

For friends and foes alike, capitalism has been largely regarded as an efficient resource allocation mechanism which has played an important role in material advancement of human society over the last 200 years. Even Karl Marx considered this system as the key to technological and material progress. However, capitalism has been often challenged on moral grounds. In this essay, I will develop a case of defending the moral foundations of capitalism within the context of a Muslim mindset.

Before writing further, a definition of capitalism is in order. Capitalism is essentially built on the basis of voluntary exchange in a marketplace – and in this sense, it certainly predates the modern understanding and application of the word, as such exchange has been happening since times immemorial. What makes capitalism in the last 200 years structurally different from the economic exchanges in previous known history is the exchange value and unprecedented prosperity that has spread across the globe. The conditions that have created that prosperity include individual freedom, the rule of law and protection of private property rights. While those were not novel concepts, it can be safely argued that those conditions were not met before at the critical level to propel human progress in the way that happened in the last 200 years. Despite scientific breakthroughs by Chinese and Islamic civilizations (which were largely limited to the royal courts) and expanding global trade, which took place long before European renaissance, those conditions were either absent, short-lived or limited to small groups of people. Generally speaking, hereditary empires and religious authorities can be cited as two major obstacles in the creation of those conditions.

Thus capitalism, as the term is used in this essay, refers to the conditions of individual freedom, the rule of law and private property as the foundation for a system of voluntary exchanges coordinated by markets for creation of value.

To return to the main issue at hand – the morality of capitalism – the generalized notion of a critique of capitalism on moral grounds runs as follows:

> Capitalism, as the name indicates, is developed for those people who are the owners of «capital» (which is often narrowed down by critics to "money"). Thus it works to the advantage of those who are in an advantageous position with respect to others. It denies opportunities to accumulate wealth to those who are not fortunate enough to own capital as an initial condition. Ultimately it feeds social and economic divergence. Further, capitalism is based on self-interest, which encourages greed, and greed is unethical and inhumane. Greed also leads to fraudulent behavior and corruption. It undermines compassion and human dignity and defines wealth creation as the point of existence. Building on that, some critics go on to argue that once we accept the basic tenet of capitalism, so understood, then greed no longer remains limited to commerce alone. It permeates the very social fabric in which commerce operates and thus leads to a more general ethical decline of society. In short, capitalism is immoral and unjust.

Those arguments are not fundamentally different from certain religious criticisms of wealth, except of course for the fact that the religious argument draws its authority from divine sources and may or may not use historical facts to advance its case. As an Islamic society is deeply influenced by divine sources, which offer a standpoint for evaluating public policy, it will be instructive to revisit some of them in order to understand the religious case.

A general case for the denunciation of wealth has been advanced on the basis of several Quranic verses. For instance, consider these verses:

> And those who hoard up gold and silver and spend it not in Allah's way — announce to them a painful chastisement. (9:34)
>
> You who believe, let neither your wealth nor your children distract you from remembering God. Those who do so will be the losers. (63:9)

Similarly, consider this *hadith* Abdullah ibn ash-Shikhir said,

> I came to the Prophet, may Allah bless him and grant him peace, when he was reciting 'Fierce competition for this world distracted you.' (102:1) He said, 'The son of Adam says, My property! My property! Son of Adam, have you any other property than what you eat and thus gets used up, wear and thus becomes worn out, and give in sadaqa and thus make effective?' [Muslim]

Also consider two other well-known *ahadith*. Abu Hurayra reported that the Messenger of Allah, may Allah bless him and grant him peace, said:

> The poor will enter the Garden five hundred years before the rich. [at-Tirmidhi]

Ka'b ibn 'Iyad said,

> I heard the Messenger of Allah, may Allah bless him and grant him peace, say, 'Every community has a trial, and the trial of my community is wealth. [at-Tirmidhi]

These are generally representative of the tone, message and spirit of several other Quranic verses and *ahadeeth*. There is a general appeal towards simplicity, modesty and charity. There is no doubt that the Islamic teachings, not very different from other religions, call the attention of our conscience not only to the needs of the poor, but also to a world hereafter. It is also true that the general character of Islamic values is spiritual, humane and favourable to the poor. On the other hand, there are various Quranic verses and *ahadith* that strongly encourage commerce, trade, and the production and accumulation of wealth. There is no point, however, in merely juxtaposing two contrasting religious sources or to interpreting the same in a different manner. Instead I call the attention of readers and thinkers to logic and reason.

Consider what is really required for one to become charitable and to become more useful and helpful to the weaker segments of society? What is required to help the poor besides, of course, a noble heart?

What is required, at a social level, to develop a human society which can benefit from all natural resources and can tame the nature to the benefit of mankind rather than mankind remaining at the mercies of unpredictable natural forces? In other words, what is required to become a real vicegerent of God (*khalifah*) on earth? What are the conditions of materializing God's will of becoming His vicegerent besides being pious?

It is obvious that a poor person, not through any fault of his own, cannot become a giver, just as a materially backward society cannot overpower nature. As a matter of fact, there have been times in human history when the symbols of nature – for examples, the sun and fire – were indeed worshipped. However, with the advance of human intellect, revealed guidance, and technological developments, those natural powers were ultimately controlled. Following that reasoning, it should be true that besides being pious, for an individual to qualify as khalifah, he/she ought to be materially advanced, rich and prosperous. As argued earlier, it was only in the last 200 years that that was achieved at a global level. Poverty and hunger still exist but they have also been eradicated in large parts of the world. Human society has achieved this by establishing, as argued earlier, the conditions for capitalism as we know it today.

There should not be any doubt that the more wealth one accumulates, the more difficult it becomes to do justice in its distribution. It is for that reason alone that the Prophet of Islam truly told us that the poor will enter the Garden 500 years before the rich. (Remember that the day of judgement spans fifty thousand years according to a Quranic verse!) For of course, it is only the rich who will be asked about the sources of their wealth and its distribution. A poor person deserves no trial for accumulation and distribution of material resources, but a rich person deserves an greater trial by a just God. It should indeed be the case. However, should such *ahadith* inspire us to denounce wealth and to impoverish ourselves, or to become more sensitive and – by becoming wealthier – more capable of helping those who may not be fortunate like us?

Islam does not condemn wealth creation; it only proscribes certain ways in which wealth creation ought to be considered not only irreligious, but also illegal. It never asks its followers to become poor or to refuse rightfully acquired wealth. It certainly enjoins its followers to be charitable with what is theirs and, consistently with that, Islam asks its followers to treat the rightfully acquired property of others with complete respect.

It is well established that Islam encourages trade, and commerce and trade, and not just war, has played a critical role in the expansion of Islam across the planet. Wealth-creating trade and commerce require certain conditions and despite internal conficts, the Islamic caliphate was fairly liberal towards merchants and traders.

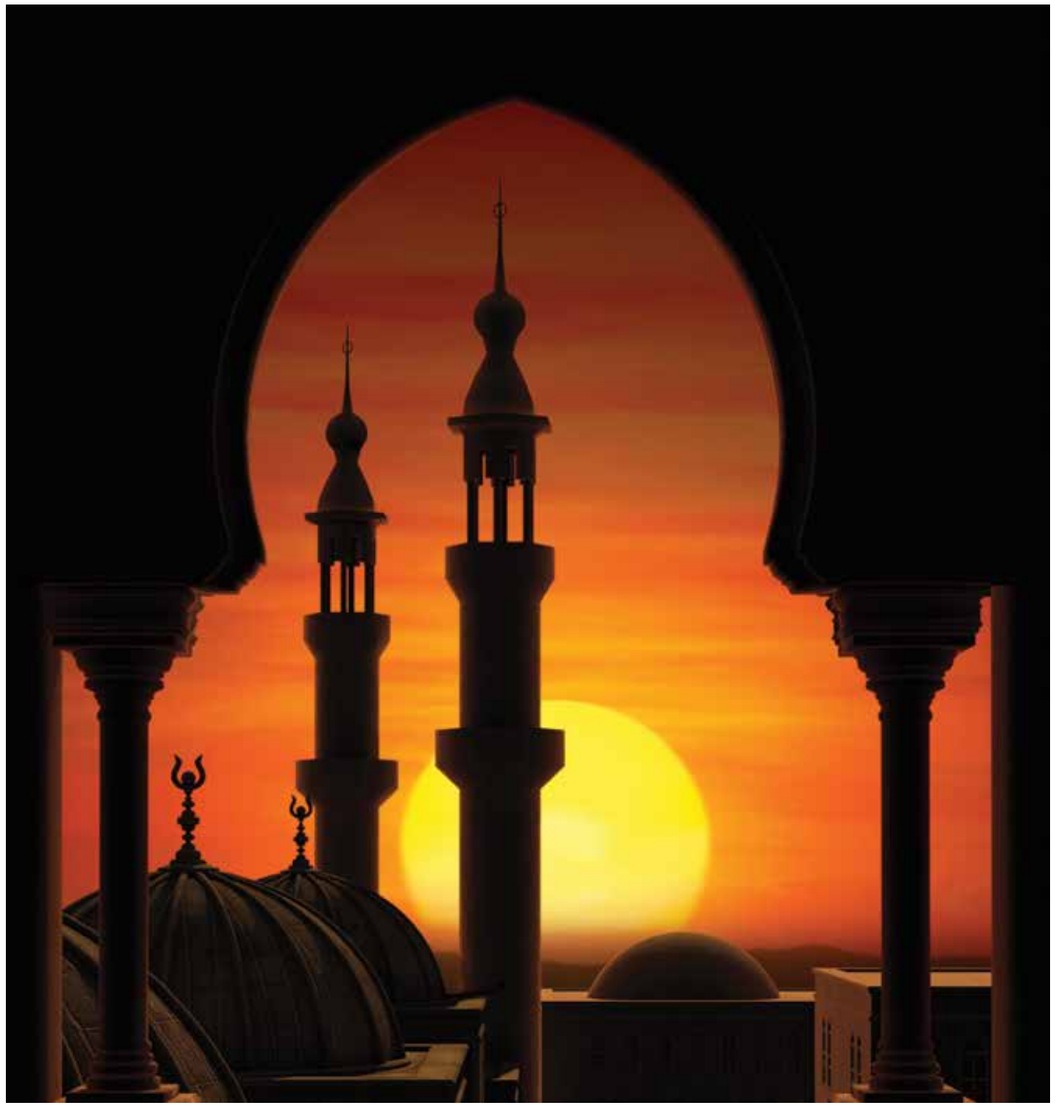
As Islam generally discourages collection of taxes other than a modest 2.5% wealth tax (*zakat*) and a 10% tax on produce (of all kinds), it also encourages a limited government. If, hypothetically speaking, Muslim rulers were to follow that principle of minimum taxation, then they would certainly arrive at a limited government.

What follows from the reasoning set out above is that the conditions that Islam envisions for human progress are fully congruent with the very conditions that have given rise to modern capitalist society.

On the contrary, the Islamic economists built the foundations of Islamic economics on the assumption of a specific conduct instead of certain methodologies and principles.

Muhammad Nejatullah Siddiqui is one of the most important authorities on Islamic economics in the modern age. For him, Islamic economics questions some of the fundamental assumptions of modern economic theory, for instance, about human behaviour. He believes that the stereotyping and universalization of human behaviour, such as its risk aversion, is Western (Siddiqi 2001:61). Islamic economics would be built on transformation of the individual behaviour (Ibid). Discussion of human behaviour has emerged as a very favourite topic of Islamic economists. They rightly know that without the transformation of an individual into an Islamic free of selfishness, the dream of an Islamic economy, as per their own ideals, will not mature. In other words, the Islamists envision nothing short of social engineering to purge the impure human beings of their illicit desires. Consider, for instance, another popular Islamic economist M. Umer Chapra, who recognizes the efficiency of the market strategy but believes that human beings are to be reformed sufficiently (Chapra 1993:127). However, in this very construct of a presumptuous approach towards the individual lies a possible predicament of Islamic economists: change human nature first.

It is believed that 'most of the différences between Islamic economies and neoclassical economics are rooted in behavioral norms'. These differences have led leading Islamic thinkers to argue in terms of *homo-economicus* and *homo islamicus*.



For them homo *economicus* implies greed, acquisition and pragmatism, whereas homo *islamicus* means dedication, altruism, humanist and cooperation. Obviously this compartmentalization of value set in two different intellectual traditions i.e. divine and humane, is not only artificially constructed, but it also negates our common observations about human behavior.

A society in which the richest most are the most charitable is the product of capitalism. Consider Bill Gates and Warren Buffet, who both made billions in honest business and are giving billions to help the poor. They have successfully used their Giving Pledge to challenge other wealthy people to match them. A society that is rich enough to provide welfare for its citizens without external help is indeed the ideal form envisioned by the Islamic teachings on wealth creation and distribution. There is no doubt that it can only be achieved through love of this world (critics use the word greed) – but it does not have to be at the cost of the world hereafter. Islam does not propose a zero-sum game, for Muslims are well aware of prophetic and Quranic prayers to seek excellence both in this world *and* in the world hereafter. One should conclude that hatred towards materialistic, mundane and humanistic achievements will not serve the purpose of God. Since the status of honest businessmen is considered spiritually similar to that of prophets and martyrs, it should instead be understood that Islam enjoins its followers to create favorable conditions for business and commerce. Those conditions, let me repeat, are the same conditions that proved necessary to give rise to capitalism. Islam, as I understand it, endorses capitalism as we know it.

To prove their point, the moralist critics of capitalism often cite the examples of bad – yet wealthy – individuals who have amassed fortunes through corruption. However, mixing the rightful pursuit of profits with the unlawful acts of thieves, dacoits and corrupt individuals requires erasing the distinction between right and wrong. To avoid that trap, we need to distinguish between free-market capitalism and crony capitalism. Socialists of all creeds have systematically used examples of crony capitalism when they advance their criticisms of capitalism. The critics of capitalism also argue that it destroys basic human values like trust because individuals have incentives to profit at the expense of others. However, in practice, we can observe that countries with favorable conditions for capitalism also exhibit societies with high degree of mutual trust. Turkey, Malaysia and Indonesia, for instance, have created enabling conditions of capitalism in their societies. Incidentally, Muslim societies which are materially backwards, such as Pakistan or Nigeria, are also low-trust societies.

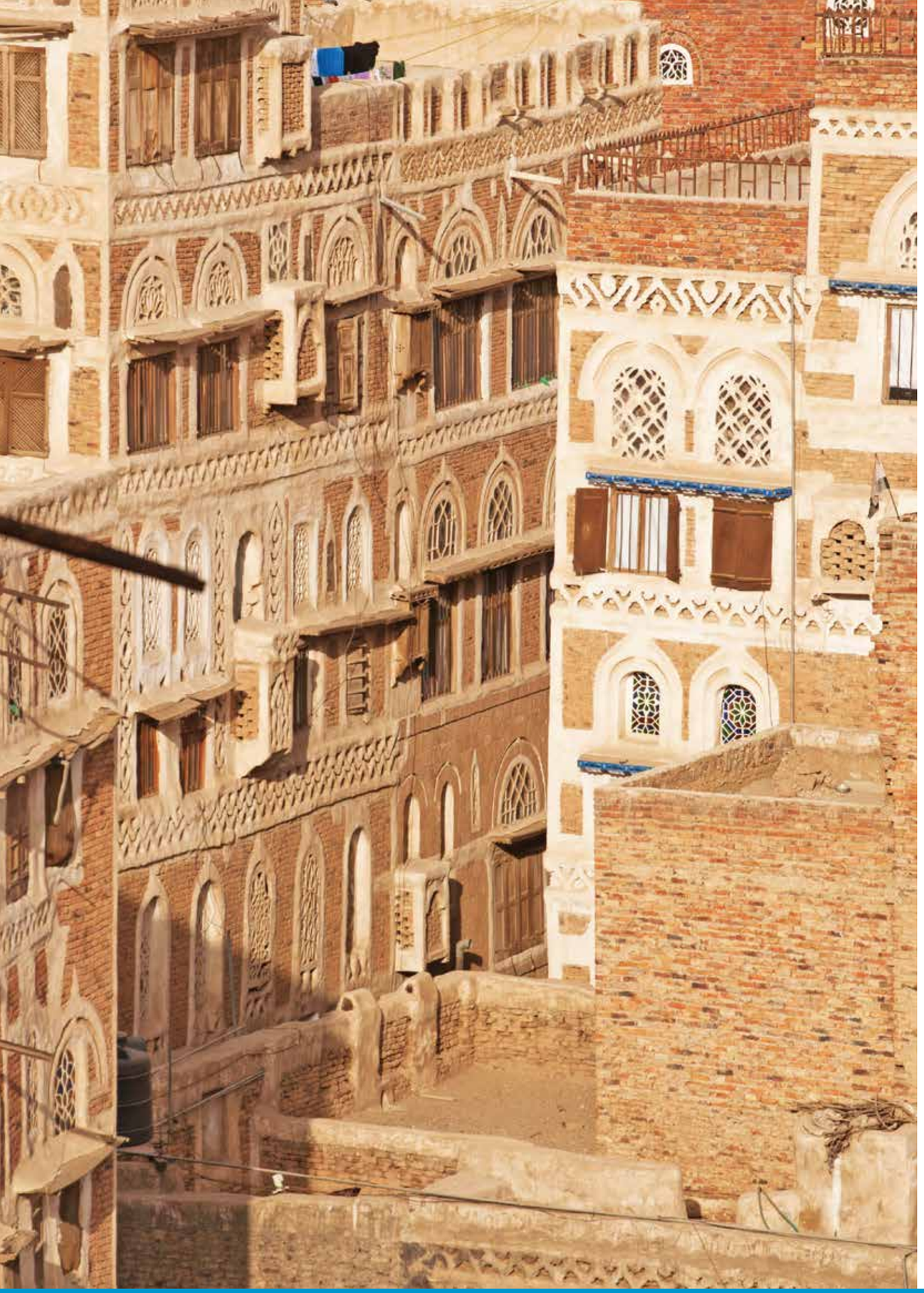
Another popular criticism of capitalism is that it creates and increases income inequalities. It is true that capitalism tends to reward those who create value through their talent, hard work, skill and even luck. It does not follow, however, that there is greater inequality than under socialistic, feudal or other systems. Moreover, the increasing level of average incomes, including the incomes of the lower-income earners in nations that have embraced capitalism, has meant that living standards have been rising considerably. It is as true in the US as in India. Two hundred years ago, kings and ordinary citizens were both miserably poor, if poverty were measured in terms of the living standards of the modern age. Today an ordinary citizen in a reasonably functioning economy has access to facilities far better than those enjoyed by the richest of previous generations, and often the same as that enjoyed by the richest. In countries that embrace capitalism a successful captain of industry and a high school student or a day labourer can talk on mobile phones, send instant text messages and enjoy access to the most advanced medical technology.

Consider if you were to travel to a far fung village, the farmer would worry far less about what a bank CEO is earning in the corporate headquarters of his bank in the capital than about whether he is earning enough to meet his and his family's needs. The humanitarian should be more concerned about raising living standards for all than about income inequalities. A society with fully equal outcomes, in terms of income and material status, would be an unjust society. It would also be a very, very poor one. By ensuring differential outcomes, capitalism rewards and encourages talent and hard work, and that talent and hard work benefits all, not only the rich, for the way to become rich under capitalism is to create value for others.

It is possible that the notions of wealth creation in early Muslim history are closely linked with military achievements. It is not to deny that later spread of Islam was to be supported with the flux of trade, but if one were to study, for instance, the Kitab Al-Amwaal for discussions on wealth and its distribution, it is almost impossible to ignore the pre-dominance of the discussion on *ghanima* and *fe'h*. For a tribal society becoming a world power, *jihad* and not *bazaar* might become an important economic strategy for the state.

In the modern age, an increasing number of free and wealthy Muslim nations living in peace show that Islam as a religion is not a hindrance to the advancement of the Muslim world. There are fve Muslim nation-states in a 20 most free economies of the world, with Bahrain occupying 7th position. How prosperous the country is depends mainly on the conditions and policy choices that the government has adopted. And while the various countries are found at different levels of economic and political freedom, the levels of prosperity of those that are adopting the conditions of capitalism have been converging.

According to a pioneer of the libertarian movement in Pakistan, Dr. Khalil Ahmad says the basic moral premise of capitalismi is this: wealth belongs to the one who creates it; therefore, capitalismi is not only ethical but also just. If we miss this moral high ground of capitalismi, all we are left with is the empty utilitarian sloganeering of some very narrow minded economists, who show only the efficiency part of capitalism. Human beings are essentially moral creatures and believers in values; they are not robots and efficiency can only take us so far. Missing this point is missing the spirit and the soul of capitalism. •



2

THE LIBERTARIAN CHARACTER OF THE ISLAMIC ECONOMY

by Ali Salman

This article reviews the shari'a approach to markets and examines its treatment by certain 20th century Islamic economists such as Nejatullah Siddiqui, Nawab Haider Naqvi, Umer Chapra and M. A. Mannan. It characterises the arguments of these economists as largely statist, redistributive and socialist, possibly reflecting post-colonial intellectual experiences. Yet shari'a endorses negative freedom by proscribing price controls and guaranteeing consumer protection from coercion. Islamic law, this article argues, as evinced in both revealed knowledge and human exegesis, has endorsed a market-friendly, libertarian and limited-government philosophy.

2.1. INTRODUCTION

Islam is not just the world's fastest-growing religion, governing more than a billion lives; it is also the most potent political currency in the world's economically most strategic areas. Prosperity and peace in these areas depends largely on the degree of legitimacy that free-market economics would enjoy in an increasingly reactionary ideological environment underpinned by specific religious interpretations. Seen in this way, the question of the compatibility of free-market economics with Islam has global implications.

This article discusses the compatibility of free-market economics with shari'a by juxtaposing literature from the Quran, hadith and fiqh against the arguments of certain 20th century Islamic economists and scholars. Unlike most modern treatments of Islamic economics, the article does not seek to compare and contrast Islamic law with prevalent discourses on economics that have resulted in 'Islamic capitalism' or 'Islamic socialism'. Rather it revisits the intellectual tensions within Islamic discourse by discussing the ideas of economic freedom and social justice, and it aims to show that, at least in the domain of economics, the goal of justice is largely achieved by ensuring freedom.

The article suggests that it is important to rediscover the economic insights offered in the earlier Islamic texts, but not in search of some pure type of economic system for no such system exists. Rather, the quest should be for an historical understanding of certain intellectual positions that draw their authority from Islam and continue to influence the domain of public policy in Islamic countries. Such analysis is especially important in relation to countries like Pakistan, whose constitution is officially subject to the boundaries prescribed by shari'a.

The second section of this article presents the basic principles of economics found in the primary sources of shari'a, namely the Quran and hadith. The third section presents the key arguments of

certain 20th century Islamic economists on the issues of economic freedom, welfare and social justice. The fourth and concluding section restates the salient characteristics of Islamic economic philosophy.

2.2. THE PRINCIPLES OF ECONOMICS IN ISLAM

This section presents the important principles and features of economics in Islam derived from the Quran, hadith and fiqh. Admittedly, what follows by way of evidence will be selective, but it is hoped that the primary nature of these verdicts, being based directly on the Quran and hadith, will help in substantiating the argument. As this discussion shows, the economic system of an Islamic state ought to be based on the principles of freedom, mutual consent and exchange. In terms of policy, this leads to the affirmation of private property rights, the absence of price controls and the endorsement of a risk–return conceptualization of wealth creation.

2.2.1. VOLUNTARY EXCHANGE

The fundamental principle of economic transactions is captured in the following Quranic verse, which enjoins its followers to observe voluntary exchange and thrift.

> Believers, do not consume your wealth among yourselves in vanity, but rather trade with it by mutual consent. (4:29; trans. Dawood 1999)

Another leading translator and interpreter of the Quran, Abdullah Yusuf Ali, has translated the same verse thus:

> O ye who believe! Eat up not your property among yourselves in vanities; but let there be amongst you traffic and trade by mutual good-will. (4:29; trans. Ali 1934, p. 53)

Commenting on this verse, Ali writes, 'Here it occurs to encourage us to increase property by economic use (traffic and trade) recalling Christ's parable of Talents (Matt 25: 14–30), where the servants who had increased their master's wealth were promoted and the servant who hoarded was cast into darkness' (1934, p. 54). This verse should form the ethical and moral foundations of the economic policy of an Islamic state as it combines the basic sources of prosperity, namely property, thrift and exchange.

2.2.2. ACCEPTANCE OF INEQUALITY AS A DIVINE SCHEME

The Quran enjoins its followers to accept socio-economic inequality as a part of the divine scheme. Thus, inequality in its own right may not be construed as tantamount to an injustice. The Quran is explicit on this point in several places, for instance:

> It is we who deal out to them their livelihood in this world, exalting some in rank above others, so that one may take the other into his service. (43:32)

Commenting on this verse, Abdullah Yusuf Ali writes, 'In his wisdom, God allows some to grow in power or riches, and command work for others, and various relative gradations are established' (1934, p. 347). It shows that in terms of socio-economic status, Islam not only condones inequality but attributes it to a divine scheme.

2.2.3. SANCTITY OF PROPERTY RIGHTS

The sanctity of private property rights is derived from extensive Quranic injunctions on inheritance and charity mentioned on a number of occasions. Although this remains an inference, a more direct verdict in favour of protection of private property can be found in the last sermon of the Prophet, which he began with these words:

> O People, just as you regard this month, this day, this city as sacred, so regard the life and property of every Muslim as a sacred trust.

2.2.4. FREE TRADE

The Prophet of Islam, himself having led the life of an active trader for 40 years, had permitted trade even with the enemy. In a state document issued during the time of the Prophet, the Prophet issued a writ of protection from 'God and Muhammad' in favour of Yuhannah ibn R'bah and the people of Ailah for trade via sea and land. It should be noted that before that writ was issued, the said tribes and their lands had been subdued and annexed by the Prophet (Yusuf 1990).

2.2.5. PRICE CONTROL

The issue of tas'ir (price control by the state) has exercised Islamic jurists for centuries. The Quran is silent on it, and we are therefore left with hadith

— the traditions of the Prophet Muhammad — as a benchmark for understanding religious notions about price control within the Islamic framework. According to a tradition of the Prophet, tas'ir is forbidden, as it is an injustice and as prices are determined by God. Various hadith convey the same meaning and message and are recorded in all leading compilations of ahadith except Sahih Bukhari. According to a hadith:

> At the time of the Messenger of God, the market price rose in Medina. The people said, 'O Messenger of God, fix the price'. He replied, 'God is the taker and the disposer, the provider, and the controller of prices. I hope that when I meet Him none of you will have a claim against me for an injury concerning life and property'. (Al-Tirmidhi on the authority of Anas ibn Malik)

There is a general consensus among the four leading schools of thought in the fiqh of the sunni Islamic tradition to the effect that price control is proscribed in Islam, although some interpretations have sanctioned intervention in order to protect consumers. The shi'a tradition also legitimizes the prohibition on state intervention in price setting, although the hadith narrated in shi'a literature is different. Accordingly, when the price of goods fluctuated considerably, the Prophet was requested to set a price. The Prophet reportedly said:

> I will not set such a precedent, let the people carry on with their activities and benefit mutually; if, however, you wish to give them advice, that will not be objectionable. (Va'ezzadeh Khorasani, quoted in Nomani and Rahnema 1994, p. 58)

Islamic jurists had clearly understood the consequences of price control. Imam Shamsuddeen Ibn Qudamah al-Maqdidi (d. 1304), a Hanbali jurist, argued against any kind of state intervention in the market. He wrote:

> In a way the control of price may give rise to price rise. The traders from outside will not bring their goods in a place where they would be forced to sell them at a price against their wish. The local traders would hide the goods instead of selling. People would have less than their need, so they would offer a higher price to obtain the goods. Both parties (sellers and buyers) would lose; the sellers because they were prevented from selling their goods, and the buyers because there were prevented from fulfilling their needs. So this act will be termed as forbidden. (Ibn Qudamah, quoted in Bashar 1997, p. 32)

Ibn Qudamah clearly understood two harmful effects of price control: the emergence of black markets and unsatisfied consumer needs. Thus, for this school consideration of the needs of both sellers and buyers shows that price control reduces welfare.

2.2.6. PROFIT AND WEALTH CREATION

A market price always contains a profit margin for the seller; and it is an established tenet of commerce that higher risk entails higher profit. What constitutes profit? A very comprehensive hadith identifies the crux of profit in these terms:

> Profit earned depends on the degree of risk assumed. (Sunan Abi Dawood, quoted by Usmani 2010; author's translation)

This implies that Islamic law does not define any quantitative upper limit on the degree of profit to be earned but ties it to the degree of risk assumed. Of course in a competitive economy any trader taking extraordinary profits in commodity markets would soon find new suppliers offering the same goods at a lower price.

2.2.7. MUHTASIB: CONSUMER PROTECTION AND ENFORCEMENT OF CONTRACTS

The early Islamic state saw the appointment of an officer, muhtasib, or the organisation of hisba (business accountability), in the city markets, largely for the purpose of inspection and regulation. The first muhtasib in Islamic history was Umar, one of the most trusted companions of the Prophet and the second caliph of Islam, who was appointed by the Prophet himself. Essentially the Prophet delegated the tasks of visiting the markets for the purpose of inspection and weight measurements to Umar. However, as established, price fixing was beyond the jurisdiction of the muhtasib (Dost 2009). Later, another noted Islamic scholar, Al-Mawardi, elaborated the duties of the muhtasib. For him, the market supervisor (muhtasib) is simply a coordinator of marketplace on the principles of 'enjoining the right and forbidding the wrong'. His functions pertaining to the economic

realm included inspecting measures, the quality of products and the integrity of contracts in the market (Dost 2009). His other duties included dealing with 'market rigidities such as bay al-gharar (speculative sales), najsh, price discrimination, monopolistic practices, collusion, dumping, hoarding of necessities and others' (Oran 2010, p. 134). A muhtasib was authorised to give advice, issue reprimands, obstruct by force, threaten, imprison or even expel individuals from the market.

2.2.8. ECONOMIC FREEDOM AND THE CONCEPT OF WELFARE IN ISLAM

The foregoing discussion establishes that Islam ordains an environment of economic freedom with minimum state intervention. In principle, economic freedom is guaranteed and there is a strong rationale for believing that it is the economic freedom of both buyers and sellers that constitutes the central pillar of Islamic economic policy. The natural question that arises is that, if this conclusion is accepted, then what does Islam offer to the weak and the poor? How can a regime that is supposedly non-interventionist by design fulfil its obligations towards those of its citizens who are poor, excluded or marginalised?

It is argued that the welfare that forms the central concern of an Islamic state comes not from controls and distribution but from liberty, enterprise and charity. As the introduction of hisba suggests, the Islamic state ensures consumer protection from theft, fraud or coercion through both legal and moral obligations. Thus, the protective aspect of an Islamic state is essentially focused on ensuring the absence of harm rather than the provision or redistribution of goods; it is negative rather than positive.

Thus, the economic policy of shari'a can arguably be understood as a validation of the notion of negative freedom. The concepts of negative freedom and positive freedom were articulated by Isaiah Berlin (1958). Negative freedom means freedom from coercion, whereas positive freedom means freedom to act. J. S. Mill (1859) and F. A. Hayek (1960) advocated negative freedom as a principle of public policy. It was argued that if the state could protect its citizens from coercion in any form, and from any party, it almost guaranteed their welfare without directly providing for it.

There is no doubt that Islam calls for compassion towards others, but this call is essentially moral and voluntary in nature; otherwise, the example of mu'akhat set by the Prophet and his worthy companions upon hijrat, wherein the Muslims of Medina shared and gave up half of their property to their brethren migrating from Mecca, would have been codified into a law. This would have prescribed that any surplus property owned by a Muslim should be given to a needy brother or neighbour. But this brotherhood remains voluntary in nature and is not legally enforceable. The forcible appropriation of property is by general consensus regarded an injustice, a zulm. So the notion of forced redistribution seems alien to Islamic law and the spirit of its injunctions.

In summary, the institutional proscription of price control and the ensuring of consumer protection at the same time constitute the two most important elements of the Islamic market. It may be inferred that the letter of shari'a calls for economic freedom but its attendant systems of consumer protection and free and fair competition provide the foundation of social justice. Seen this way, Islam provides its followers with a firm moral foundation for economic transactions.

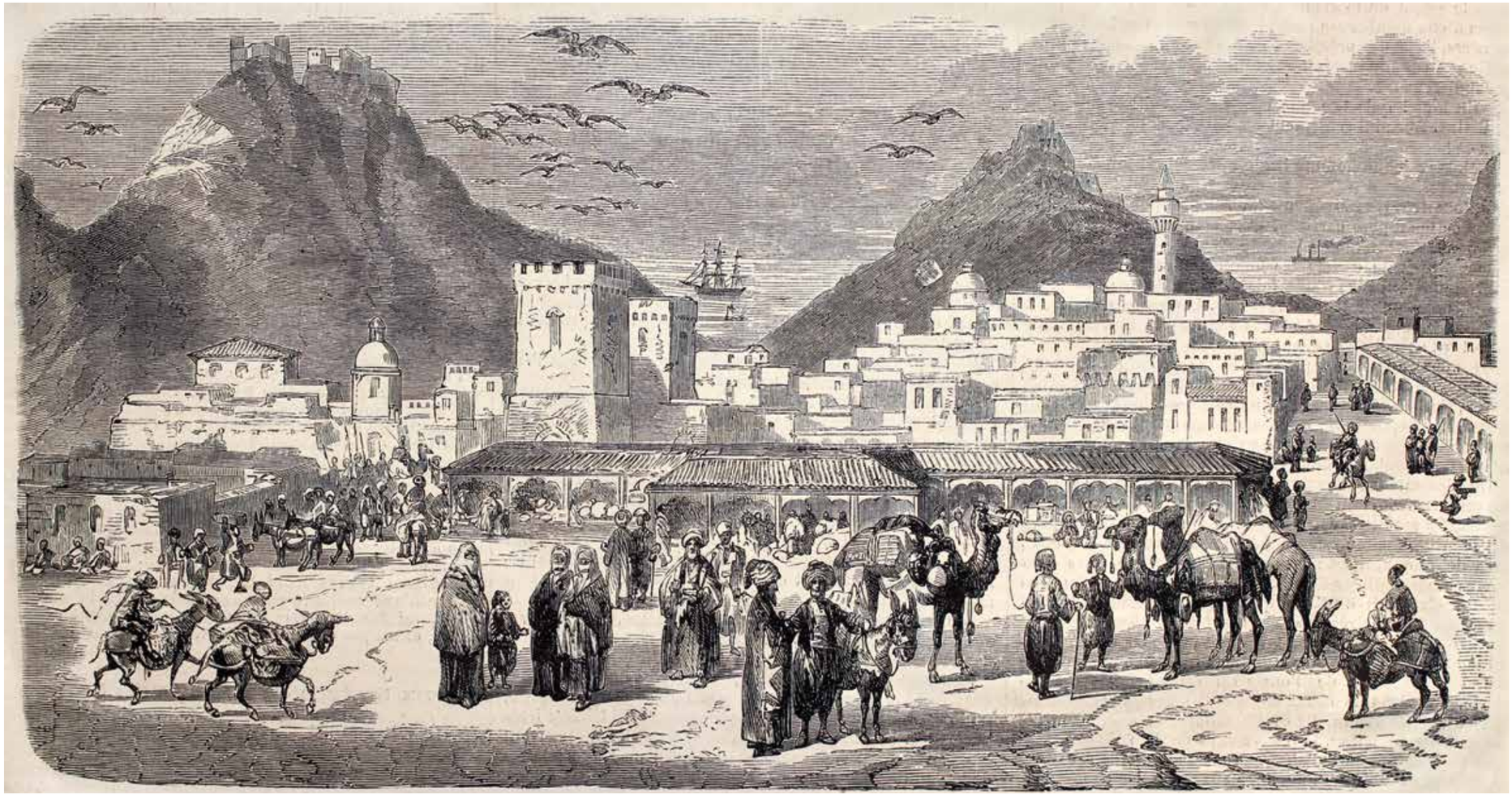
2.3. ISLAMIC ECONOMICS: SIGNPOSTS TO STATISM

This section reviews some of most important topics that are generally debated in Islamic economics. It revisits the arguments of certain leading Islamic economists of the 20th century, such as Nejatullah Siddiqi, Syed Nawab Haider Naqvi, M. A. Mannan and Umer Chapra. It raises the fundamental question of whether an Islamic economy is plan-based or market-based. It also discusses some of the important methodological assumptions of Islamic economics, such as 'Islamic man'.

2.3.1. IS AN ISLAMIC ECONOMY PLAN-BASED OR MARKET-BASED?

In an in-depth and comprehensive review of various strands of Islamic economics, Nomani and Rahnema (1994) have analysed all the major tenets of Islamic economics. They argue that the primary sources of shari'a – the Quran and hadith – legitimise the concepts of a free-market economy, whereas the secondary sources, and in particular those developed in recent decades, legitimise a planned economy. In fact, Nomani and Rahnema (1994, p. 55) concede that:

> An economic system built on the strict letter of the [Islamic] law would resemble a perfectly competitive market system. This will be called the 'Islamic market mechanism'. An economic system rigidly built on the equitable spirit of the law would resemble an egalitarian system



> in which the plan would have to become the coordinating mechanism of the economy. This will be called the 'Islamic plan mechanism'.

The authors cite leading jurists and scholars in support of this seemingly self-contradictory and incoherent finding. However, in the final analysis they seem to incline towards a planned economy by stressing the secondary sources. This is evident in their solution, which they call the 'Islamic plan-then-market mechanism' (1994, p. 55). Thus, it is likely that, despite the unambiguously libertarian principles of Islamic economics, the authors have been influenced by modern historical and intellectual developments resulting in socialist and statist philosophies.

Nomani and Rahnema (1994) also believe that the primary aim of an Islamic government is to meet the basic needs of the poor. However, a contrasting 'aim' is found in Islam's traditions and medieval understanding: 'Easing production and distribution of commodities is the most important objective of exchange in the shari'a' (Ibn-e Ashur, quoted in Bashar 1997, p. 40).

Nomani and Rahnema (1994, p. 65) hold that, once a state has achieved the goal of tending to the poor, it can afford the luxury of adopting a free market: 'According to the plan-then-market coordinating mechanism, during the post-need-fulfilment phase, having established social justice, the Islamic economy can then go back to the letter of the law by adopting the Islamic market allocation, distribution and reward.' Thus they call for a planned transition from the state to the market-based system. However, they seem unaware that once the genie of planning is out of the bottle, it becomes impossible to limit it to any specific time or scope. This genie grows mechanically over time in the form of state bureaucracy, and by the force of its own inertia, it tries to envelop everything. Those Islamic economists advocating social coordination in the name of social justice seem unable to understand how bureaucracy permeates the very fabric of human life and perpetuates rent-seeking.

M. A. Mannan, a pioneer of Islamic economics, captured the gist of his discipline thus: 'In an Islamic economy, the heart of the problem lies not in the prices offered by the market, but in the existing level of inequality of income' (Mannan 1984, p. 140). This passage aptly reflects the tension between economic freedom (price) and social justice (inequality). Islamic economics has concerned itself with the causes of poverty rather than the causes of prosperity. It discusses wealth redistribution more enthusiastically than wealth creation, which suggests that modern Islamic economists understand shari'a to sanction a plan-based economy and to focus on reducing income equalities.

Consider, for instance, Syed Nawab Haider Naqvi (2003, p. 15), another towering figure of the discipline who has argued in favour of forced redistribution of wealth, claiming such a policy Islamic. He writes that:

> "For Islamic moral values to become a source of social binding, Muslim societies must be re-organized on the basis of human freedom, social justice and a commitment to help the poor and the needy by restoring to them from the wealth of the rich what is morally and legally theirs as a matter of right.

Naqvi is not alone in conflating moral injunctions of charity with the legal principles. In fact, he led an important official commission set up at the advent of the Islamisation of the economy in Pakistan. To cite another example of this conflation, it is instructive to see how this commission defined the private property from a so-called Islamic perspective. The commission, following in the footsteps of most Islamic economists, developed the argument that in Islam, 'all wealth belongs to Allah' and 'man is only a trustee of whatever he has and not its owner' (Naqvi et al. 1980, p. 3). This argument has been used consistently to negate the central tenet of private property. However, it should be obvious that as owners we take all the decisions to acquire or dispose of property, but we always undertake it under a law — whether secular or divine. We do not ask the lawgivers to complete such transactions on our behalf. The same commission even suggested the introduction of an inheritance tax of up to 30% for non-family heirs over and above the explicit Quranic code of distribution of inheritance among legal family heirs. Isn't the suggestion of this tax to include non-family heirs a case of playing God?

2.3.2. CAN THE MARKET BE HELD ACCOUNTABLE FOR DISTRIBUTIVE JUSTICE?

Mainstream Islamic economists treat distributive justice as a touchstone of economic policy. Like socialists, these economists would hold the market responsible for poverty and inequality. They view private ownership as exploitative. They confound the moral injunctions of the Prophet with canonical law. For example, in expounding his theory of social justice, Ahmad Hassan (1971) relies on Imam Ghazali (d. 1111), a leading Muslim jurist of the medieval era. According to Hassan, Al-Ghazali defined five fundamental human rights, namely, rights to the protection of religion, of life, of reason, of posterity and of property. This list clearly calls for an essentially protective, not a distributive, policy on part of the state. Imam Ghazali advocated the notion of 'negative freedom'. But this point is lost on our friends. Indeed, Hassan (1971, p. 212) so distorts Al-Ghazali's reasoning as to argue that 'the Quran insists on providing the basic necessities of life to all the members of the Muslim society'. As a matter of record, the Quranic text contains no such injunction. Sadly, some Islamic economists do not even spare the Quran in trying to bolster their arguments.

While Hassan may be regarded as an extreme example of an Islamic socialist, writing in the heyday of communism, the role of justice in economic policy confuses even those scholars who have otherwise established freedom of trade as an 'over-riding factor of the shari'a's price control rulings' (Kamali 1994, p. 26). Consider this passage by the same author.

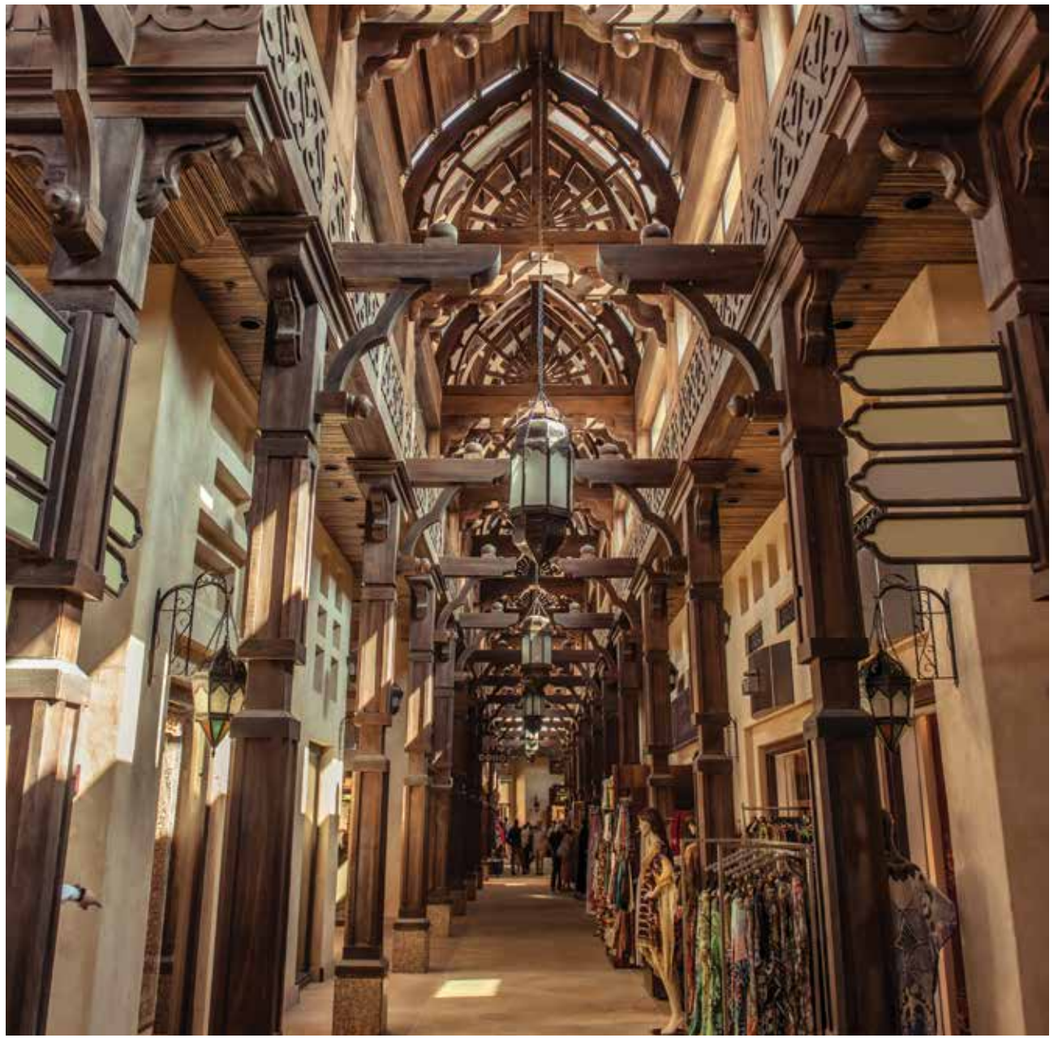
> "Justice is the cardinal duty, indeed the raison d'être, of the [Islamic] government not only in its retributive sense of adjudicating grievances but also in the sense of distributive justice, of establishing equilibrium of benefits and advantages in the community. (Kamali 2008, p. 7; emphasis added).

Kamali's distributive justice is a far cry from retributive justice, and a far cry from the essence of Islam's message on economic rewards. How can a system guaranteeing freedom of trade ensure an 'equilibrium of benefits and advantages'? Freedom ought to result in unequal benefits, and as we know, inequality is a permissible, even desired, state in an Islamic economy. The essence of justice is freedom, not equality. This relationship between liberty and justice was best established by Ibn-e Khaldun, the best-known medieval Islamic scholar for founding sociology and for his masterpiece, Muqadimmah. He wrote, 'Whoever takes someone's property, or uses him for forced labour, or presses an unjustified claim upon him, it should be known that this is what the Lawgiver had in mind when He forbade injustice'. The Islamic economist Muhammad Abdul Mannan writes: 'Market prices may not enable all the potential consumers and producers to enter into the market' (Mannan 1984, p. 136). He is right about this, but in fact prices function as means of expression of preference. Like most Islamic economists, Mannan also confuses the concept of freedom with the concept of ability. Freedom is essentially determined by the absence of coercion, particularly coercion from lawful authority, but also coercion from other humans. If a person lacks the ability, or the favourable circumstances, to enter a market, then this is not due to coercion. Just as Ibn-e Khaldun elaborated, the spirit of justice is the absence of coercion.

Not all Islamic economists have expressed reservations about the institution of the market. But it is noteworthy that those who favour the market come from non-economic backgrounds. Consider these foundations of the Islamic economy elaborated by S.M. Yusuf, a professor of Arabic: **(a)** no corner market (that is, no hoarding); **(b)** no hoarding of gold and silver; **(c)** no price controls; **(d)** no restrictions on trade; and **(e)** the maintenance of the gold standard (Yusuf 1990, p. 40). Note that Yusuf's understanding of an Islamic economy is 'negative' in character, a spirit much closer to the original, least restrictive attitude towards the market.

2.3.3. THE MORAL ENGINEERING OF THE INDIVIDUAL: THE PREDICAMENT OF ISLAMIC ECONOMICS

Muhammad Nejatullah Siddiqi is one of the most important authorities on Islamic economics in the modern age. For him, Islamic economics questions some of the fundamental assumptions of modern economic theory, for instance about human behaviour that is understood as equivalent to self-interest. According to Siddiqi (2001), Islamic economics would be built on the transformation of individual behaviour. Human behaviour has emerged as a favourite topic of discussion among Islamic economists. They rightly know that without the transformation of the individual into an Islamic man free of selfishness, the dream of an Islamic economy living up to its own ideals will not materialise. In other words, Islamists envisage nothing short of social engineering to purge impure human beings of their illicit desires. For instance, another popular Islamic economist, M. Umer Chapra, recognises the efficiency of the market strategy but



believes that human beings need to be reformed (Chapra 1993, p. 127). However, in this presumptuous approach towards the individual lies a possible predicament for Islamic economists: how to change human nature first? Thus, Islamic economists build the foundations of Islamic economics on the assumption of specific human conduct instead of certain methodologies and principles.

2.4. CONCLUSION

The foregoing analysis has sought to show that while shari'a calls for the establishment of an order of economic freedom based on mutual consent and stringent consumer protection measures, the modern discipline of Islamic economics seems to have drifted in the opposite direction. With few exceptions, mainstream Islamic economics prefers to discuss poverty instead of wealth creation, income differences rather than prices, and the role of the state rather than the role of the market. Notably Islamic economics is built on the assumption of an imaginary 'Islamic man' who responds to different incentives from those that motivate ordinary human beings. This approach has essentially developed an intellectual framework that provides a spiritual justification of both market-based and plan-based economies without necessarily taking a clear position on principles, methodology and legal framework. However, the general tone of modern Islamic economics remains statist and redistributive. The discipline of Islamic economics that originated in the 20th century exhibits strong distributive and socialist tendencies in its epistemological assumptions and policy prescriptions. Thus, Islamic economics has shown intellectual leanings towards social justice as a touchstone of economic policy. This has influenced Muslim public opinion and encouraged the largely unelected rulers of Muslim countries to follow predominantly statist, redistributive and even socialist economic policies.

On the other hand, the tradition of Islamic jurisprudence, and in particular its rulings on economic policy, has endorsed a market-friendly, liberal and limited-government philosophy, though subtle and important differences remain between various schools of thought. If the jurists generally stood for economic freedom, why have redistributive tendencies crept into the work of modern Islamic economists?

The classical jurists of Islam are separated from their modern counterparts by the sharp historical wedge that is known as colonialism. The rise of Islamic economics, against the backdrop of a resurgence of the Islamisation of knowledge, is essentially a 20th century phenomenon that invites comparison with the gaining of independence on the part of a majority of Muslim countries or their defeat at the hands of Western powers. That has led to the creation of novelties like Islamic socialism or Islamic capitalism, whereas the economic exegesis of the medieval Muslim jurists is free from any such epistemological apologies.

The original spirit of Islamic economic policy as expounded in shari'a was protective, non-interventionist and non-redistributive in character. It looked on market participants and especially traders as benign 'trustees of God on earth', and prescribed legal restrictions on the state, discouraging its intervention in markets. The conclusion of this article is that Islamic law, as demonstrated in both revealed knowledge and human exegesis, has endorsed a market-friendly, liberal and limited-government philosophy, which we may characterise as libertarian.

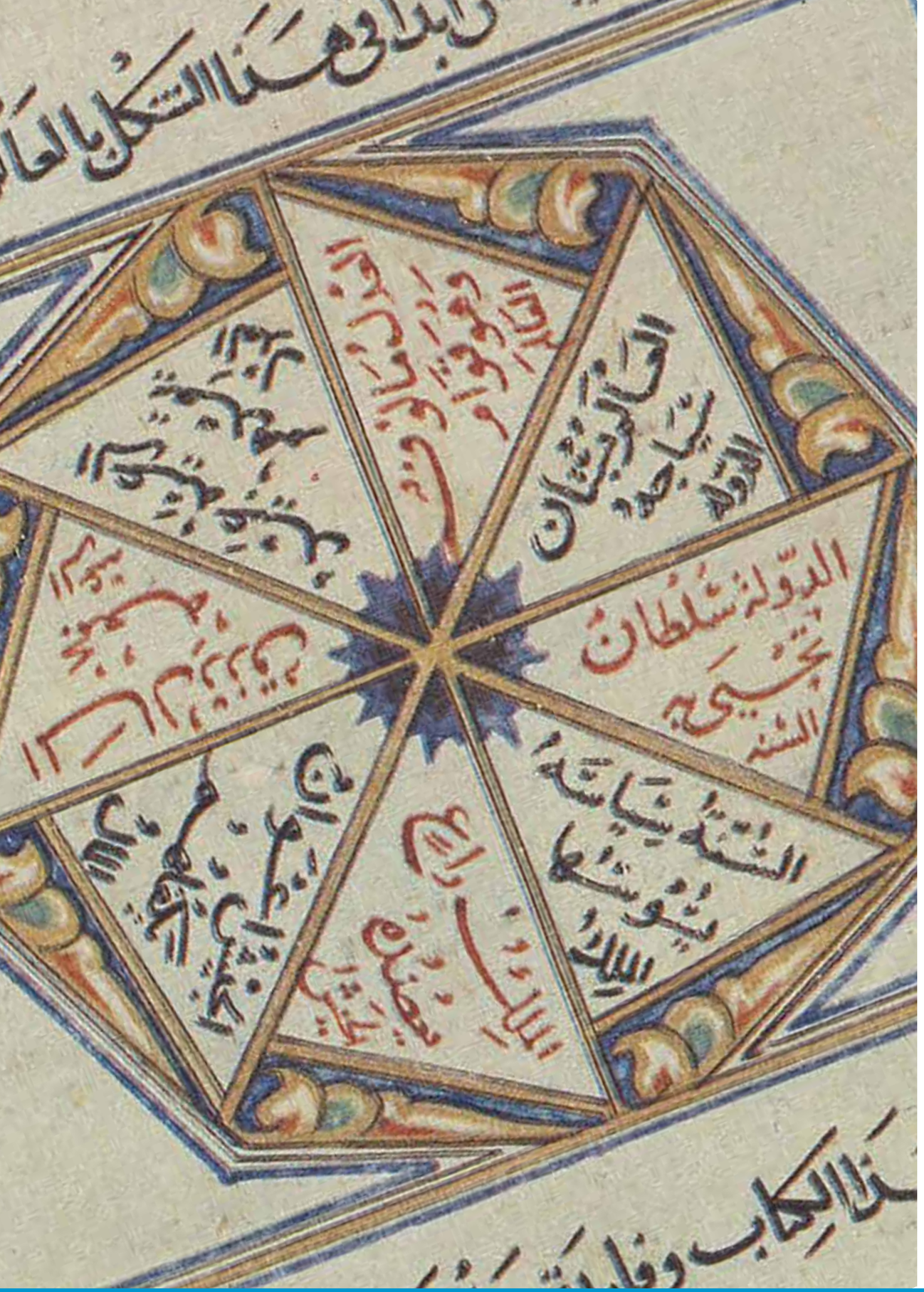
Islam was introduced by a Prophet, who led an active life as a merchant for 40 long years and who is reported to have said: 'Welfare and blessedness is composed of ten parts, nine-tenths of which is attained through trade.' This is possible only if the economy is organised on enterprise-centric rather than state-centric lines. The letter of shari'a guarantees economic freedom, and its spirit enjoins social justice. The spirit of welfare, which Islam propagates, is based on the degree of choice and freedom that individuals enjoy, and is dependent on the absence of coercion. Welfare does not come from a big state; it comes from prosperous and responsible individuals who imbibe the notion of mutual goodwill and charity towards others.

The Quran makes it categorically clear that what an individual receives flows either from his own efforts or from God's bounty, a favour he does not necessarily deserve. The Quran says 'Man can have nothing but that he strives for' (53:39). And on many occasions it mentions the Lord's bounty as a favour from Him. For instance, it says, 'Allah may reward them [according to] the best of what they did and increase them from His bounty. And Allah gives provision to whom He wills without account' (24:38). A hadith says that our faith swings like a pendulum between fear and hope; likewise, our sustenance, our economic achievements, oscillate between our effort and our luck. For intellectual convenience, this comes very close to a Misesian understanding of human effort and human design.

Let me finish this article with a sober reminder from Bastiat, who began his treatise The Law, first published in 1850, by treating human life – physical, intellectual and moral – as the sole gift from God, whose preservation, development and perfection is our responsibility.

> God has given to men all that is necessary for them to accomplish their destinies. He has provided a social form as well as a human form. And these social organs of persons are so constituted that they will develop themselves harmoniously in the clean air of liberty. Away, then, with quacks and organizers! Away with their artificial systems! Away with the whims of governmental administrators, their socialized projects, their centralization, their tariffs, their government schools, their state religions, their free credit, their bank monopolies, their regulations, their restrictions, their equalization by taxation, and their pious moralizations!... And now that the legislators and do-gooders have so futilely inflicted so many systems upon society, may they finally end where they should have begun: May they reject all systems, and try liberty; for liberty is an acknowledgement of faith in God and His works. (Bastiat 2007, p. 58)

Such is the design of the Mighty One, the all-knowing. •



3

ISLAM AND CLASSICAL LIBERALISM: ARE THEY COMPATIBLE?

by Mustafa Akyol

At first glance, classical liberalism and Islam may seem not just incompatible, but in complete opposition.

Classical liberalism is a political philosophy that aims at maximizing individual freedom. Islam, on the other hand, is a religion that stresses 'submission' and 'obedience'.

Moreover, today's predominantly Muslim societies are not beacons of liberty — to put it lightly. The Muslim world is full of dictatorships, some of which — such as Iran or Saudi Arabia — justify themselves with references to Islam. According to Freedom House, a Washington-based think tank that measures freedom in the world, among the nearly 50 Muslim-majority states on the globe, only one, Tunisia, ranks as free.

All this has led some classical liberals and libertarians to consider Islam as an enemy of liberty — in fact, the biggest threat to liberty in the 21st century. In my view, however, they are making a mistake. They are looking at the most rigid, bigoted, and aggressive manifestations of contemporary Islam and then judging a whole religion accordingly.

With the same logic, one could have had a very negative view of Christianity a thousand years ago by looking at its most rigid, bigoted, and aggressive manifestations — such as the Inquisition that tortured and killed 'heretics', or the crusaders who slaughtered 'infidels'. The same Christianity, however, also gave us thinkers like John Locke and Adam Smith who saw liberty as a divine gift. Islam is a similarly diverse religion, and while its own Dark Age is at its zenith now, Islam also has classical liberal interpretations that give hope for the future.

3.1 THE BASICS

Just like Judaism and Christianity, Islam is an Abrahamic religion. It is based on the belief that the whole universe is created and sustained by an all-powerful, all-knowing God who guides humanity through prophets and revelations. Islam, in fact, honors the preexisting monotheistic religions, claiming that it completed them with the final revelation given to the Prophet Muhammad, which is the Qur'an.

The Qur'an — just like the Bible — has various commandments that interfere in human lives: Do not worship idols. Do not eat pork. Do not consume intoxicants. Do not have extramarital sex. Do not eat or drink during the day throughout the holy month of Ramadan. And so on. Are these commandments, by definition, encroachments on human liberty?

The answer depends on whether these commandments are moral or legal. In other words, is refraining from intoxicants — alcohol, drugs — a moral commandment that the individual Muslim may (or may not) decide to follow? Or it is a legal dictum that will be imposed on every individual?

If Islamic commandments are moral categories, then there is no clash with classical liberalism. Just like observant Jews in Western society who only eat kosher foods or who rest on the Sabbath, Muslims can freely chose to be observant. Conservative Muslim women can freely choose to cover their heads, for example, and that would be the way they experience liberty.

However, if Islamic commandments are legal categories, then the Qur'an seemingly justifies states like Saudi Arabia or Iran, which impose their vision of an 'Islamic way of life' by law. They force women to cover their heads and punish people for engaging in 'immoral behavior', or spreading 'false religions'. These states also criminalize acts they view as apostasy or blasphemy, leading to dramatic violations of freedom of religion and freedom of speech.

The key issue, therefore, is whether Islam is a religion to be voluntarily followed by individuals and communities in a free society, or a legal system to be imposed by a theocratic state.

3.2 'NO COMPULSION IN RELIGION'

On this key issue, I must confess that the classical mainstream interpretations of Islam tend toward theocracy. Since the very beginning of Islam, Muslims had political power, and divine commandments evolved into earthly law broadly called the Sharia.

In that classical age of Islam — say, from the 7th century to the 19th century — there was at least one gain in terms of liberty: Muslim states did not have a single law of the land. They rather had multiple legal systems to which individuals would be subject based on their religion. In the Ottoman Empire, for example, the Sharia was binding on Muslims, whereas Christians and Jews had their own laws. While alcohol was forbidden to Muslims, it was allowed for Christians.

In the modern era, theocratic states such as Saudi Arabia have taken a much worse step by making the Sharia the law of the land. That is how Islamic commandments became binding on non-Muslims as well. Thus, Christians visiting Saudi Arabia from abroad may not drink or even possess alcohol — or, alas, even a copy of the Bible — for example, and are subject to imprisonment for violating the law.

Yet in the same modern era, there have also emerged reformist Muslims who call for revisiting this whole idea of state religion. These reformists — my humble self being among them — argue that the marriage of Islam and the state is just an accident of history, not a requirement of religion.

They emphasize a key Qur'anic verse, 'Let there be no compulsion in religion' (2:258), and argue that the Sharia must be reinterpreted in light of this principle. Compulsion, they add, breeds not genuine religiosity but only hypocrisy. Jihad, they argue, is only a justification for defensive and just war, not a warrant for aggression and conquest.

This reformist argument makes sense to many Muslims around the world and is promoted by plenty of scholars, intellectuals, movements, and parties. (Tunisia's recent success was made possible partly because its main pro-Islamic party, En-Nahda, is led by Rashid Ghannouchi — a prominent Islamic scholar who takes the 'no compulsion in religion' principle seriously.)

3.2 THE LIMITED MUSLIM STATE

While Muslim reformists argue against certain aspects of the Islamic tradition, they embrace other aspects of it. One of them is a little-noticed but crucial feature of the Sharia: It was not a law devised by state power. It was rather a law devised by religious scholars who were often independent of state power.

That is why and how, throughout the long centuries of classical Islam, the Sharia often acted as a constraint on arbitrary rule and became the guardian of rights. (It is not an accident that in Arabic, the term 'law' translates as huquq, which literally means 'rights'.) The rights that the Sharia protected included property rights. This protection was crucial at time when despotic states could typically plunder wealth at will.

In a tell-tale episode, when Alaud-din Khilji, a fourteenth-century Muslim ruler in India, wanted to overtax his wealthy Hindu subjects, he was dissuaded by his top scholar because doing so would violate the property rights recognized by Islam. 'Whenever I want to consolidate my rule', Khilji complained, 'someone tells me that this is against the Sharia'.

To further consolidate the protection of private property, medieval Islamic scholars developed a version of the legal doctrine of trusts. This allowed the transmission of wealth across generations through the creation of the charitable foundation, the waqf, which was legally immune from governmental interference. The result was a vigorous civil society, including charities, hospitals, and schools, all supported by the private foundations that were under the Sharia's protection.

The medieval Muslim state, in other words, was a state limited by law. Thanks to the sanctity and independence of the Sharia, a form of checks and balances was established that allowed nonstate institutions to flourish. If there was a big secret to Islam's much-praised golden age, it was this notion of a limited state.

Today, what are we supposed to understand from this whole legacy of the Sharia? A good answer comes from a theory developed by a 14th-century Islamic scholar named Imam Shatibi. He studied all injunctions of the Sharia and reasoned that the 'intentions' behind all of them could be rendered to the protection of five values: religion, life, property, intellect, and lineage. Reformist Muslims often take these 'five intentions' of the Sharia as the guiding light and argue that any state that protects them — and is constrained by them — is welcome regardless of whether it is 'Islamic' or not.

3.3 ISLAMIC CAPITALISM

There is one more area to consider: the economy. What kind of economy does Islam envision? Answers among Muslims vary, as there are defenders of so-called 'Islamic socialism'. Others, however, argue that if there is a specific Islamic model of the economy, it is certainly capitalism.

This argument for capitalism is partly rooted in the life of the Prophet Muhammad. Before the beginning of his religious mission at the age of 40 in the city of Mecca, he was a successful merchant. This meant that he saw the blessings of trade and understood the mechanisms of the market. No wonder he has many recorded sayings in which he promotes trade and praises the "honest merchant."

The same spirit can be found in the Qur'an. It is quite notable that the longest verse of the Qur'an (2:282) is about how to write a proper loan contract with the right witnesses.

In a remarkable episode in Prophet Muhammad's life, we also read that he was asked by his faithful believers to regulate the increasing prices in the marketplace. He responded negatively, saying: 'Only God controls the prices'. Some later commentators have seen a spirit here similar to Adam Smith's invisible hand.

The protrade spirit of Islam's prophet and scripture led to the rise of a financial and commercial capitalism in the Middle East in the early centuries of Islam. Some inventions of this 'Islamic capitalism' were later borrowed by Europeans. (That is why, for example, the English word 'check' comes from the Arabic word saqq, which means 'written document'.)

In his remarkable book *Early Islam and the Birth of Capitalism*, economist Benedikt Koehler documents all these economic achievements of Islam. 'The roots of Chicago economics', he even argues, 'lie in seventh century Medina'.

The decline of this medieval Islamic capitalism — due to many factors, including wars, invasions, and the change in trade routes — led to the overall decline of Muslim civilization. The Muslim world stagnated, lagged behind, and ultimately panicked in the face of a much more advanced West. It is a trauma that is still alive and kicking. And the solution lies in revitalizing the capitalist creativity of Islam's golden age.

3.4 MUSLIM LIBERALS

None of this means that classical liberalism is a popular idea among Muslims today. Quite the contrary — there are very powerful illiberal, statist, autocratic trends among Muslims, not to mention the violent extremists that threaten us all.

But a defense of classical liberalism on Islamic grounds is possible — and is not unheard of. Many Muslims, especially those living in the West, accept classical liberal ideas intuitively. Moreover, there are initiatives dedicated to this cause, such the Minaret of Freedom and Muslims for Liberty in the United States, the Islamic Renaissance Front in Malaysia, and the Liberal Islam Network in Indonesia. They are led by Muslims who are serious about their faith and who are genuine in their commitment to liberty.

Such pious Muslims can usher a reform in Islam toward 'no compulsion in religion' and freedom for all. This concept of freedom is not something that will be poised against God. Quite the contrary: it is a freedom that is bestowed by God. •

4

ISLAM, CAPITALISM AND DEMOCRACY

by Dr Guy Sorman

Of all the great religions, Islam is the only one that is not a priori hostile to enterprise, to commerce or to the profit motive. According to the Quran, Mohammed married Khadija, who belonged to a great trading family of Mecca, and both Mohammed and Khadija actively participated in the organisation of caravans, the equivalent of today's international trade. After Mohammed was revealed as Prophet, at no time did he deny his entrepreneurial past; on the contrary, to attain riches by trade is seen in the Quran as a blessing, on the condition that the wealthy give back to the community a voluntary tax called the zakat, an early form of solidarity and philanthropy administered by religious foundations.

In this Islam directly opposes Christian revelation and Christ's exaltation of poverty. On the basis of these religious premises, should not popular capitalism logically have been born in the Arab and Muslim world? The fact is it was born there. In the West, when we consider the origins of the Muslim world, we think of the Arabs mainly as conquering warriors, which they were as well, beginning with Mohammed. But their Empire had barely been constituted, from India to Spain, when Muslims simultaneously created the first form of economic globalisation, as the organisers and masters of trade relations between China and Europe. This commercial empire was not the work of the caliphate, but the product of the labor of individual entrepreneurs.

This first globalisation, which lasted about four centuries, was interrupted by the military counter-offensive of the Christian kingdoms. Beginning in the 12th century, Muslims ceased to dominate international trade because communication had become dangerous and because other entrepreneurs, based in Genoa in particular, surpassed the entrepreneurial spirit of the Arabic Muslims. The Genoans had invented the joint stock company, which allowed them to expand their financial resources and to undertake great capitalist adventures, while the Arabic Muslims, giving priority to blood ties and tribal allegiances, condemned themselves to remaining modest entrepreneurs.

The Muslim world's relatively slow economic growth, which then facilitated Western colonisation, is thus not intrinsic to Islam but rooted in pre-Islamic tribal culture. To escape from poverty, it makes sense in our day for Muslims to return to the spirit of enterprise of their origins and to overcome their tribal affiliations. And this is possible; for it to happen it is necessary to replace the tribe by the rule of law and to allow Muslim peoples to engage in enterprise without excessive restraints. There is no shortage of examples to support our hypothesis. In Turkey, when the AKP (Justice and Development) party came to power, it brought back the popular spirit of enterprise that till then had been crushed by socialist-leaning governments, under which only the state and the political clients of the government, who kept the rents and the monopolies for themselves, were able to pursue profits. As soon as this socialism of cronies and rascals was dismantled, a true capitalism of the people burst forth, particularly in Anatolia, the most conservative and Muslim region of Turkey. These new entrepreneurs, who came to be known as the Tigers of Anatolia, today constitute the engine of Turkish growth and omnipresent in the global economy, in competition with the Tigers of Asia. The inverse demonstration is found in Egypt, where the state and its bureaucracy continue to crush the spirit of enterprise of ordinary Egyptians. An investigation by the economist Hernando De Soto showed that, in order to open a simple bakery in Cairo, about six years of administrative procedures were necessary, as corruption impeded approval at every stage in the process. It will not make sense to speak of an Arab Spring until it is possible, without obstacles, to open a bakery in Cairo, and this is true for the whole Arab-Muslim world.

A people's capitalism is obviously the economic solution for Muslims, especially since this has its roots deep in Islam. Still, the path to this solution is a narrow one as long as this popular capitalism is caught between 'on the one hand' Muslim fundamentalists, who want to prohibit everything in the name of their personal interpretation of the Quran and 'on the other' the authoritarian tendency of rulers in areas where democracy is still fragile.

There are a thousand possible readings of the Quran, and I will here add nothing to its interpretation except to observe, as of course others have before me, that Mohammed was an entrepreneur and that, having become his people's guide, he decided nothing without consulting a popular assembly: the democratic spirit, no less than the spirit of enterprise, is very much at the heart of Islam for those who adhere to it. •

5

POPULAR CAPITALISM CAN SAVE THE ARAB WORLD

by Dr Guy Sorman

Among all major religions, Islam is the only one founded by a trader. According to the holy Quran (dictated by Allah himself to His prophet), profit is good as long the wealthy merchant redistributes a modest part of his acquired wealth to the poor.

No idealization of poverty can be found in Islam, which makes it a much more pro-business faith than Christianity. When at the peak of their political and cultural influence around the Mediterranean sea, Arabs dominated global commerce, benefiting from the intersection of the Silk Road and the Fertile Crescent. The reason they were supplanted by Italian merchants around the 13th century had nothing to do with their respective creed. Traders in Genoa had invented better accounting techniques and initiated business contracts through civil covenants, while economic relations in the Arab world remained confined within the family.

From the Middle Ages until the 20th century, however, trade and popular capitalism never vanished from the Arab world. Since the 1950s, independence leaders have imported anti-capitalist concepts, such as central planning and state ownership, into the Arab Muslim world. In Egypt, all remnants of popular capitalism were destroyed by Gamal Abdel Nasser, who was president from 1956 to 1970. The Ba'ath Party in Syria and Iraq – Saddam Hussein among its leaders – acted much the same when it seized power in the region. The same happened in Turkey in the 1920s and 1930s after Mustapha Kemal, praised as the founder of modern Turkey, proved much inspired by fascist and Soviet economic models from Europe. The Turkish economic renaissance started only recently when the Justice Party rejected Kemalism and rehabilitated popular capitalism along with a religious renaissance. Anti-capitalist dictators happen to be anti-Muslim, pushing Islamic organizations into clandestine and later violent resistance.

So far, the Arabs have not been as lucky as the Turks, except for the tiny sliver of the population who happens to be sitting on huge gas and oil reserves.

Then the Arab Spring took place, in 2011, whose true origins should never be forgotten: the economic frustration of the people. The hero of the uprising was a young Tunisian student by the name of Mohamed Bouazizi, who tried to start a modest business by selling fruits and vegetables on a street cart. After he was arrested by police for not showing the right bureaucratic authorisation, Bouazizi committed suicide by setting himself on fire.

Spontaneously identifying themselves with Bouazizi, young Arabs by the millions took to the streets all over the Arab world. The revolt was most acute in Egypt where, not by coincidence, popular capitalism happened to be the most severely repressed under Hosni Mubarak. A survey by the noted Peruvian economist Hernando de Soto before the Arab Spring revealed how opening a modest bakery in Cairo required two and a half years in order to obtain all the necessary legal documents, most of them delivered by petty and corrupt state bureaucrats. The creation of a larger business which might have a chance of competing with a state monopoly proved to be forbidden in Egypt. With varying degrees, this remains the prevalent situation in all Arab countries.

The civil wars between sects and tribes in Syria, Iraq and Lebanon – or ready to explode in Algeria or Morocco – would certainly not have erupted in an environment of economic prosperity. The Islamist parties which seized power in Egypt and Tunisia, in the aftermath of the Arab Spring, proved no better than the dictators they had replaced, as they did not understand that economics was the people's priority. Facilitating popular capitalism would have been the way to go. Mohammad Morsi, for example, was dismissed by his own supporters after demonstrating his administration's incapacity to tame food inflation and spur inclusive and balanced growth.

Peace will never return to the Middle East as long the economic ambitions of the would-be entrepreneurs remain repressed. So far Turkey is the only positive, if imperfect, demonstration of what the combination of Muslim faith with local entrepreneurial spirits can achieve. Will this so called Turkish model ever emerge in the Arab world? The Arab people are torn apart between statist autocrats and radical Muslims. Moderate pro-market Muslims remain silent or crushed.

Popular capitalism is the only way out of misery and chaos. Enlightened Arabs should proclaim it, not by imitating the West or importing Western values, but by rediscovering their own faith and history. Adam Smith is not needed in the Arab world. Muhammad's life is enough of a reliable model to rekindle economic growth and opportunities for the people. •

6

CAPITALIST TRADITIONS IN EARLY ARAB-ISLAMIC CIVILIZATION

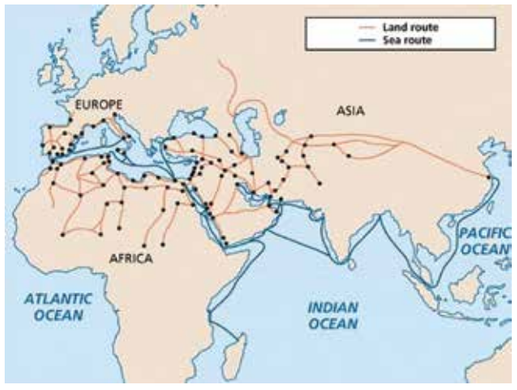
by Shaikh M Ghazanfar

In the following article, Professor S. M. Ghazanfar, a specialist in the history of economic thought in the Islamic civilisation, explores the evidence concerning the roots of historical 'capitalism' as it evolved in the early Islamic world. After delineating the geographical extent of capitalistic, commercial/business ventures in the early Islamic world, he discusses the major centres of Islamic commerce, then focuses on the nature and content of the economic activities undertaken by early Muslim entrepreneurs, and finally describes the development of financial institutions. The article concludes with the argument that, notwithstanding the relatively recent origin of the nomenclature, the capitalistic system indeed was the prevailing mode of economic activities in the early Islamic civilization.

6.1. INTRODUCTION

In his posthumous classic *A History of Economic Reasoning* (1983), the late Karl Pribram (1877-1973), while tracing the origins of European Renaissance, mentions 'two significant streams' of influence from the Arab-Islamic sources. Thus, 'one stream originated in Italian cities, which in the wake of the Crusades had established relations with the traders of the Near East and had adopted various institutions and devices which were at variance with the rigid pattern of medieval social and economic organization. The other, far more important, stream started with the body of Scholastic theologians, who derived their intellectual armory from the works of Arabian philosophers' (Pribram, 21).

Observations such as these corroborate the well-established fact that during several medieval centuries, there was a considerable transfer of diversified knowledge from Islamic civilizations to Latin-Europe. The 'intellectual armory' has been variously identified by scholars–what Harvard's late Charles Homer Haskins and others have called the 'turning point' for 12th-century Renaissance of science and philosophy (see Haskins, 282; also see Sarton, Nebelsick, Hitti and others). Thus, as a consequence of the 'shaping of European attitudes, feelings, and values' through prolonged contacts with the Islamic world, specially during the Crusade centuries, the two 'cultural advances' were: **(1)** the emergence of humanism (meaning human dignity, rationalism and reason, nature as comprehensible) and **(2)** the discovery of the 'individual' (self-discovery, self-expression, inner intention free from authority) (Ferrueolo, 137).



Land and sea trade routes in the Islamic world.

Clearly, Pribrams's two 'streams' are inseparably interdependent and mutually nurturing and reinforcing. However, some recent explorations have documented the 'intellectual armory' in the field of economic thought, originating among several medieval Arab-Islamic scholastics (see Ghazanfar, 1990, 1991, 1998 and 2003). Those explorations also provide evidence as to the prevailing market-oriented, capitalistic economic environment of the early Islamic world. The present paper intends to explore that environment further.

Specifically, we wish to explore some evidence concerning the 'various institutions and devices', mentioned only tangentially by Pribram, that evolved and flourished in the Islamic civilization for centuries but which were 'at variance with the rigid pattern of medieval [European] social and economic organization' at the time. Again as suggested by Pribram, those "institutions and devices" spread to Italy and other parts of evolving Europe over a period of several centuries, the Crusades being among the most prominent source. Through these contacts, the 'Crusaders were the strongest influence on the development of medieval trade and industry', thus promoting 'the capitalistic cycle of capital, investment, profit, and reinvestment of profit for further profit and initiated a money economy which threatened and certainly modified the old land economy of Western Europe' (Krueger, 72-23).

It is worth noting here that the purpose of this paper is not to trace the sociological or ideological roots of capitalism, originally the subject of Max Weber's controversial book. Briefly, Weber argued that capitalism emerged as part of the European Reformation that transformed individuals into 'rational capitalistic' behavior (see Weber, Robertson, Rodinson, Green, Walker, Turner, for example). It is argued by some, however, that the capitalistic 'ethos' and the related institutions evolved not as a 'religious calling' but more as a historical process which can be traced, among other things, to the 12th Renaissance of Europe. Thus, 'The great cause of the rise of rational capitalism was not Christian at all – it was a secular scientific development, taken over by Western Europeans from Muslim Arabs and Syrians' (Robertson, 45; see Haskins, Sarton, Nebelsick and others for similar perspectives). Further, Weber ('still the godfather of Eurocentric historiography', Blaut, 204) dismissed all non-Western cultures, including the Islam world, as 'non-rational'. Despite historical evidence to the contrary, he suggested that 'the ideal personality type in the religion of Islam was not the scholarly scribe, but the warrior' (Weber, 1978, 626). Indeed, the Islamic scripture endorses and encourages the sort of economic institutions and practices which are regarded as capitalistic in character, 'the free-market economy', as characterized by one scholar of Islam (Goieten, 1967).

But, what is free-market capitalism? Fundamentally, it is a system of 'a private property in which goods are bought and sold – and production is for the market with goods and services obtained from markets. In this respect, capitalistic production implies a commercial economy', in contrast to production-consumption within one household/clan or by a centralized authority (Lane, 5). There is nothing in Islamic scriptures that denies private property or condemns in principle, or hinders in practice, the development of a capitalistic exchange economy and related institutions and practices. In fact, profit-making activities are encouraged and looked upon with utmost favor, though within the Islamic moral-ethical rules of conduct (see Ghazanfar-Islahi for some details). After all, Islam's Prophet Mohammed was a businessman, as were several of his companions and successors; Caliph Umar is reported to have said, 'Death can come upon me nowhere more pleasantly than where I am engaged in business in the market, buying and selling on behalf of my family' (Rodinson, 17). Because of such emphasis on economic pursuits, some have gone so far as to characterize the Holy Quran as 'a businessman's book' (Huston Smith, 250); and it is 'a holy book in which rationality plays a big part' (Rodinson, 78).

The present paper presents some evidence as to that historical 'capitalism' as it evolved in the early Islamic world. First, the succeeding pages will provide some evidence as to the geographical extent of capitalistic, commercial/business ventures in the early Islamic world. Then, there will be some discussion as to the major centers of Islamic commerce, including a discussion of the commercial/trade links where the capitalistic traditions dominated. This will be followed by a discussion of the nature and content of the economic activities undertaken by early Muslim entrepreneurs. Then there will be some discussion of the development of financial institutions. The paper will conclude with the argument that, notwithstanding the relatively recent origin of the nomenclature, the capitalistic system indeed was the prevailing mode of economic activities in early Islamic civilisation.

Model of a 'chebec', an Arab ship famous for its speed and maneuverability. The chebec proved so useful as a fast raider, despatch boat or even merchant ship that versions of it were adopted in other countries.

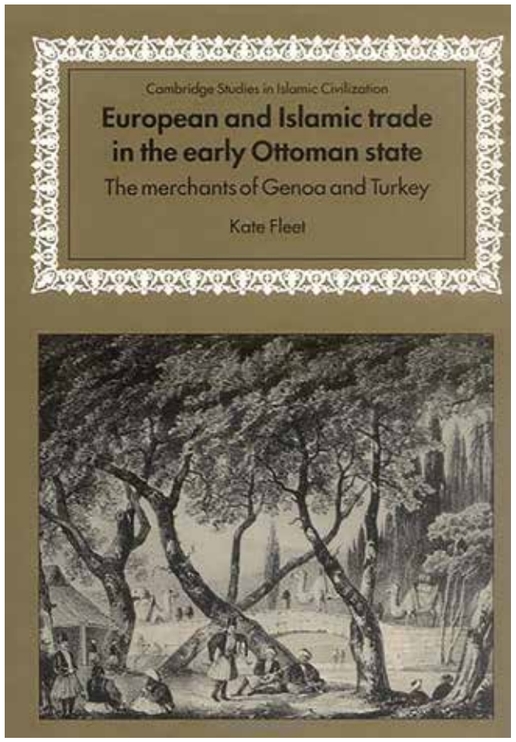
6.2. GEOGRAPHIC EXTENT OF ISLAMIC COMMERCE

As noted, Islam scripture approves and encourages economic activities as part of the Islamic sacred-secular spheres of the socio-economic system. The Muslim entrepreneur was born into an active business community. The caravan trade between the Indian Ocean and the Mediterranean Sea passed through the Arabian Peninsula ever since antiquity. The city of Mecca, where Islam originated, arose as a South Arabian settlement around a shrine and acquired significance as a commercial town and religious-spiritual pilgrimage center. The main caravans were communal undertakings in which whole tribes participated. These conditions led eventually to a familiarity with a money economy; and Byzantine and Persian coins circulated in this exchange economy. The cities of Mecca and Medina were not only the holy places of Islam, but they were also the cradle of its culture, its business and its government.

United through the new faith and favored by the decline of the world powers of the time, the Arab armies extended into neighboring lands and founded an empire which spread from western Turkestan to the Atlantic Ocean. Three quarters of the coastlands of the Mediterranean Sea, including the Islamic Al-Andalus (now Spain), now belonged to Islam. Further, the Arab expansion ended the long Roman-Persian challenge in the Middle East, and the Islamic Empire now forged economic and political links between the Mediterranean and the Indian Oceans.

Arab and Persian businessmen expanded their trade links to India, Malaya and Indonesia. Merchants of the Islamic world became indispensable middlemen because of their contact with the West – either through the Mediterranean or the Baltic – and also the Far East. Due to their global trade links, the Arabs brought sugarcane from India, cotton to Sicily and Africa, and rice to Sicily and Spain. From the Chinese, they learned how to produce silk and paper and took this knowledge (including the use of compass and numerals from India) with them into all parts of the Empire. Wherever they traveled, they activated business life, fostered an increasing exchange of goods and played an important part in the development of credit. Profits from business ventures formed an important source of income both for states and individuals.

In the early Middle Ages, the Pax Islamica was the foundation of an economic golden age in which the protagonists in commercial enterprises were Arabs, Persians, Berbers, Jews and Armenians. The traders reached from Gibraltar (Jabal Tariq in Arabic) to the Sea of China. The voyages of Europeans, in contrast, were limited to modest coastal journeys along the shores of the Adriatic and southern Italy and between the islands of the Greek Archipelago. It was centuries later that the citizens of Italian republics were able to penetrate the Islamic-Byzantine domination of the Mediterranean. The Muslim entrepreneurs created a phase of activity which can be called commercial capitalism. Similar activities also prevailed to a limited degree in Europe,



Front cover of *European and Islamic Trade in the Early Ottoman State: The Merchants of Genoa and Turkey* by Kate Fleet (Cambridge University Press, 1999).

however, with two key distinctions. First, capitalism was able to develop much earlier in the Islamic regions than in Europe. The process of reverting to agrarian activities and dismantling the exchange economy, which began in Europe in late antiquity, was intensified in the time of the barbarian invasions and continued beyond the Carolingian period. Further, in the agrarian society of Europe, commercial activities were not as prominent. In contrast, the Islamic world at this time was not affected by any similar invasions and an exchange economy thrived throughout.

The essential difference between the economic development of East and West came about during the late Middle Ages. Trade within the Islamic world could not keep pace with international commercial developments, for the Islamic lands of Asia, affected by the Mongolian invasions, lost much of their economic resilience, and thus, their business potential diminished (Spuler, 215-217). In addition, around the Mediterranean there was considerable deterioration of economic life in the wake of the Crusades.

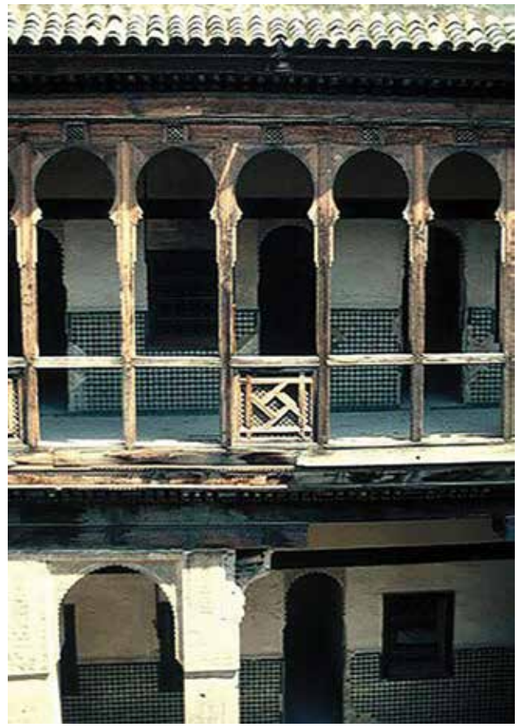
6.3. ENTREPRENEURS AND CENTERS OF ECONOMIC ACTIVITIES

Although commerce and trade did not significantly change the social structure of the Islamic society, however, it had considerable effect on the accumulation of capital and the promotion of economic progress in various regions. The centers of Islamic capitalism were in the main cities of the Islamic world. In the early centuries, Baghdad was the commercial metropolis and exerted a huge influence on the development of business ventures everywhere. As the 10th century approached, the weight of Islamic commerce gradually shifted from Iraq and the Persian Gulf to Egypt, the Red Sea and the harbors of the Arabian Peninsula on the Indian Ocean. Cairo replaced Baghdad as the commercial center and now the commercial links of Fatimid Egypt strengthened in the Mediterranean, particularly Sicily, Tunisia and Syria.

For Egypt's relations with Europe, a unique group of entrepreneurs and large-scale merchants was represented by the Karimi family, who first emerged in the 11th century. Distinguished by their entrepreneurial skills, they soon attained wealth and influence in all important Eastern markets and became quite prominent in financial activities as well as in politics. From the 12th century, the Karimis and the Franks dominated commercial activities between a East and West and displaced the Jewish and Christian merchants of the Byzantine, Ayyubid and Mamluk empires. Karimi funduqs (a specialized trading center equivalent to a large, contemporary shopping mall) emerged on the main trade routes from the Indian Ocean to the Mediterranean, in particular in Cairo, Alexandria and Qus in Egypt: in Aden, Ta'iz, Zabid, Ghalafiqua, Bir ar-Rubahiyya in Yemen, and in Mecca, Medina and Jeddah in Hijaz (now Saudi Arabia). The Suq al-Attarin or Al-Buhar (a merchandise market) was known to be the center of all Karimi family business activities in Alexandria. Karimi trade routes by sea led through the Red Sea and the Indian Ocean as far as China, and the land routes in times of peace went from Egypt through Syria, Iraq and Iran. As the Ottomans conquered important parts of Asia Minor, the Karimi enterprises expanded their trading activities into this area as well. In Africa they traded not only on the west coast of the Red Sea but also on the caravan routes with Nubia and Ethiopia. Their trading activities reached into distant Ghana and Mali; the gold mines of Mali were a source of wealth for them (Labib, 102-3, 116).

If one estimated the average capital of a wholesale merchant at about 30,000 dinars prior to the Karimi period in Egypt, the wealth of the Karimi entrepreneurs would amount to at least 100,000, or even 1 million dinars or more. From the biographical sources of the 14th century, one source describes a wealthy Karimi named Nasir al-Din b. Musallam (d. 1374) 'as the marvel of his time, as far as his wealth was concerned' (Labib, 115). The ancestors of this Karimi entrepreneur were also merchants. His grandfather, Ibn Yasir al-Balisi, was among the most famous merchants of the East, if not the world. His wealth is said to have amounted to 10 million dinars, described as about the wealthiest Karimi merchant of his time. His financial fame went beyond the business circles of Egypt; except for a non-Muslim partner in India, none matched his wealth. The famous world traveler Ibn Battuta (1304-1368) noted that the wealth of the Karimi merchants was comparable to that of the greatest middlemen of China (Labib, 116).

Among other important entrepreneurial families were the al-Kharrubi, al-Kaubak, Yasir, al-Mahalli and the al-Damanini family – all of whom inherited the business traditions of the Karimi group. Each generation inherited the family businesses, as well as the accumulated wealth and customers for future growth. A Karimi prepared his children for their profession, and he sent them to various countries to acquire necessary experience and to entrench the family business more firmly. Further, the Karimi merchants had agents/representatives who imported and exported merchandise and recruited for them. The Karimis played another important role in the history of Islamic capitalism; the financing of state projects was one of their methods of acquiring capital, and they operated a type of banking institution for loans and deposits. Among their best customers were not only Frankish merchants but also Sultans (rulers) and Emirs (state dignitaries), whom they helped with credits – and also with soldiers and weapons if necessary.



View of Najjarin Funduq in Fez, Morocco. Like the Caravanserais, the Funduq is a North African term for a small, urban shop complex. A typical funduq is a square two-storey structure built around a central courtyard with shops on one floor and store rooms on the other.

In one important respect, the Karimi businessmen differed from other entrepreneurs and merchants of the Egyptian Empire prior to their era (before the 12th century): they were not landlords, nor tax collectors. Their capitalism rested primarily on commercial and financial transactions. On the other hand, the most important Jewish merchant families in Egypt up to the end of the Fatimid period and also outside of Egypt (primarily in Iraq and Iran) were wholesalers, bankers and tax-farmers of entire provinces. Indeed, the financial relationships of prominent Jewish financiers with the Abbasid caliphs and ministers at the beginning of the 10th century represent an important chapter in the history of the Islamic world's financial capitalism. Ibn Allan al-Yahudi (d. 1079) was a wealthy financier/tax-farmer of Basra and served the caliphs for more than 20 years; once he gave a loan of 100,000 dinars to the reigning caliph (Fischel, 345).

Islamic commerce from the very beginning included traveling merchant al-Tajir as-Saffar, in addition to the resident merchant al-Tajir al-Muqim. The former tended to be imbued by the spirit of adventure as well as business acumen. There is evidence of numerous merchants who traveled between China and Andalusia and who were keen to acquire knowledge, as well as profits through economic pursuits. Many tales from the Arabian Nights give examples and reconstruct the picture of the adventurous merchants of the early-medieval Islamic world. From the late Middle Ages, a typical example of wealth accumulation is the following: One of the most prominent merchants of his time, Muhamed b. Abd al-Rahman b. Ismail al-Jaziri (d.1302) (who traveled between Syria, Mecca,

Egypt, Iraq and the Persian Gulf and undertook three trips to China) started with 500 dinars as capital and left behind 50,000 dinars at the time of his death. Further, sometimes ambitious entrepreneurs were the ambassadors of their countries, and it was not unusual for an ambassador to combine a diplomatic duty with a lucrative business deal. One example is that of Fakhr al-Din Uthman, Egypt ambassador to Aragon during the early 14th century, who borrowed 60,000 dirhams before his journey in order to buy goods and sell them for profit in Aragon (Labib, 79).

A factor that contributed to the growth of capitalistic trade was access to effective and secure transportation infrastructure. However, the distance and danger of the routes as well as the scarcity of merchandise often influenced prices. Ibn Khaldun analyzed the links between travels and profits and concluded that those who traded and exchanged their merchandise over longer distances earned greater profits compared to those who traveled and traded between cities and villages within the same province: One reason for this profit was the plentiful supply of the wares in nearby areas (Khaldun, 298). Thus the experienced merchants were persuaded to buy goods through long-distance trading when the goods were in season and in demand. This in turn required a thorough knowledge of the conditions of the wares in their original locations. Traders had to be well-informed about market conditions – not only supply and demand conditions. but also product quality and quantity, relative costs, safety of travel routes, etc. Some of this knowledge had to be obtained through inquiries and close questioning of caravans. In other words, successful businesses required rational, calculated decisions in order to safeguard against potential risks.

Of great significance for the capitalistic trade in the Islamic world was the establishment of the *funduqs*, which, as noted, were large-scale, specialized commercial institutions and markets and that developed into virtual stock exchanges, warehouses and trading centers. They dominated the landscape of the major cities in the entire Islamic world. A few illustrations are in order. At the time of the Crusades, there were four *funduqs* in Cairo that engaged in commercial exchange between Egypt and Syria. One of them was related to the import of oil from Syria. According to the available information, a 14th-century oil trader paid 20,000 silver dirhams for oil imports and 90,000 dirhams for other goods he imported from Syria. Another specialized as a fruit-market where the wholesale fruit merchants of Egypt and Syria traded and stored their wares. Another specialized in amber which was imported even from the Baltic region and which found a ready market in Egypt, for it was a popular spice and also used for cosmetics. Further, goods imported from China, India, Africa and the Levant were stored and traded in the Cairo *funduqs*. There was a fur market, for this item was much in demand as a fashion good; thus, we hear of a merchant who bought at one time 300,000 garments of gray squirrel to sell on the Cairo market. Further, there were *funduqs* for storage and trading of grain and textiles in all large cities, such as Baghdad, Cordova and Damascus.

6.4. MAJOR COMMODITIES TRADED: TEXTILES AND FABRICS

Among the important lines of business were the grain trade, the spice trade, and mining, but considerably more significant was the production and highly-esteemed trade in textiles and fabrics. The Caliph Abu Bakr himself had been a textile merchant. 'If there were trade in Heaven, I would choose cloth-trade because Abu-Bakr al-Siddiq was a fabric-merchant', wrote Abu 'l-Fadhl Ja'far b. Ali al-Dimashqi, a 12th century businessman/scholar, author of Kitab al ishara ila mahasin al-tijara (Indication of the Merits of Commerce). Often the entire family participated in the production (spinning and weaving) of fabrics. The Umayyad and Abbasid rulers and other elite owned and operated textile mills which not only manufactured cloth for their wardrobes, but also the covering of Mecca's Ka'ba and for royal honor-presentations and gifts. The importance of these fabrics increased under the Fatimid Dynasty. State-sponsored textile factories were built not only in Egypt and Syria but also in other parts of the Islamic world. In Al-Andalus (Spain), they were located in Almeria, Murcia, Sevilla, Granada and Malaga; in Asia Minor there was a factory at the Saljuq's court. Even in Sicily, under Arab rule for about 200 years, the tradition of state factories was preserved and in Palermo there were factories which produced finely woven silk down to the 13th century. Baghdad remained the most important center of royal production. Also there were factories in Persia.

These factories were not only producing for the needs of the rulers but also for general commerce. The town of Tinnis (Egypt) is an important example, with 5000

Covered Bazaar in Istanbul. View from the Beyazit Gate, leading into the Kalpakçilar Street at its western end. Above the entrance is the royal monogram (tugra) of Abdülhamid II (1876-1909), marking the construction of the gate during the 1892-94 restoration. A short Arabic phrase included in the monogram medallion says: "God loves the one who does trade".

looms and a factory of the court. The export of Tinnis textiles was substantial, and by the late 10th-century, their annual exports reached 20-30,000 dinars, a rather large sum at the time. The significance of their textile trade becomes evident from the fact that the Egyptian towns of Tinnis, Damiette and Al-Ashmunayn in 974 (Fatimid period) could pay 200,000 dinars as taxes in one day. One scholar of early Islamic economic history gives a few examples of textile production for the needs of the rulers' courts. Also, there was textile production, commercially and for the needs of the rulers, in cities such as Baghdad, Tabriz, Isfahan, Yazd and Nishapur.

As the golden age of Islam dwindled in the wake of the Mongol invasion, beginning in the late 13th century, the textile/fabric production began to decline. Ibn Khaldun informs us that the fabrics and garments were no longer made in state factories, but what the state required was woven in the private facilities (usually houses) of the weavers (Labib, 293-94), which was not an uncommon practice throughout these early Islamic centuries. In Almeria (Spain), where 800 looms were operational during the 12th century, gold-silver brocades were manufactured in the style of those of Isfahan.

It might be noted that the activities of private textile manufacturers often suffered greatly because of state controls, particularly during the Fatimid dynasty in Egypt. They had to obtain materials from the state officials; and the finished fabrics could only be sold through state-appointed brokers; and the Caliph himself was known to be involved in making large profits from this business. Often state officials invested in textile manufacturing through contracts. They sometimes had their own 'house' factories, which produced large volumes and competed with the private manufacturers. Further, it might be noted, that at the weekly markets and trade fairs, the merchandise traded – whether woollen or cotton, silk or linen – carried the name of the producing city or town so that the buyers would know the quality of the material, for the various cities and towns were known for their qualitative differences.

Thus,

> the accumulation of data relating to towns and districts certain of whose products were destined to be sold elsewhere shows at least that production for the markets was highly developed (Rodinson, p.34).

Indeed, capitalistic practices and institutions were thriving in this environment.

6.5. DEVELOPMENT OF FINANCIAL CAPITALISM

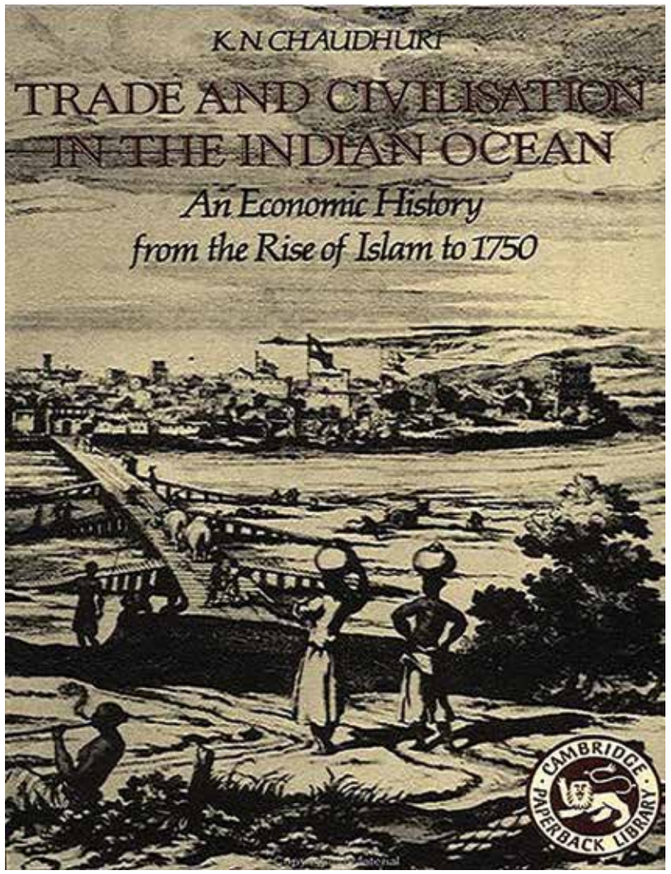
Capitalistic commercial trading ventures also necessitated the evolution of financial capitalism. The practice of lending at interest, albeit surreptiously, with the development of financial capital, was equally well known in the Meccan society in which Islam first appeared. There is evidence to suggest that, despite the scriptural prohibition of *ribs* (as also by the prior Abrahamic traditions), the practice prevailed in subsequent times. It was quite customary for the creditor to calculate his interest and include it in the sum owed without stating it separately in the agreement (see Rodinson, 35-37 for further insights). Private money-changers and bankers worked on a capitalistic basis and played a major role in a borrowing-lending business. Also, there is some evidence of borrowing-lending businesses conducted under state supervision, although very little is known about such practices.

Currency problems and variation in the value of coins forced a search for safer forms of payments, particularly in the late Middle Ages. Thus the need to safeguard the integrity of money transactions,

especially with respect to large private and state transactions, led to the evolution of financial innovations in the Islamic world. One such device was the bill of exchange or letter of credit (*suftajeh*), which became well established in state and private commerce. Adam Mez explored and discovered considerable information on this institution (i.e., bills of exchange or *suftajahs*) in the early Islamic literature. He describes:

'A savant who journeys to Spain takes with him a letter of credit (suftajah), and 5,000 dirhams in cash. Nasir-I Khusrau received from an acquaintance in Asuan a blank letter of credit addressed to his agent (wakil) in 'Aidhab, of the following content: "Give Nasir all that he may demand, obtain a receipt from him and debit the sum to me."' The Viceroy of Egypt sent his representative in Baghdad letters of credit for the cashiered vizier. The representative accepted them and put the money at the vizier's disposal. A sort of bill of exchange was the sakk... In August in the western Sudan, ibn Hauqal saw a check for 42,000 dinars drawn by a man of Sijilmasah on one Muhammad ibn 'Ali Sa'dun in Sijilmasah; it was officially certified. The paper had travelled through a great part of the Sahara. In Islamic metropolises the sakk was a regular check in connection wherewith the banker plays an important part. In the 3rd/9th century (to which the anecdotes connected with Harun al-Rashid belong) a magnate drew checks on his bankers. About 300/900 a great man paid a poet in this way, only the banker refused the check, so that the disappointed poet composed a verse to the effect that he would gladly pay a million on the same plan. A patron of the same poet and singer (320/936) during a concert wrote a check (ruq'ah, 'note') in his favour on a banker (*sairafi*) for 500 dinars. When paying, the banker gave the poet to understand that it was customary to charge one dirham discount on each dinar, i.e., about 10%. Only if the poet would spend the afternoon and evening with him, he would make no deduction. Another banker (Jahbadh), who was even a greater patron of the fine arts not only made no deduction, but he presented the poet with an extra 10%. There was, therefore, plenty of employment for bankers, and it is not surprising that in Isfahan there were 200 banks in the Bankers' Bazaar – for these too sat together.

About 400/1000 the banker had made himself indispensable in Basrah: every trader had his banking account and paid only in checks in his bank



Front cover of *Trade and Civilisation in the Indian Ocean: An Economic History from the Rise of Islam to 1750* by K. N. Chaudhuri (Cambridge University Press, 1985).

(Khattsaraf) in the bazaar. This would appear to have been the most important refinement of monetary operation in the empire on the frontier between Faris and Iraq. For the people of Basrah, the Persians of Faris and the South Arabians were the best traders among the Believers and had their colonies wherever anything could be produced. About the year 290/902 al-Faqih al-Hamadhani observes:

> The people of Basrah and the Himiarites are the greatest moneygrubbers. One who travels to the remotest region of Ferghanah or the Western edge of Morocco is sure to find a man from Basrah or a Himiarite there. (Mez, 448, quoted in Labib)

Ibn Battuta (1304 - 1368), the Muslim adventurer who traveled to Africa, Persia, India and the Far East, far in excess of what we know of Marco Polo's travels, wrote a priceless account of his travels and narratives of life in the East before the rise of Europe (The Rihlah, or The Travels). Among other things, he discusses the profitable practice of credit:

> Every person proceeding to the court of the King of India, Sultan Muhammad Shah, must needs have a gift ready to present to him, in order to gain his favours. The sultan requites him for it by a gift many times its value. When his subjects grew accustomed to this practice, the merchants in Sind and India began to furnish each newcomer with thousands of dinars as a loan, and to supply him with whatever he might desire to offer as a gift or to use on his own behalf, such as riding animals, camels, and goods. They place both their money and their persons at his service, and stand before him like attendants. When he reaches the Sultan, he receives a magnificent gift from him and pays off his debt to them. This trade of theirs is a flourishing one and brings in vast profits.

Ibn Battuta himself made use of the occasion; he says:

> On reaching Sind I followed this practice and bought horses, camels, white slaves and other goods from the merchants. I had already bought from an Iraqi merchant in Ghazna about thirty horses and a camel with a load of arrows, for this is one of the things presented to the sultan. This merchant went off to Khurasan and on returning to India received his money from me. He made an enormous profit through me and became one of the principal merchants. (Gibb, 184-85)

With the growth of commerce, trading companies were formed which evolved the development of other financial instruments and transactions. One such institution that evolved for pooling of financial capital was known as the commenda (*mudarabah*). The principle of the commenda contract calls for an association of individuals in which the partners are equal, and one furnishes the capital while the other manages the business, and the profits/losses are shared as agreed upon. In practice, the suppliers of funds for this arrangement were not only merchants but also wealthy individuals who invested their surplus resources for profit. One scholar reports the discovery of a rare commenda contract setting forth this type of agreement between a Venetian and an Egyptian made in the early 15th century Alexandria (Labib, 501). While this record does not deal with the details of the contract, it does report that the Egyptian sent a letter to the Venetian consul in Alexandria to inform him that certain problems which had arisen had been resolved and that he and others had informed the chief justice in Alexandria so that the Venetian merchant would no longer be prosecuted. The suppliers of the funds for the commenda companies were not only merchants but also the wealthy who wanted to invest their surplus for profit. As for the capitalistic character of such arrangements, one scholar says,

> With no real guilds available, the Moslem world relied for business upon individualistic capitalism in which the dominant type of association was the partnership which took various forms. (Lewis, 1988, 31)

As noted, the commenda was intended to be a form of capital investment wherein the profits/losses were distributed according to a pre-determined agreement among the partners. Here the contract involves a capitalistic calculation of accounts. The original capital invested is compared with the final sum, and the residual, after all expenses, is marked profit to be distributed. This type of settlement was not unknown in the regions that became part of the Islamic world. However, the practice was not widespread in the Islamic civilization until the introduction of numerals. And that emerged with the mathematical innovations of the Muslim mathematician Muhammad ibn Musa al-Khwarizmi (d. 850), who introduced the Indian positional numerals with index values and zero. With this development, numbers and the numerical system became the framework for the capitalistic industrial economy; he himself stated that his book was compiled for the purpose of resolving questions of business transactions, inheritance, wills, purchase and sales agreements, matters of money exchange, and a variety of other needs requiring quantitative measurements (Labib, 216; also see Bernardelli). Another early Muslim scholar-entrepreneur who lived in 12th century Damascus (Syria) was Al-Dimashqi. He wrote a book on business practices, and he advised his readers,

> Everything that is being bought and sold shall be measured by the dry measure, or by time, or in numbers. Therefore a merchant should know the swindler and the methods which he applies

> when measuring, weighing and counting, so that he shall not be dependent upon unreliable people (al-Dimashki-Ritter, 62, quoted in Labib).

Credit transactions as well as the organization of trading companies made accurate accounting imperative. Bankers and money changers were required to keep records and to enter the transactions of their clients accurately in ledgers, although they were not required to specify their own profit. Generally bankers received deposits which could be withdrawn by means of a written assignment. The double entry bookkeeping was an important part of a merchant's skill. It allowed him to watch not only the flow of single values but also the circulation of the capital, and it enabled him to register quantitatively its change and transformation and to control and guide the success and the development of the business. The account-keeping pertained to goods and completed business. Normally a merchant would settle a sale immediately and would enter the profit or loss in his ledger. This method gave a current account of profit and loss. A periodic balancing was, therefore, not necessary; if it was made, it served the purpose of audit and control. It might be noted that the Islamic state did not take steps to establish a national bank, although embryonic banking practices were commonplace. Perhaps one reason for this phenomenon might be the possibility that such an institution would have become a political force and would have assumed an unusual position between the state and private enterprise. On the other hand, it might have provided a mechanism that would have helped to prevent or overcome economic upheavals in the society.

However, some scholars of Islamic history have discussed the evolution of a financial institution in the Islamic world called *maona*. This institution was a kind of private bank which loaned out state money. The word maona (in Arabic *ma'una*) means support or help or, as the case might be, reciprocal, mutual help. The maona did not go through the same development as did the European maona subsequently - the latter was used for financing wars or mining. The function of the *ma'una* in Islamic society remained restricted to giving financial assistance to businesses on a limited scale. The maona institution was also operational in Tuscany, established for the exploration of iron mines and a large trade in iron (see Dozy, quoted in Labib).

One can find precursors of the modern stock exchange/money market in Islam: there was not only the wholesale/retail commercial exchanges in the *funduqs*, but also activities typical of the modern commodity exchange, i.e., the futures trading in commodities not yet available in the market but to be delivered in the future. Dates were legally sold at auction before they were harvested. Even the wholesaling of many kinds of tuberous vegetables (such as onions, garlic, carrots, turnips, radish and colocasia) took place before they were harvested.

As a summary observation relating to the development of monetary and credit institutions in the early Islamic civilization, it is useful to quote an eminent medieval economic historian:

> Until forty years ago the prevalent view was that the Middle Ages constituted a pre-credit era... The earliest Muslim sources now justify the assertion that already in the 8th century, and possibly earlier, credit arrangements of various types constituted an important feature of trade and industry... Any assertion that medieval credit was used for consumption only, and not for production, is quite untenable with reference to the medieval Near East (Udovitch, 1967, 87).

6.6. SOME CONCLUDING REMARKS

It should be noted that the primary focus of early capitalistic practices, in the Islamic world as elsewhere, was not the functioning of the national economy; the economics of the medieval centuries pertained to the study of the house, *oikos*. The tradition of the *oikos* economics begins with the Greek oikonomia, known among Islamic philosophers as Ilm tadbir al-Manzil (science/management of the household or domestic philosophy). This tradition, with its Islamic additions and refinements, subsequently reached Europe through Latin Scholasticism. Indeed, both the early Islamic civilization and Latin-Scholasticism discussed the issues of ethics, economics and politics in a holistic perspective which viewed all human behavior in teleological terms. One even finds reminders of this in Adam Smith's 18th century writings; his *Theory of Moral Sentiments* especially talks in terms of "sympathy" and a moral-ethical framework through Providential guidance. While the profit-motive is acceptable, it must be must be tempered by larger ethical-social considerations and concern for the common good.

However, as for the main purpose of this paper, based on considerable historical evidence presented, it is abundantly clear that the early Islamic civilization functioned in a market-exchange, capitalistic framework, not only in its basic premises but also in terms of its various practices. There were entrepreneurs who pursued production and exchange for private profits and who owned and operated financial institutions for that goal. Further, they played key roles in the distribution process; their merchandise, either bought from abroad or produced in their own factories, was sold to wholesalers and retailers or directly to consumers. While Islamic capitalism tended to be largely a commercial/financial capitalism, those who engaged in such enterprises, given their motivations, would be 'very difficult to differentiate' from those who engaged in industrial capitalism (Robertson, 203).

Further, these early entrepreneurs pursued activities that required rational calculations; they pursued the goal of 'fructifying' capital and earning profits. Certainly, it was not quite the 'non-rational form of capitalism outside of modern Europe' that Weber talked about (Rodinson, 247). These entrepreneurs added value to raw materials and products, transforming them into marketable commodities; and they directed their production towards exchange – all such activities, geared by the lure of private gain, reflect what capitalism is all about.

As an eminent French scholar of early Islamic economic history suggests, while similar capitalistic economic activities are to be found in the Greek and Roman world, India, China, Japan and even medieval Europe, early Islamic capitalism differs:

> A level does seem to have been reached in the Muslim world which is not to be found elsewhere at the time, or earlier. The density of commercial relations with the Muslim world constituted a sort of world market of unprecedented dimensions. The development of exchange had made possible regional specializations in industry as well as in agriculture, bringing about relations of economic interdependence that sometimes extended over great distances. A world market of the same type was formed in the Roman Empire, but the Muslim 'common market' was very much bigger. Also, it seems to have been more 'capitalist,' in the sense that private capital played a greater role in forming it, as compared with the part played by the state than was the case in the Roman Empire. Not only did the Muslim know a capitalistic sector, but this sector was apparently the most extensive and highly developed in history before the establishment of world market created by the Western European bourgeoisie (Rodinson, 56).

Further corroboration of such observations also emerges in the writings of numerous early Muslim scholars who wrote on economic issues. Thus, not only various techniques and methods of commerce, as well as the spirit of enterprise and adventure, spread to medieval Europe from the Islamic civilization, but, further, 'the Muslim writers of this period do tend to be more sympathetic to mercantile activity than those of Christian Europe' (Cook, 219 and 226; also see Hitti). Indeed capitalism and related institutions and practices represented the modus operandi of economic life in the early Islamic civilization, much before that transformation took place in Europe. •

7

ISLAM AND ENTREPRENEURSHIP: WHY INSTITUTIONS MATTER?

by Hicham El Moussaoui

7.1 INTRODUCTION

Although much of the recent flurry of research and writing on the economics of religion by mainstream academics has been motivated by concerns about links between Islam and terrorism, there is also a long-standing debate over the impact of religion on economic growth. The bottom line is that most Muslim countries face very difficult governance issues that have impeded rapid economic growth. The facts are undisputed: Muslims make up 19% of the world's population but earn only 6% of its income. Why do the majority of Muslims tend to be relatively poor? The importance of entrepreneurship to the economic well-being of the Islamic countries is common knowledge. So the deficit of entrepreneurship is at the heart of the poverty in these countries.

Ever since the Islamic world slipped into a state of underdevelopment, many observers have linked such situations to Islam per se, which has impeded entrepreneurship and innovation by inculcating conformism and fatalism. Advocates of Western economies sometimes point to the relative financial success of Western business activities as evidence of the superiority of Western practices over those of Islamic systems. Such advocates often assert that Islam-based economies hinder economic growth or that they don't provide adequate incentives or motivation to engage in productive business ventures. But if advocates of Islam's hostility to entrepreneurship were right, how does one explain the glorious past of the Muslim civilisation where innovative entrepreneurship is felt in all scientific and economic fields, especially during the early period of Islam? The partisans of Islam as a religion favourable to entrepreneurship highlight the glorious past of Muslim civilisation where innovative entrepreneurship is felt in all scientific and economic fields. So if Islam's spirit isn't inimical to entrepreneurship, how does one explain the decline of entrepreneurship supply and its low quality in the majority of Muslim countries now?

The two observations are raising a great debate on hostility or openness of Islam to entrepreneurship. In this paper, we aim to achieve two objectives: On the one hand, show that Islam isn't inherently hostile to entrepreneurs. On the contrary, it encourages entrepreneurship, but some lectures, interpretations and practices in Islam have driven Muslims away from entrepreneurship. On the other hand, if Islam isn't hostile, we would explain observed weak entrepreneurship, and particularly unproductive and underground entrepreneurship, as overwhelming.

In this paper, we will use the institutional approach to explain the level of entrepreneurship in Muslim countries. Indeed, the decision to undertake depends on the rules of the game (formal and informal institutions) that frame the entrepreneurial act. We will show that in the first periods of Islam, entrepreneurship flourished in all its forms. The decline came following the deterioration of the quality of institutions governing entrepreneurship (rule of law, financing, property rights, innovation, etc.). That is, if the positive spirit of Islam remained favourable to entrepreneurship, at least in the original texts, the practice of entrepreneurship has been discouraged in the field because of the inadequacy of institutions.

Our thesis is that if today in most of the Muslim world entrepreneurship is not developed enough, it is because the institutional soil is not fertile enough. Indeed, if during the first centuries of Muslim civilization, entrepreneurship boomed, it was because there were several institutional innovations from the rules in force in the pre-Islamic societies. However, the failure of Muslim societies institutionally to accompany the changes experienced by the economy and trade and become more globalized and impersonal was fatal and precipitated the decline in the Muslim world from the 11th century. It followed a long period of apathy and inertia until the 19th century, when Muslim countries aimed to undertake significant reforms to import modern institutions from the West. This institutional transplant did not stimulate entrepreneurship since it was a mere imitation rejected by the local environment.

All in all, if entrepreneurship is weak in most Muslim countries, it is due to inappropriate institutions inherited from the old Islamic law, and secondly, because of the conflict between imported institutions and local institutions in addition to the lack of true capacity and expertise to implement the reforms in question. This institutional failure is attributable in large part to Muslim countries who not only stifled private initiative through their excess of interventionism and regulation, but also because they failed in institutional change by just copying and pasting other countries.

7.2 IS ISLAM INIMICAL TO ENTREPRENEURSHIP?

Following Max Weber's (1958) study on Protestantism and the development of capitalism in the West, it has been argued that Islam with its fatalistic, warrior ethic and other-worldly inclinations is incompatible with modern economy and polity. Lerner (1964), referring to the modernization process in the Middle East and Turkey, has argued that Muslims had to choose between 'Mecca or Mechanization', meaning that Islamic values are not compatible with the modern capitalist economy. Lerner seemed to suggest that Muslims had to either give up Islam or accept underdevelopment as their fate. Similarly, Huff (1999, pp. 42-3) has recently argued that neither classical nor reformed 'Islamic moments produced the inner worldly economic ethic analogous to the Protestant ethic, though some came close'. So, is Islam really incompatible with entrepreneurship?

7.2.1 WORK, PROFIT AND WEALTH ACCUMULATION DISCOURAGED BY ISLAM?

Islam places a great focus not only on prayer, but also on earning a living in order to support oneself, one's family and society. One such way of earning a productive living is through engaging in economic. Thus, Allah says:

> And when the prayer is finished, then may you disperse through the land, and seek of the Bounty of Allah: and remember Allah frequently that you may prosper. (62:10)

Islam has stressed the importance of hard work and entrepreneurship to prevent laziness. Islamic work ethic argues that engagement in economic activities is a source of independence, self-respect, satisfaction and self-accomplishment' (Yousef, 2001).

The economic history of the Islamic world demonstrates that Muslims never had any trouble with making money. Islam considers the profit motive to be legitimate and moral as long as it is kept free of greed, speculation and exploitation. Profit, therefore, should be intended for pleasing the Almighty Allah through lawful and righteous use. The profit motive is legitimate as it is consistent with Islamic 'ethics':

> O people! eat of what is on earth, lawful and good; and do not follow the footsteps of the evil one, for He is to you an avowed enemy. (2: 168)

Regarding wealth accumulation, it's recommended:

> O you who have believed, shall I guide you to a transaction that will save you from a painful punishment? [It is that] you believe in Allah and His Messenger and strive in the cause of Allah with your wealth and your lives. That is best for you, if you should know. (61: 10-11)

The wealth and profit achieved in business is a good means to please the Almighty by donations, zakats, charity, etc. Thus wealth became an input to make good deeds and gain the approval of Allah: entrepreneurship was a form of worship. Thus, entrepreneurship in Islam has a religious dimension alongside its economic dimension.

7.2.2 ENTREPRENEURSHIP DOWNGRADED BY ISLAM?

By virtue of human nature, the Muslim entrepreneurs are khalifah and have the responsibility to develop prosperity and fructify all resources. Allah says:

> It is He Who made the earth manageable for you, so traverse it through its tracts and enjoy of the sustenance which He furnishes: but unto Him is the resurrection (15:67).

Although Islam endorses working for others for a fixed salary, it encourages and stimulates Muslims to embark on entrepreneurship as the preferred option to earning halal income. The Prophet Muhammad expounded that nine out ten sources of risque can be found in business (Al-Tirmidhi, n°1987). Business activity is part of ibadah or is good deed: Muslim entrepreneurs perform business not solely for profit, but also to get the Allah's blessing. Thus, the honest, truthful and sincere entrepreneurs, their honour will raise to those of prophets, siddiqin, shuhada and salihin. The honest businessman is in constant jihad against the temptation of sins on each sale and trade. The Prophet says:

> The truthful trustworthy merchant is with the Prophet the True ones and the martyrs (on the Day of Resurrection). (Al-Tirmidhi, n°1213)

Beg (1979) noted that Islam does not only motivate Muslims to be entrepreneurs, but in fact, it makes it obligatory on them to work hard and gain halal earnings beyond their immediate needs in order to care for the community and the Muslim ummah at large. Muslim entrepreneurs perform business not solely for profit, but above all, to fulfill the fardhu kifayah. The concept of fardhu kifayah (collective obligations) in Islam is based on the ability of society to meet its minimum and basic needs from a specified activity or meet national challenges and obligations. An appropriate share of the Muslim population should undertake entrepreneurial activities by their own choice and according to their own initiative to ensure the continuity of the nation's economic viability. In Islam, to indulge in business is to perform an obligatory duty (fardhu kifayah); unless and until there is an entrepreneur in a community, the entire community is deemed to be sinful! That's how seriously Islam perceives and encourages entrepreneurship. As narrated by Hudhaifa, that the Prophet said: 'Once a man died and was asked: "What did you use to say (or do) (in your life time)?" He replied, "I was a business-man and used to give time to the rich to repay his debt and (used to) deduct part of the debt of the poor." So he was forgiven (his sins)' (Hadith Hasan).

7.2.3 DOES ISLAM CONTAIN ANTI-ENTREPRENEURIAL VALUES?

Entrepreneurship literature within the Western context suggests that entrepreneurial activity flourishes where values such as individualism, autonomy, self-interest, achievement and self-reliance are prevalent. However, the assumption that such values are universal is unsubstantiated and unwarranted.

By observing traditions of majority-Muslim societies that show collectivist practices and fatalistic attitudes, we will be pushed to think that these cultural dimensions unsurprisingly indicate that the Muslim culture is anti-entrepreneurial. Recognizing human nature and the need to be in harmony with natural laws, Islam has institutionalized the primacy of individual choice and responsibility as the corner stone of worship. Allah says:

> No sinner will bear the sins of others (39:7).

This freedom of choice and responsibility cannot be conceived outside an individualistic conception. Then, several choices and practices, serving others' interests, promoted and encouraged by Islam are not only altruistic. Instead all choices are ultimately motivated by the self-interest of the individual. Not only will the individual be rewarded in the afterlife, but they will reap the fruits of his altruism, morality and integrity already in the life of this world.

Islam is said to encourage submission and fatalism.

Yet Allah says,

> Never will we be struck except by what Allah has decreed for us; He is our protector, and upon Allah let the believers rely (9:51).

Islam teaches that we must, therefore, take all necessary precautionary measures in relation to a world of cause and effect. However, having done everything in its power and its human scale, we must rely on Allah for the size of which is unpredictable and on which we can't act. It is indeed Allah who manages everything, and it is on Him that we should refer our confidence. This confidence in Allah prevents man to anxious for nothing. This will provide serenity. Moreover, in Islam not all things are predetermined as Allah says:

> Allah will not change the condition of a people until they change (13:11).

This means that people can change their lives and destiny.

I think that the confusion comes from the interpretation of submission in Islam, especially by Westerners. Muslims themselves by their perception and social practice corroborated this impression since they feel compelled to show any family or religious authority the same allegiance and submission as to Allah. However, the submission in Islam does not mean the denial of individual autonomy. On the contrary, it is recognized that submission to Allah, the transcendent entity of all other creatures, cultivated the spirit of non-submission to other men regardless of their gender or status. This means only one thing: the individual can't submit to the will of the group if it challenges submission to Allah. So children can disobey their parents when parents push them to break the rules of Islam. Likewise, men are allowed to disobey rulers when they deviate from the spirit of Islam. This proves the primacy of individual autonomy on collective will.

The submission to the will of Allah escapes a blind determinism because the absolute sovereignty of Allah does not diminish the sense of human responsibility. If not, it's meaningless to reward or punish human beings according to their choices, as the latter are predetermined. Unfortunately, the spread of certain practices, traditions and customs that have nothing to do with the original precepts and the essence of Islam have led many Muslims and Westerners to believe the individual must be submitted to the will of the group. This has resulted in resignation and fatalism, which led to the standardization of irresponsibility synonymous with underdevelopment and social immobility.

Muslims are presented to believe that wealth and poverty are Allah's will (kadar). In Muslim countries, people tend to be fatalist, meaning that they do not believe that they have much control over events that affect them. They strongly believe in destiny and events being controlled by fate. Here we should be careful in the interpretation of the concept of kadar (destiny). Kadar should not be interpreted as if individuals have no control over their income and wealth. Rather the essence of Islam is the responsibility that establishes a close link between choice and outcome. Kadar doesn't mean that your income is predestined, it simply means that Allah's will is His judgment, which is based on your efforts and your choices. So rich or poor is a state of affairs judged by Allah according to your work, and it is never predetermined in advance. Kadar should not be interpreted as if Allah determines your fate in this world once and for all. Allah has also given free will to people through which they should work hard and thrive in this world. Allah will not change one's lot and conditions unless individuals themselves strive to change their own conditions. This attitude stems from a notion prevalent among Muslims that value 'being satisfied with less', which actually is a non-Islamic belief that has become a part of popular Islam.

> So how will it be when We assemble them for a Day about which there is no doubt? And each soul will be compensated [in full for] what it earned, and they will not be wronged (3:25).

This idea has led Muslims to adopt a passive and negative attitude towards this world.

Also, Islam is blamed because wealth and hard work don't guarantee personal salvation. Since one's condition is still ultimately the will of Allah, the poor can neither be morally condemned nor can the wealthy be deemed as more virtuous. Thus wealth and work in and of themselves do not necessarily confer greater virtue to the rich. It is how one uses his/her wealth that brings salvation and moral superiority to a person. Otherwise, it is only when one puts wealth into the service of Islam and the betterment of the Islamic community that the wealthy can earn Allah's merit. Defined as such, many observers considered that the Islamic work ethic critically departs from the Calvinist work ethic oriented towards the self and personal salvation. I think that the two ethics aren't incompatible but complementary because Islam considers wealth accumulation as a mean of worship, but in Islam entrepreneurs seek two kinds of salvation through their work ethic: personal salvation by following the commands of religion and communal salvation in this world that will lead to a prosperous Islamic society.

7.2.4 PROHOBITION OF RIBA AN OBSTACLE TO ENTREPRENEURSHIP?

The aim of prohibition of interest in Islam is grounded in the rejection in Islam of rents and usury and the promotion of revenues derived from productive activities and from adding economic value. So the prohibition of interest, though it may seem to penalize entrepreneurs by making loans more expensive and difficult, it encourages the spirit of entrepreneurship by linking investment to risk-taking and backing the gain to the obligation of creating value through participation in productive activities, especially the sharing of risk inherent in any productive activity.

According to the capitalist theory, capital and entrepreneurship are two separate factors of production. The former gets interest while the latter is entitled to profit. Interest is a fixed return for providing capital, while profit can be earned only when there is a surplus after distributing the fixed return to land, labour and capital (in the form of rent, wages and interest). Islam, on the contrary, does not recognize capital and entrepreneurship as two separate factors of production. Every person who contributes capital (in the form of money) to a commercial enterprise assumes the risk of loss and, therefore, is entitled to a proportionate share in the actual profit. In this manner 'capital' has an intrinsic element of 'entrepreneurship', so far as the risk of the business is concerned. In this way the profits generated by the commercial activities in the society are equitably distributed to all those persons who have contributed capital to the enterprise. In other terms, investors in the Islamic order have no right to demand a fixed rate of return. No one is entitled to any addition to the principal sum if he does not share in the risks involved.

Business is a risky activity in terms of execution and gains in comparison to other forms of occupation. There are inverse relationships between the motivation to build a business with the level of risk and uncertainty. Based on this the Islamic financial system is more keen on providing protection to entrepreneurs as compared to the conventional banking system in facing risks and unexpected returns. The conventional banking system allows loans to be made by entrepreneurs, provided that the amounted loan be paid with interests as scheduled. The bank will not take responsibility on any loss or failure faced by the entrepreneurs. On the other hand, the Islamic banking system offers a unique mechanism to protect entrepreneurs from negative impacts or consequences of the business. For example, under the mudarabah system, every risk of loss will be endured by the loaner while the entrepreneur will not receive any gains.

Moreover, under a debt arrangement, when the venture does extremely well, the lender still only receives the fixed interest payment. Thus lenders are only motivated to finance projects of lower risk in order to ensure their repayment. As a result, higher risk and innovative ventures may go unfunded. On the other hand, if the venture goes poorly, the entrepreneur is still obligated to pay the fixed debt payment. Thus the entrepreneur is often motivated to engage in riskier projects in order to maximize his profits and ensure debt repayment. This conflict of interest between lenders and entrepreneurs under fixed debt payments has been documented and often results in an overall increase in the costs of financing. Consequently, this arrangement is one that is held by Islamic teachings as inherently unfair.

As an alternative to debt financing, Islamic economies have developed arrangements that aim to provide capital to Muslim entrepreneurs in a more equitable fashion, as well as to align the incentives between the entrepreneur and the lender. Two such arrangements, mudarabah and musharakah, are essentially profit sharing agreements.

Under these agreements, the entrepreneur is able to borrow money from a financial institution, but instead of interest payments, the financial institution receives a predetermined share of the profits (or losses). Under a mudarabah relationship, the financial institution typically supplies all the capital needed, and the entrepreneur is charged with providing his or her expertise in carrying out the venture. Musharakah is a similar relationship; however, under this arrangement,

the entrepreneur typically supplies some capital as well. Musharakah tends to be the financing mechanism preferred by most financial institutions because it most aligns the interests of the lender and the entrepreneur.

7.2.5 IS THERE AN ISLAM'S INNOVATION REPULSION?

Every innovation (bid'ah) is misguidance (Sahih Muslim). In its strictest form, bid'ah served to dismiss as unIslamic every commodity, habit, and idea unknown in Arabia during Muhammad's lifetime. In this misread hadith, what is meant is a divergence from scripture and religious matters, as this is considered to have happened with other religions, rather than innovation in business activities. More broadly a distinction between good or praiseworthy bid'ah and bad or blameworthy bid'ah is made by Imam Al-Shafi' I. He is the leading contributor to one of Islam's four major schools of law. He held that bid'ah encompasses only innovations that contradict the Quran, the sunna and the consensus (ijma) of the Muslim community. It does not subsume innovations that no one contests. By this logic all bid'ah is blameworthy, but not all innovation is bid'ah.

So Muslims should make a distinction between good and bad innovations (new sunna):

> He who inaugurates a good practice in Islam earns the reward of it, and of all who perform it after him, without diminishing their own rewards in the least. (Tirmizi, Page 92)

It is important to note that a religion is per definition based on a certain inalienable core and proposes certain immutable practices and values. The process of ijtihad serves to distinguish between good and bad innovations. Ijtihad incorporates both text and context and allows for entrepreneurial interaction. A closure of the doors of ijtihad created some form of inertia. Islamic regulations are theoretically not static but may rather both in their content as well as process be termed entrepreneurial or entrepreneurship enabling and encouraging.

The use of traditionalist rhetoric to discredit innovation is not unique to Islam. Every society, past and present, harbors groups who oppose innovations: Witness the French campaigners who fought against McDonald's not for health reasons but on the ground that McDonald's threatens the French way of life.

Charges of bid'ah undoubtedly had a retarding effect on the diffusion of some innovations. In 16th century Arabia many clerics urged their congregations to destroy coffeehouses. A half-millennium later leaders of Saudi Arabia's puritanical Wahhabi sect proudly serve coffee to their guests, treating it as an ancient Arab delicacy. In the early 1960s Wahhabi leaders opposed television. It violates the Islamic ban on graven images, they said, and might encourage idolatry. Once Wahhabi leaders understood television's immense potential as an instrument of religious indoctrination, they promptly discovered that it falls, after all, within the sunna. Charges of bid'ah also have dampened the incentives for entrepreneurship. However, in and of themselves they cannot explain why, after several centuries of innovative Muslim rule, the Middle East lost some of its institutional dynamism. After all, the concept of bid'ah was already present in the golden age of Middle Eastern entrepreneurship. It was available to opponents of innovation in the 8th century when Muslim entrepreneurs replaced fragile and expensive papyrus with Chinese paper and then founded paper mills to produce Baghdadi paper, a fine substitute. Likewise, it was present during the 9th century as Muslim jurists were continuing to develop what was to become classical Islamic contract law.

The crux of the problem lies more in Muslim clerics who promote the view that the Quran, which was revealed to the last of a long line of Prophets, embodies the unaltered words of Allah. By implication, it outlines a way of life that cannot possibly be improved upon. This presumption of perfection may serve, and in certain contexts has served, as a rationale for immobility; in an already flawless social order, innovations cannot yield benefits and may well do harm. A steady rhetoric of institutional fixity effectively denied legitimacy to the process of innovation. Moreover, the fabrication of ostensible Islamic precedents for diverse innovations helped to erase from the collective memory the innovativeness of past Muslims and the dynamism of Islamic history.

Cleric rhetoric of Islam perfection denied status to innovators. The founders of the Middle East's paper industry were not remembered or celebrated as entrepreneurs who spotted a useful Chinese commodity, marketed it locally and then developed a technology for manufacturing a local variant. Nor, for that matter, were the generations of jurists who developed Islamic contract law remembered as institutional architects. They were treated as interpreters rather than innovators, as discoverers of an all-encompassing, fixed and eternally perfect legal system rather than as creative legislators in their own right. Cleric rhetoric of institutional fixity would have discouraged entrepreneurship both by underrating its social significance and by denying social rewards to individual innovators, insofar as Islam's self-image of timeless perfection required the denial of esteem to Muslim innovators.

Also, the absence of a system recording and publicizing judicial innovations, would have limited incentives to develop new commodities, invent new production processes and concoct legal reforms, among other possible entrepreneurial activities. No system existed for publicizing the evolution of the law to produce general precedents. One result was a duplication of judicial effort: judges had to resolve common disputes by going back, at each occurrence, to first principles. Although news of judicial decisions could travel, the lack of a system of granting authority to precedents would have hamstrung legal development. It would also have reinforced the above-discussed perception of institutional fixity. The former effect would have limited entrepreneurial capabilities and the latter would have dampened the rewards.

7.3 AN INSTITUTIONAL APPROACH TO ENTREPRENEURSHIP DECLINE

Institutions are vital to the expansion of entrepreneurial activity, which is at the heart of the process of development and economic growth. What is generally missing in the majority of Islamic countries is not entrepreneurship spirit as such but the right institutional context for entrepreneurship to take place and to be socially beneficial. In the following, we will use the institutional approach to explain the level evolution of entrepreneurship in Muslim countries.

7.3.1 INEFFICIENT INSTITUTIONS

If classical Islamic law of the first few Islamic centuries established institutions suitable to the sort of entrepreneurship that fuelled commercial expansion under early Islamic law, a major reason for it is that the Muslim jurists who incorporated them into Islamic law, and refined them repeatedly, were themselves businessmen. In the Arab heartland of Islam, during the 9th and 10th centuries 75% of all religious scholars (ulamù), whose ranks included all jurists, earned a living primarily from business. Such factors did not guarantee that Islam would promote institutions supportive of entrepreneurship. Later, law scholars went away from the business realm and became employed by state and ignored the real needs of business, which resulted in inadequate institutions.

This stood as an immense obstacle to introducing corporation into the Middle East. Traditional Islamic contract law was well-suited to the personal exchange prevalent in the medieval global economy. However, it became increasingly dysfunctional as global commerce, and then gradually commerce within the Middle East, became progressively more impersonal (Kuran, 2011). So, Islamic law recognizes only flesh-and-blood persons; it lacks a concept of legal personhood. By pre-modern standards the Islamic inheritance system is highly egalitarian for all its distributional advantages, but it led to the fragmentation of successful enterprises. The problem was particularly acute for highly successful businessmen because they tended to have more children from multiple wives. Another unintended effect of the Islamic inheritance system was a reduction in the scale and expected longevity of commercial enterprises. Merchants, producers and investors minimized the probability of having to deal with the heirs of their partners by forming small and ephemeral partnerships. In the process, they also minimized the expected costs of untimely liquidations.

Waqf through it's basic principle, static perpetuity, entails the immobilization of endowed assets for the purpose specified in the waqf charter. This principle of static perpetuity commonly locked resources into inefficient uses. When a successful merchant established a waqf in order to gain material security, to protect their properties from the state predation, resources thus got transferred from a sector in which they were mobile to one with more or less enforced allocational restrictions. Therefore, additional obstacles to entrepreneurship came into play. If Middle Eastern merchants were held back by inadequate means for forming large enterprises, the caretakers of waqfs were generally barred altogether from pooling resources. Assets that flowed from the commercial sector to the waqf sector harmed entrepreneurial capacity in two other ways. Because courts had supervisory authority over waqfs, as a

matter of practice, caretakers trying to preserve the value of waqf assets had less freedom than managers of private portfolios. Waqf rules limited institutional change also by barring the use of resources for political purposes.

But if these traditional institutions became ill-suited to impersonal exchange, one could wonder why Muslim countries didn't change them?

7.3.2 FREEZING INSTITUTIONAL CHANGE

State policies are among the determinants of entrepreneurial opportunity and productivity. In Islam's early centuries, Middle Eastern states assisted commercial development through various means. Subsequently they did little to improve entrepreneurial performance. They left the provision of services relevant to entrepreneurial productivity largely to waqfs, which came to control vast economic resources. Thus the caravanserais that enabled merchants to travel long distances were financed through waqfs, as were schools that provided literacy and numeracy. The building of centralized urban markets, or grand bazaars, is the major exception that proves the point. However, rulers wanted also to facilitate the monitoring of trade flows for the purpose of taxation. During financial emergencies, rulers doubled their efforts to locate untapped sources of wealth. But they did not pursue institutional innovations to stimulate wealth creation.

In the great cities of the medieval Middle East, social services were supplied largely by waqfs. Just as Mamluk, Ottoman and other Middle Eastern rulers sought to use the waqf system to their own advantage, so in various contexts they tried to benefit from the activities of merchants and producers. Political stability required major cities to remain well stocked with staple commodities, so protections were extended to businessmen belonging to relevant supply chains. Rulers also imposed economic restrictions or provided economic privileges to alleviate perceived threats to favoured constituencies. Ayyubid and Mamluk sultans extended financing as well as commercial privileges to the Karimi traders who in the 12th and 13th centuries dominated the Indian Ocean spice trade. Shah Abbas I of Iran (r. 1587—1629) and several of his successors invested in the cross-continental silk trade of the Armenians based in New Julfa.

The Ottoman government's opposition to the transferability of enterprise shares, like so many other state policies in Middle Eastern history, are commonly attributed to the economic conservatism of ruling elites. Moreover, conservatism on the part of rulers is often treated as a basic determinant of recorded entrepreneurial deficiencies. The Middle East's loss of economic standing created fertile ground for the spread of economically protectionist ideologies, such as Turkish statism and Arab socialism. Inward-looking secular ideologies have done harm by reducing intellectual and economic competition, thereby discouraging innovation. For its part, in promoting the notion of an inexorable clash of civilizations, Islamism has fostered political uncertainty, which is inimical to investment. It has induced policy makers and business leaders, including secularists, to eschew reforms, such as veritable freedom of the press, that might subject them to charges of impiety. It has also provided pretexts for intellectual suppression and hostility to experimentation. Islam's age-old prohibition of apostasy has compounded the resulting conservatism, above all in countries political regimes draw legitimacy from Islam.

Also, Muslim countries have experienced poor economic performance as an outcome of corrupt economic policies practised by the state. Policies such as excessive state intervention, regulations and an oversized public sector limit the scope of economic activity, hence hindering the emergence and development of a viable indigenous entrepreneurship within the country. Unfortunately, the weaknesses of private sectors and civil societies, which are rooted in the region's institutional history, breed complacency toward autocratic rule. This explains a political system with a low capacity for innovation and experimentation.

Indeed commercial sectors of the pre-modern Middle East were atomistic. Enterprises were usually small and ephemeral. The lack of the corporate form and the persistent simplicity of Islamic partnerships hindered the emergence of Middle Eastern merchant organizations later. And in the absence of fundamental changes in commercial and financial practices, these groups did not get habituated to thinking about new institutional possibilities. Their own contentment with the institutional status quo would have limited the stimuli, inducing statesmen to think about commercial capabilities. Had businessmen been more creative in regard to the structure of commerce, they would have initiated debates on institutional alternatives, forcing statesmen to ponder the desirability of reforms.

7.3.3 FAILURE OF INSTITUTIONAL REFORMS

Modern organizational forms (corporations, banks, etc.) have been transplanted into societies with social norms inimical to their efficient use: relatively high corruption and nepotism, and low trust in organizations. These norms are among the legacies of traditional Islamic law. Only a subset of the institutional complementarities critical to the effectiveness of particular reforms could be borrowed from abroad. Indeed transplanting a legal code, organizational form or business technique is not the same thing as appropriating the social system that produced, refined and sustained it. The performance of a borrowed institution necessarily depends on pre-existing local institutions, including norms and understandings. It depends also on capabilities of the receiving community. Where formal and informal rules conflict, previous experience and tacit knowledge are typically the main influences on entrepreneurial behaviour, and this weakens the formal rules.

Consider the transplant to the Middle East, starting in the 1850s, of commercial courts modelled after those of France. The judges appointed to serve on Turkish and Egyptian commercial courts did not become proficient at applying the French commercial code overnight. If nepotism and judicial corruption have remained rampant, this is partly because at the time of the reforms, state employees were accustomed to personalizing exchanges involving judicial persons. As officials, they dealt with the employees of other organizations as individuals rather than as functionaries representing an organization. It took time to train competent lawyers. Local norms of fairness and liability did not change instantly.

To succeed, formal institutions need to be legitimized through societal norms and values and they also need to be stable over time. In situations where formal rules fail or are absent, institutional trust is low or absent. In contrast, personal trust becomes dominant and substitutes for the deficient formal framework. It is only in situations where formal and informal institutions form a coherent framework that formal regulations and the rule of law will predominate and boost entrepreneurial behaviour. In fragile settings with institutional conflicts, personal trust typically dominates, limiting entrepreneurship. Early-stage transition economies (Smallbone and Welter 2001) are typically characterized by ineffective formal institutions, which go hand-in-hand with weak or absent enforcement mechanisms. In such cases, informal institutions can be either competing or substituting. The former refers to informal institutions coexisting alongside formal institutions, fostering rule-violating entrepreneurial behaviour as entrepreneurs draw on familiar routines and rules to guide their behaviour.

7.3.4 BAD QUALITY OF INSTITUTIONS HINDERS ENTREPRENEURSHIP

Entrepreneurship critically relies on the ability to secure transactional trust. Long term transactions are often untenable because information asymmetry, moral hazard, adverse selection and agency problems undermine transactional trust. Well enforced rules and regulations strengthen transactional trust. Clearly laying out what is acceptable and what is punishable gives transacting parties stronger property rights by letting them more readily detect and punish cheating. So entrepreneurial activity depends on how well entrepreneur's property rights are protected from the grabbing hands of bureaucrats and from established elites with political influence. Constrained governments with smaller budgets and fewer regulatory powers are, therefore, likely to be less corrupt and better at administering an efficient and effective court system. Constraints can stem from a strong constitution, mass media creating social transparency, a well educated populace or plain social culture and values.

'Grabbing hand' governments impose economically inefficient regulations that burden entrants to protect incumbents with political influence or to extort bribes. Overall, empirical work suggests excessive laws and regulations are the more general problem. Entry barriers deter entrepreneurship. An interventionist government imposing burdensome rules and market regulations can stifle incentives to be entrepreneurial. Entry barriers can be subtly imposed by dominant economic powers to lock in the status quo. Entry rates are also higher where regulations are more business-friendly, less burdensome and interfere less with market mechanisms. Entry is also higher in countries with fewer restrictions on foreign capital flow.

Generally, direct government activism favours large established corporations by offering protection from competitors in return for cooperation in implementing

new social policies. Politicians quite understandably find dealing with the controlling owners of a few large corporate groups simpler and more predictable than dealing with the managers of many smaller, independent businesses, which adversely affects entrepreneurship. Government subsidy programs of any sort are tempting targets for political lobbying. These transformations do not require corrupt civil servants, only a degree of self-interest similar to that of everyone else. Direct government interference with market price mechanisms discourages entrepreneurship, which is itself a market mechanism. Entrepreneurship is more evident if the government is more impartial when choosing subsidy recipients and contractors for public contracts.

Entrepreneurship entails inter-temporal exchange — investing time, effort and money now for returns in the distant future. Ill conceived or erratic macroeconomic policies make foreign exchange rates, tax rates, interest rates and inflation rates unnecessarily unpredictable. These risks make promised future payments less valuable to entrepreneurs, their prospective financial backers and technology experts they might otherwise compensate with future claims, like stock options.

Macroeconomic volatility thus discourages entrepreneurship. Financial backing becomes more expensive. Also, such risks impede transactional trust. McMillan and Woodruff (2002) explained that macroeconomic volatility makes it harder to decipher whether or not transaction partners behave honestly. This discourages the long-term contracts and relationships necessary for successful entrepreneurship.

Elites with concentrated corporate control over their economy's large corporate sector also plausibly have capital market power (Morck, Stangeland and Yeung, 2000). In an economy where the control of corporations is concentrated in the hands of a few rich families, entrepreneur supply suffers. In practical terms, this capital market power could arise in several ways. First, weak investor property rights keep small players out of equity markets. The low ambient level of transactional trust raises the cost of equity capital, as only the very wealthy supply capital. Upstarts are negatively affected. Second, rich families could directly own banks, the other major financing alternative. Wealthy families can use their banks to channel capital to the corporations they own. Third, elites can plausibly use their formidable political influence to forestall capital market reforms or even reverse them (Rajan and Zingales, 2004). Their means include directly seeking public office, financing politicians or parties, controlling the mass media, bribing public policy decision makers, etc. (Acemoglu et al. (2004) and Morck, Wolfenzon, Yeung, 2005). Such families also have a direct interest in suppressing technological change that would disrupt the status quo.

7.3.5 INSTITUTIONS AFFECT THE EXTENT AND THE NATURE OF ENTREPRENEURSHIP

In most Muslim countries, entrepreneurship was always present but its quality wasn't very good. That is entrepreneurship in the Muslim world isn't oriented towards the most productive and innovative activities. So this is why entrepreneurship, while present, doesn't contribute efficiently to the development of these countries. Indeed, entrepreneurship is a process of discovery and an exploitation of profit. So in order to discover and exploit the riskier, more innovative and productive opportunities, entrepreneurs should have the appropriate incentives. And the incentives depend on the quality of formal and informal institutions. Following the nature of the formal institutions, entrepreneurship will be directed towards rent seeking, underground activities or productive activities.

In the majority of Muslim countries, weakly specified regulations, combined with inadequate law enforcement, encourage corruption, not only when an entrepreneur is first registering a company, but also in everyday economic transactions. As a result, an inadequate legal framework contributes to forms of enterprise behaviour, which although rational from an individual entrepreneurs point of view, is non-productive from the economy's standpoint, falling into the category of unproductive entrepreneurship (Baumol, 1990). This behaviour is considered unproductive because it diverts resources that could otherwise be put to productive use into dealing with some of the unnecessary costs associated with an institutional context in which the framework conditions for sustainable entrepreneurship have still to be established. Institutional deficiencies lead to mistrust on behalf of the entrepreneur and towards state officials and society more generally (Rose-Ackerman, 2001; Tonoyan, 2005). This can lead to a potentially vicious circle of mistrust fostering further evasion behaviour of entrepreneurs, which in turn fosters further mistrust and corruption practices.

Heavy and misguided regulations combined with a prohibitive tax level and inadequate access to external capital encourage entrepreneurs to use evasion strategies (Feige, 1997; Leitzel, 1997). These 'evasion' strategies allow private entrepreneurship to exist and survive in an environment where government typically considers private businesses to be mainly a source of tax revenue and where inadequate public law enforcement leads to arbitrariness and corruption. 'Typical' evasion strategies include combining legal and informal production, setting up a 'fictitious' enterprise, and making cash payments to employees. For example, evidence drawn from a study of employment behaviour in Russian small businesses indicates a predominance of unofficial payment strategies to workers in order to reduce social security contributions (Welter and Smallbone, 2003).

In Muslim countries, formal institutions provide incentives for entrepreneurs to ignore and thus avoid the formal institutional framework. This is because the formal legal system reduces the value of the gains from exchange and thus drives individuals out of formal arrangements. Most commonly this corresponds to situations where taxation and regulation are high or where legislation is unstable and doesn't provide the necessary certainty for exchange and investment to take place (property rights, thus understood, are weak or uncertain). Evasive entrepreneurship is costly to society since entrepreneurs, as they go underground to continue exploiting socially productive opportunities, must allocate resources to avoid the formal system. Entrepreneurs who are alert to business opportunities must often pay officials bribes to obtain the appropriate permits, licenses and authorizations. They can also choose to evade formal institutions when doing business, and this situation has created an informal sector.

If formal institutions are not stable and/or can be manipulated to one's gain, they create incentives to engage in the exploitation of the formal rules by predating over those who engage in socially productive activities. Rent-seeking (i.e. obtaining revenues through activities that are protected by legislation and at the expense of consumers and taxpayers) and theft are the most common examples. This is costly to society because, on the one hand, entrepreneurs allocate resources to avoid the formal system that could have been used for productive activities, and, on the other, the enforcement costs of formal institutions are much higher than they need to be.

7.3 CONCLUSION

The above analysis suggests that Islam isn't inherently inimical to entrepreneurship. Besides that, some beliefs, values and practices observed in Muslim societies that appear inimical to growth (e.g., the ban on interest and restrictions on speculation) are routinely circumvented. The corporation is now an acceptable and popular organizational form in most Muslim countries. Insurance contracts are legally enforceable. Banks are integral components in every Muslim country's economy. And contracts involving interest payments are commonplace, although payments are sometimes disguised as commissions or fees. It seems clear that the economic institutions Islamic law prevented — corporate law, banks, stock markets, modern firms, insurance — are all integral parts of most economies of the Muslim world. Moreover, entrepreneurship spirit is very present in Muslim countries. So what is generally missing in the majority of Islamic countries is the right institutional context for entrepreneurship to take place and to be socially beneficial.

Indeed, entrepreneurship is a process of discovery and exploitation of profit. So in order to discover and exploit the riskier, more innovative and productive opportunities, entrepreneurs should have the appropriate incentives. And the incentives depend on the quality of formal and informal institutions. Following the nature of the formal institutions, entrepreneurship will be directed towards rent seeking, underground activities or productive activities.

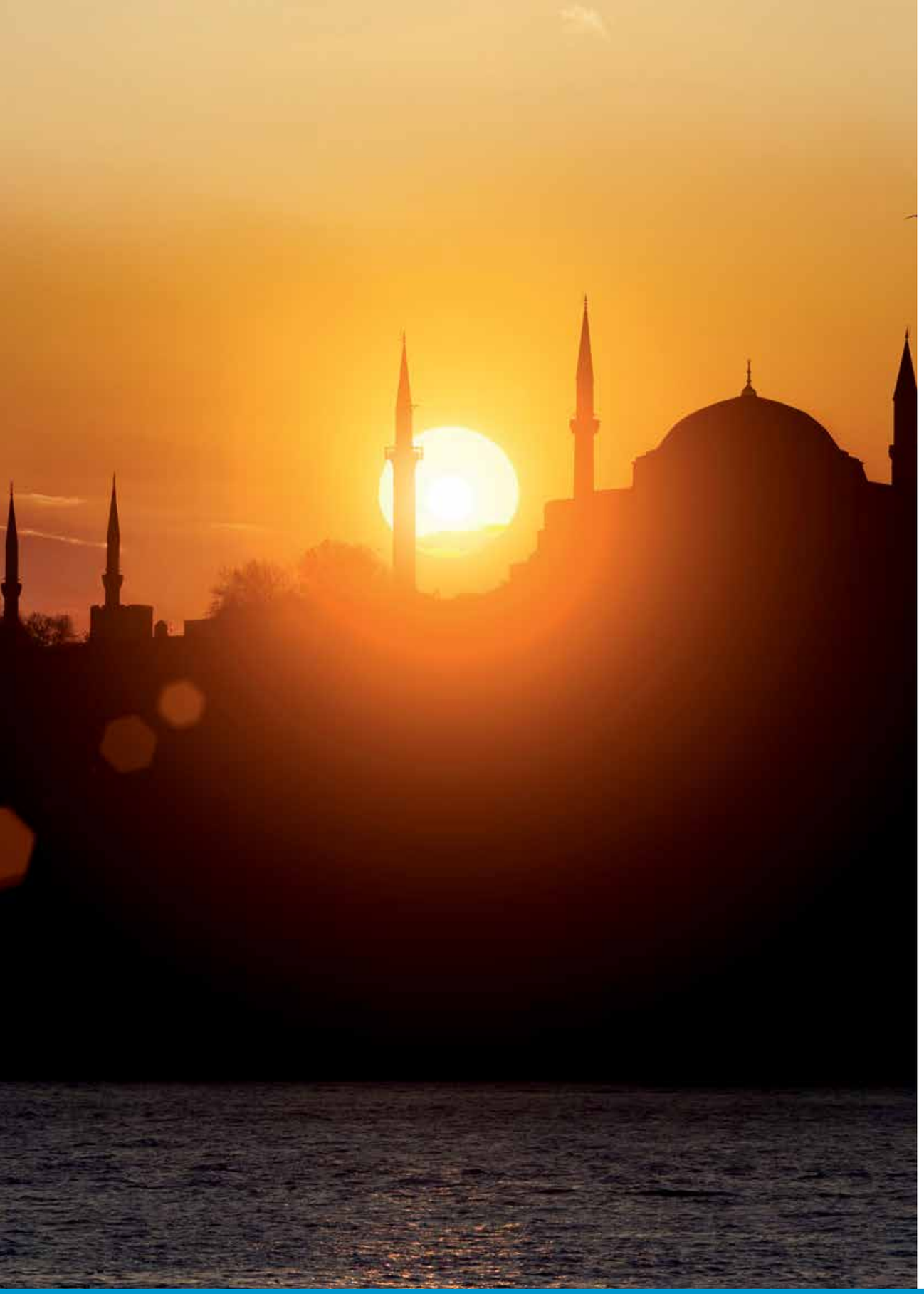
The overall implication of our analysis is that instead of condemning Islam for it's alleged hostility to entrepreneurship, we should revive the spirit, values and some healthy practices of the classical Islam favourable to entrepreneurship. Muslim governments should enhance the quality of their institutions by implementing reforms that respect the compatibility between formal and informal institutions and create appropriate incentives to take risks and innovate. As the problem with most Muslim countries is not that entrepreneurial activity is missing but that it is misdirected into socially destructive activities,

effective policy should always aim at making unproductive activities more costly to engage in than productive activities. The overarching idea is that the goal of economic policy must be to change the relative payoffs society offers to entrepreneurs in order to foster productive entrepreneurship.

Nowadays in Muslim countries we have two kinds of entrepreneurs: homo-traditionalus (traditional businessman) and homo-economicus. Traditional businessman is a man of small needs and means. He owns a small shop or workshop, and mainly relies on family labour along with, may be, two or three wage labourers. He is highly pious in his religious orientation and avoids the institutions of modern capitalism.

Homo-economicus entrepreneur is a rational, calculating, self-maximizing, utilitarian businessman. He is said to be devoid of any morality other than his greed, materialism, egoism and love of wealth for the sake of wealth. Homo-economicus is the polar opposite of esnaf or homo-traditionalus. Unlike homo-traditionalus, he is highly motivated and ambitious in his pursuit of wealth, but he is short of moral and ethical values. He has entrepreneurial spirit, but lacks virtue. He is regarded as a rent-seeker, profiting from speculative rather than productive activities. Under the state's protection, they monopolize the domestic economy, but they lack competitive spirit, innovativeness and efficiency. However, like homo-economicus, they are economically powerful as well as wealthy with no dint of religious morality and social responsibility.

Muslim countries need to develop the emergence of a new race of entrepreneurs. Unlike homo-economicus and homo-traditionalus, this new entrepreneur is said to be both entrepreneurial and moral. He defines his existence by combining private and public life and religious and economic activities through his Islamic ethical values and norms. He does not eschew economic activity and retreat to other-worldly asceticism because of his religion. Nor does he make concessions with regard to his religion and morals for his business activity. He is competitive, productive and innovative, rather than a rent-seeking and speculative. He thinks that being economically successful is a duty of any and every Muslim, as Islam condemns idleness, laziness and encourages hard work and resourcefulness. He is the ideal persona who will bring genuine economic and technological development while being just and fair towards others as dictated by his religion. •



8

WHY ARE FREE-MARKET ECONOMIES WEAK IN THE ISLAMIC WORLD?

by Hicham El Moussaoui

8.1 INTRODUCTION

Trust is the lubricant of trade. It reduces the costs of transactions and uncertainty, which allows it to provide a dual mission: the incentive for individuals to participate in the exchange and coordination of their individual plans. Therefore, without trust there would be no exchange and without exchange no market economy. Adam Smith (1776) argued that wealth was built on the division of labor. He gave the famous example of the pin factory, but the pin factory could achieve nothing if the workers cannot trust each other. Trust matters!

Economists distinguish between the personal, specific trust that comes from being friendly with your neighbours and the impersonal, institutionalized trust that lets you give your credit card number out over the internet. The two kinds of trust are correlated with each other because we are more willing to trust people if we feel that, ultimately, we can call the police or get a fair hearing in court.

In the Islamic world today, the market economy has hardly taken root or consolidated, which explains the nature of rentier economies in the Muslim world where rent-seeking behavior pushes out productive behavior. This fact explains the lag in the development of Muslim countries despite achieving high growth rates.

The majority of countries that have managed the transition from a rentier economy to a market economy have managed it through the institutionalization and the extending of social trust among all stakeholders (trust each other, trust state, trust corporations). Unfortunately, all this is still lacking in Muslim societies and explains the difficulty of their transition to a market economy. In the Muslim world trust still remains limited to the confines of one's personal circle, family, tribe or ethnicity. This limitation of the extent of trust in society greatly restricts the opportunities for exchanges, partnerships and cooperation between members of the Muslim society. But to grow a market economy needs to expand its circle of trade beyond family and close acquaintances. It's a network of impersonal exchange, and it's sometimes anonymous. Such a network can't develop without individuals having trust beyond their blood ties.

In this paper, I will show first how the absence or at least the lack of institutionalized trust explains the absence or the weakness of a market economy in

Muslim countries. Then I will highlight the factors behind this lack of institutionalized trust in Muslim societies, which blocks the market economy. Finally, I'll explain how economic freedom could be a strategy to pass from the personalized trust to the institutionalized trust and allow the consolidation of the market economy in Muslim countries.

8.2 MARKET ECONOMY AS A NETWORK OF IMPERSONAL EXCHANGES

A market economy isn't hamperned only by the interference of state but also by the limitation of exchange opportunities to personal circles.

Opportunities for economic development depend on exchange opportunities. These could be personal or impersonal. Personal exchange is limited to a circle of relatives, kinship relations, friends, colleagues, and it's often iterative. In contrast, impersonal exchange extends to strangers,
and it is anonymous and it's usually a single transaction. But development opportunities are greater when trade is impersonal instead of limited to known people.

Economic historians have emphasized the impersonal nature of markets and the opportunities for speculation and arbitrage that they afford. Indeed by observing the history of the development of markets, North (1987) argued that personal exchange was appropriate only for the modest level of medieval trade, but as the volume of trade expanded, exchange networks became more dense and complex enabling more specialization and division of labour. The densification and the deepening of exchange networks enable more specialization and a more sophisticated division of labour. So there is more partnership and association to create business. This in return creates more opportunities to exchange and so on.

While personal exchange dominates economic transactions in subsistence economies and still characterises reproduction and the household economy (but also many small-scale crafts and trades), in market economies, due to the complexity of exchange networks and the division of labor, individuals enter into a transaction with only limited information about the counterpart's specific attributes, which is an impersonal exchange.

Such a process of impersonal exchange can't develop without individuals having confidence beyond their blood ties. It can't develop without trust in strangers. Indeed, as market activity grows, there are more opportunities of exchange and profit, but the amount of information that has to be collated and processed increases transaction costs. This implies that to benefit from this new opportunity, it's necessary to move towards more efficient forms of exchange organisation.

In other words, to grow a market economy needs to expand its circle of trade beyond family and close acquaintances. It is a network of impersonal exchange, and it's sometimes anonymous.

8.2.1 WHAT IS TRUST ?

Generally speaking, trust refers to the confidence that people have in others that they will act as we might expect. Hence, as Gambetta (2000) stated, it reflects the subjective probability with which a person (or a group) assesses that another person (or a group) will perform a particular action. Sarageldin and Dasgupta (2001) described trust as **'the expectation of one person about the action of others'.** We distinguish two big categories of trust: interpersonal and institutional.

- **Interpersonal trust:** concerns the trust about persons. We could divide it in two categories: specific trust directed to relatives or friends and generalized trust relative to strangers.

Specific trust, or as Putnam (1993b) named it **thick trust,** is based on experiences embedded in personal roots and relationships, and it is generated by networks of kin and friends (specific individuals). It's very strong and identity-embedded and evolves when individuals repeatedly interact and so build reputations. Conversely, when A and B are people who do not know each other, there is **thin trust** or generalized trust, which results from values, attitudes or social norms that produce trust when certain conditions are met. This form of trust describes a wider radius and is not limited to a relationship between specific individuals.

- **Institutional trust:** can be characterized as depersonalized trust in relation to officially established rules, norms and principles. It denotes trust in institutions (where institutions, for example the law, are the object of trust).

  Institutional trust is not the result of an attitude to contracts, laws and organizations, but to persons responsible for the implementation of appropriate policies. For example, political trust includes trust in the political system and its institutions and trust in the personnel in charge of these institutions

So system-based institutional trust reflects the degree in which individuals have confidence in the institutions. While actors-based institutional trust reflects the confidence of people responsible for implementing institutional policies and running organisations.

8.2.2 WHY TRUST MATTERS FOR MARKET ECONOMY?

The market itself is a product of the mutual trust of its participants because the market cannot exist in such conditions where everyone would deceive each other. Trust is necessary for a market economy because it performs the following:

- encourages an intensive exchange of information which facilitates coordination and cooperation.
- reduces transaction costs associated with formal coordination mechanisms like contracts, hierarchies, bureaucratic rules and the like. It is of course possible to achieve coordinated action among a group of people possessing no social capital, but this would presumably entail additional transaction costs of monitoring, negotiating, litigating and enforcing formal agreements. No contract can possibly specify every contingency that may arise between the parties; most presuppose a certain amount of good will that prevents the parties from taking advantage of unforeseen loop-holes.

Contracts that do seek to try to specify all contingencies — like the job-control labor pacts negotiated in the auto industry that were as thick as telephone books — end up being very inflexible and costly to enforce. Trust reduces the need for controls and monitoring to safeguard abidance by transactional agreements.

- reducing uncertainly and risks associated with opportunistic behaviour. An asymmetry in the available information leads to an adverse selection as a form of pre-contractual opportunism, based on which some seller may achieve a short-term benefit. This will force the less informed party to spend costly resources in gathering information about the trustworthiness of the other party or to draw up of a more detailed purchase contract, which would specify the parameters of the quality of goods and the obligations of the seller in case the goods sold do not match the specified parameters. This option involves additional transaction costs, incurred both by preparing such a contract and forcing the retailer to meet its obligations, which further burdens the business transaction. Developing trust enables people to economize all these resources and spend and reallocate them for more valuable uses.

Institutional-based trust deserves more attention than interpersonal trust because:

- Many transactions aren't repetitive. So we can't rely on reputation-based trust to facilitate exchange.
- We can hardly rely on interaction-based forms of trust creation alone. The latter requires repeated face-to-face contacts and is thus usually very time-consuming and — economically speaking — not always very efficient. Too often transactions would simply not take place if strong but time-consuming forms of interaction-based trust developed in long-winded face-to-face interactions were always needed before any exchange is considered. In contrast, where institutional trust exists, both parties refer to institutional safeguards in their decisions and actions and can thus develop trust without having any prior personal experience in dealing with one another.
- Institutional trust could bring interpersonal trust: Trusting someone builds on a decision which is based on an assessment of the other party's competence, integrity and benevolence (Currall, 1992; Sako, 1992; Mayer et al., 1995), as well as a rough and quick semi-conscious assessment of the unrecoverable costs that would occur if the other party turned out to be untrustworthy (Bachmann, 2001). In the case that the trustor and the trustee do not know each other, a third actor known to and trusted

> by the first two actors may function as a 'third-party guarantor' and thus play an essential role in trust development (Coleman, 1990; Shapiro, 1987). The third-party guarantor does his or her job in that he or she provides an overlap of both parties', i.e. the trustor's and the trustee's, explicit and tacit knowledge domains, and allows for judgments on part of the (potential) trustor that would not be possible otherwise.

Within the concept of institutional-based trust, institutions can be reconstructed as being functionally equivalent to a personal third party guarantor (Bachmann and Zaheer, 2008). Zucker (1986) has shown in her historical studies in the US-American socio-economic system of the 19th and early 20th centuries that institutional forms of behavioural coordination and control, such as institutional-based trust, are essential if the function of trust in inter-organizational relationships in differentiated modern business systems is to be understood.

8.3 IS ISLAMIC LAW RESPONSABLE FOR MARKET ECONOMY WEAKNESS IN ISLAMIC WORLD?

Timur Kuran (2010) claims that while Islam is neither inherently conservative nor hostile to commerce, institutions (inheritance systems, polygamy, specific partnership rules, absence of the concept of legal person, rigid **waqf** provisions) that emerged during the first two centuries of Islam retarded the development of impersonal, as opposed to personal exchange, weakening the market economy.

8.3.1 PARTNERSHIP RULES

In an Islamic partnership, any individual partner could end the relationship at will, and even the most successful ventures were terminated on the death of a partner. As a result of these rules, most businesses tended to be small and short-lived. Theses rules offered little protection to investors and could not be scaled-up to exploit economies of size and scope. These shortcomings meant that Islamic partnerships were unable to sustain long-lasting or large-scale trading ventures. These limitations were largely irrelevant in the Middle Ages and only became binding during the early modern period once opportunities for longer distance and larger-scale trade emerged. Moreover, Islamic partnership lacked entity shielding that active partners carried full liability. Any partner could force its dissolution unilaterally, and its assets were exposed to demands from third parties. The partnership termination rule, like the lack of entity shielding, discouraged the formation of large and long-lived partnerships.

8.3.2 INHERITANCE RULES AND MARRIAGE REGULATIONS

Customs also hindered business consolidation by enabling the fragmentation of wealth. The Quran dictated that when a Muslim merchant died, at least two-thirds of his estate had to be split among surviving family members. This egalitarian stipulation helped prevent Islamic societies from accumulating capital and evolving into European-style feudal systems. But it further stymied the creation of long-lasting, capital-intensive companies.

> The resulting organizational stagnation then prevented the Middle East's mercantile community from remaining competitive with its Western counterpart,

Kuran writes. Moreover, in allowing polygamy, Islam compounded the incentives to keep partnerships atomistic and ephemeral because merchants with more than one wife tended to have more heirs. The business empires of the most successful merchants rarely survived them because their estates were divided into too many pieces to make recombination practical.

8.3.3 WAQF RIGIDITY

The waqf wasn't taxed. So it becomes a credible vehicle for sheltering wealth against arbitrary taxation and expropriation. Not surprisingly, vast resources flowed into **waqfs.** In establishing them, successful merchants transferred wealth from a sector in which resources could be deployed flexibly to one in which uses were essentially fixed, depressing the already low demand for more advanced forms of commercial organization. Kuran develops a parallel argument to show why waqfs — unincorporated trusts which allowed investors to fund mosques and schools — did not evolve into corporations as European universities did. Waqf impeded the development of market economy because many services provided through these charities would have been provided by corporations. Also, the inflexibility of **waqfs** became an obvious handicap only with industrialization, whose new technologies created a need for reallocating vast resources quickly.

If we should agree with Kuran explanation, that is the non adaptation of Islamic institutions is an obstacle to the consolidation of market economy, why the latter remains weak in Islamic world despite reforms of the 19th and 20th centuries which allowed Muslims to borrow from banks, to invest in stock markets, to establish corporations.

As argued before, the market economy relies on the development of impersonal exchange. This one depends on the spreading of institutional trust. Consequently, if people don't trust institutions' underlying market economy, they can't trust strangers. And if they don't trust strangers, exchange will remain limited to the personal sphere and the market economy will become weak. Thus, if a market economy is weak in Islamic world the reason is that Muslim people don't trust dysfunctional institutions even when they appear pro-market.

8.4 ALTERNATIVE EXPLANATION OF THIS WEAKNESS...

Similar to a **personal guarantor** in the case of interaction-based trust, institutions help to establish a 'world-in- common' (Bachmann and Zaheer, 2008), i.e. shared explicit and tacit knowledge between the trustor and the trustee. In these circumstances, an individual or collective actor finds good reasons to trust another actor, individual or collective, because institutional arrangements are, like a personal third party guarantor, capable of **reducing** — which is not the same as eliminating! — the risk that a trustee will behave untrustworthily, allowing the trustor to actually make a leap of faith and invest trust in a relationship. Institutions enable pooling the risks of being cheated through formal and informal arrangements, extended families and community responsibility. All these mechanisms allow reduce the size of the material threat should cheating occur. Moreover, institutional arrangements create familiarity and can lead to the suspension of critical questions about the actual trustworthiness of trustees.

Consequently, the high is the quality of institutions and the trust of people in theses institutions, so the institutional trust is stronger. Institutional trust is established more completely in such an environment where the institutions function efficiently and fairly.

As argued before, market economies rely on the development of impersonal exchange. This one depends on the spreading of institutional trust. Consequently, if people don't trust institutions that underlie the market economy, they can't trust strangers. And if they don't trust strangers, exchange will remain limited to the personal sphere and the market economy will weaken. Thus, if a market economy is weak in the Islamic world, the reason is that Muslim people don't trust dysfunctional institutions even they appear to be pro-market. So the relevant question is why Muslim people don't trust enough of these institutions?

8.4.1 UNSUCCESSFUL IMPLEMENTATION OF PRO-MARKET INSTITUTIONS

The reason why Muslim people have no confidence in pro-market institutions is that they are dysfunctional because their transplantation wasn't successful. This has hampered the development of institutional trust necessary to impersonal exchange.

LACK OF COMPLEMENTARY INSTITUTIONS

Indeed a market economy couldn't take place strongly without a set of complementary rules. It's insufficient to import only the corporation template or modern banks in hopes of consolidating the market economy. The latter needs also other institutions like the rule of law, free contracts, free prices and free competition.

For example, the importation of French civil law into the Ottoman Empire was hampered by the absence of appropriate preconditions. The judges appointed to serve on specialized commercial courts lacked proficiency because centuries of organizational stagnation removed the need for judges equipped with more sophisticated skills. No modern law schools existed because commerce remained largely personal, and training in Islamic law remained adequate to handle the disputes that commonly arose among people doing business under traditional Islamic institutions. It took time to train competent lawyers; local norms of fairness and liability did not change instantly. Nepotism and judicial corruption have remained rampant in part because at the time of the reforms, state employees were not accustomed to arm's-length transactions.

Probably the most important determinant of the emergence and sustainability of extended trust is the

availability of complementary contract enforcement from the state. Zak and Knack (1998) establish a close statistical relationship between their measure of (extended) trust and the quality of formal institutions (the protection of property rights, the enforceability of contracts, the extent of bribery and an index of investors' rights).

However, government officials have few incentives to provide efficient third-party enforcement because they remain members in 'old boys' networks preserved for the purpose of rent-seeking. The lack of incentives for government officials to provide efficient contract enforcement — and admittedly the limited capacity of the state due to absent legal and administrative skills — find their corollary in persistently low levels of trust in public institutions.

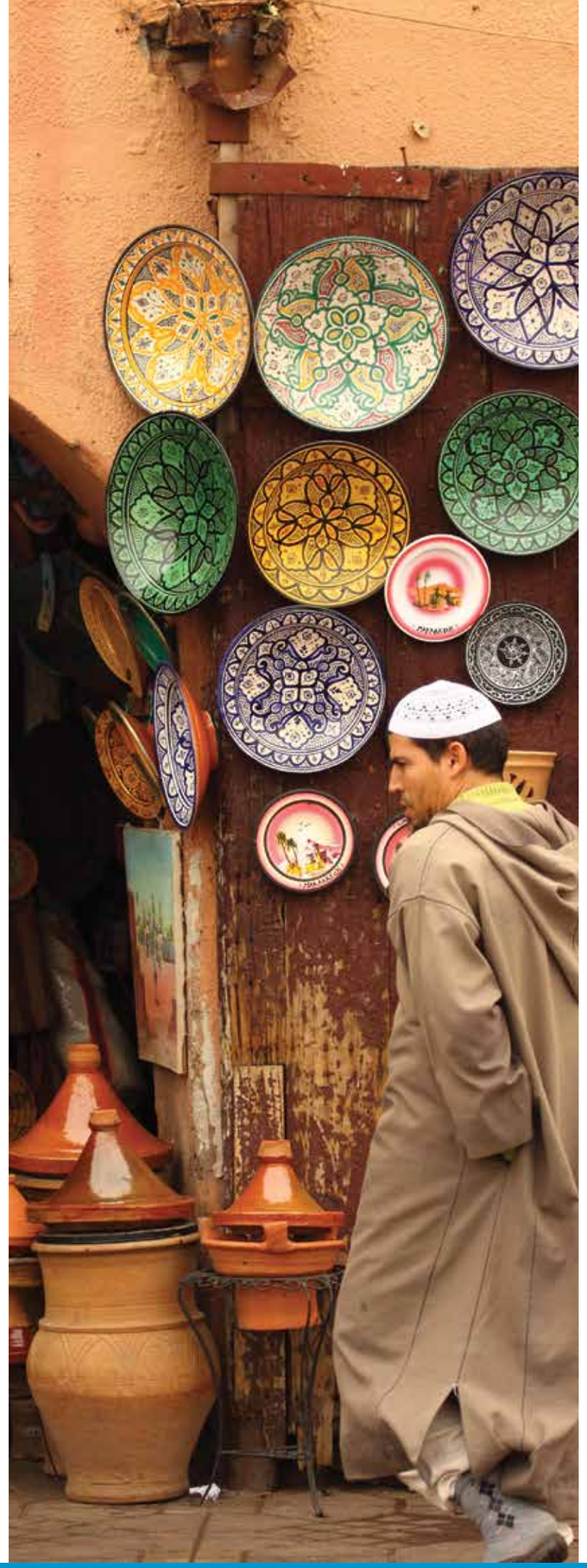
DEFICIT OF CULTURAL APPROPRIATING

Only a subset of the institutions needed could be borrowed from abroad. Indeed, transplanting a legal code, organizational form or business technique is not the same thing as appropriating the social system that produced, refined and sustained it. The performance of a borrowed institution necessarily depends on pre-existing local institutions and depends on the capacity of the recipient community to adapt.

The Genoan merchants outpaced the Maghrebis, Greif (2005) argues, because they invented various corporate institutions that formed the core of capitalism, including banks, bills of exchange and joint-stock companies, which allowed them to accumulate enough capital to launch riskier but more profitable ventures. These institutions, in Greif's (1994b) account, were an outgrowth of the Genoans' Western culture, in which people were bound not just by blood but also by contracts, including the fundamental contract of marriage. The Maghrebis' Arab values, by contrast, meant undertaking nothing outside the family and tribe, which limited commercial expeditions' resources and their reach. The bonds of blood couldn't compete with fair, reliable institutions.

WEAKNESS OF CIVIL SOCIETY

States can have a serious negative impact on social capital when they start to undertake activities that are better left to the private sector or to civil society. The ability to cooperate is based on habit and practice; if the state gets into the business of organizing



everything, people will become dependent on it and lose their spontaneous ability to work with one another, limiting the development and undermining all forms of horizontal association in favor of vertical ties between party-state and individual (Putnam, 2000). This would limit opportunities to cooperate between strangers and to enhance generalised trust level in Muslim societies.

For example, France had a rich civil society at the end of the Middle Ages, but generalized trust between individuals weakened as a result of a centralized state that set Frenchmen at each other through a system of petty privileges and status distinctions. The same thing occurred in the former Soviet Union after the Bolshevik Revolution, where the Communist Party consciously sought to undermine all forms of horizontal association in favour of vertical ties between party-state and individual. This has left post-Soviet society bereft of both trust and a durable civil society (Putnam, 1993b).

The weakness of civil society further limited the ability of indigenous firms or banks to emerge in the early modern period (see also Balla and Johnson, 2009). This weakness persisted, even after western legal institutions were adopted. Indeed, the Middle East began to modernize without a strong civil society in place, which made it easier for states to take the lead in the development of sectors that might otherwise have advanced through decentralised private initiatives. The top-down development programs prevalent in the region have been criticized for limiting private enterprise through over- regulation and misregulation.

8.4.2 BAD POLICIES AND PREDATORY GOVERNANCE

Besides the legacy of colonialism, generalised trust necessary for impersonal exchange and a market economy was hindered by the policy choices of decolonised Muslim countries.

SOCIALISM AND CENTRALISM

Independence took place at a time when the Soviet Union was influential and many believed that centrally planned socialism was a shortcut to power and prosperity. Arab governments thus found it tempting to confiscate private property, eradicate the existing bourgeoisie and create massive state monopolies in resources like copper, oil and phosphate. In the name of national independence and economic modernization, all the wealth could be concentrated in the hands of the ruling militaries and bureaucracies. In other words, Muslim governments chose to consolidate the planned economy instead of the market economy.

Moreover, centralism has fostered personal exchange at the expense of impersonal exchange. Indeed the centralised nature of resource allocation did not require decentralised contracting between parties for a transaction (Greif and Kandel, 1994). Contracts were made between the planning agency and producers. Monitoring problems were acute and enterprises effectively suffered little sanction from contract under-fulfilment — they operated under soft budgets and soft contracts. Because the reliability of supplies under the planning system was low, enterprises were effectively forced to seek necessary inputs informally. Hence, central planning leads to the emergence of informal networks between enterprises — often using specific contact persons —based on repeated interactions (Martin, 1999).

Bureaucratic coordination furthermore led to extensive bargaining, in which personal connections to government officials were a crucial asset. Central planning relied extensively on specific trust and not generalised trust, with enterprises, local and national government officials closely linked through informal networks. Following Putnam (1993b), it could be argued that social capital was low under central planning. The scope for social interaction, which would have allowed extended trust to emerge and to be reproduced, was limited. Business networks based on ties often remained closed to outsiders, hindering generalised trust.

BAD AND PREDATORY GOVERNANCE

Predatory and poor governance reduces trust in public officials and institutions. In 1382, much of the Middle East came under the jarring rule of the Circassian Mamluks, who hailed from the Caucasus and treated their subjects as cash cows. 'They not only continued the traditional exploitation of the peasantry, but also introduced extortionate taxes and forced sales on industrial production and commerce,' Ronald Findlay and Kevin H. O'Rourke write in Power and Plenty (2007), leading to the decline of production and trade.

Halil Inalcik (1970) explains that the Ottoman rulers, being interested first and foremost in keeping their power, put a premium on economic stability. Accordingly, the enforced prices controls, regulated investments and exports, established charitable foundations and kept the burden of taxation largely on the countryside. This system was productive in the conquest of similar territories, but it proved a serious handicap in developing market economy.

Bad policies and governance led to the exacerbation of land and income inequalities. Zak and Knack (1998) for instance present cross-country evidence that the extent of trust between anonymous individuals (derived from the World Values Survey) is positively related to measures of social distance (income and land inequality and ethnolinguistic fractionalisation).

Institutional trust is closely related to perceptions of corruption. Political corruption — the misuse of public office for private gain — is one of the most important factors contributing to lower institutional trust in both the developed and the developing world (Blind, 2006). Institutional trust can be destroyed by corruption (either real or perceived), which casts a shadow on the transparency of institutions. So, countries with a high level of perceived corruption (like the Slovak Republic, Poland, Hungary, Korea and Italy) have below-average levels of trust in institutions, while countries scoring a low level of perceived corruption (like Norway, Denmark and Finland) have much higher levels of institutional trust.

RENT-SEEKING AND CRONYSM

Berry (1989) gives a convincing illustration of how redistributional rent-seeking both within and between groups leads to inbred stagnation. She emphasizes the role of social institutions (social norms) regarding access to productive resources for the strategies of resource use. During the transition from traditional tribal society through colonial rule and independence, cost saving 'indirect rule' by the colonial authorities to a large extent led to the survival of traditional kinship and community-based polities, and their extension into higher levels of governance. As a result, both in productive enterprise and state governance, access to resources still depends heavily on strong community-based social relations, that is exchange is still personal and trust specific. This has prevented the development of generalised trust beyond blood and kinship ties.

Moreover, the discovery of oil and natural gas in many Islamic countires lead to the emergence of a rentier economy contrary to the market economy. In an economy when interactions become locked in a social structure characterized by parochial vested interests and patrimonial channels of access to resources, the political and economic sphere will be dominated by nepotist rent-seeking. Fukuyama (1995) and Knack and Keefer (1997) identify patronage and rent-seeking with low generalised trust.

After the fall of the Soviet Union showed socialism to be far less efficient than the free market, Muslim governments began to free up markets somewhat, but without surrendering their tyrannical authority. This resulted in an Arab crony capitalism, which is now the dominant economic arrangement in the Muslim Middle East. In today's pseudo Arab market economies, it makes little sense to be an independent entrepreneur. If you want to open a business, you'll need a license, and the only surefire way to obtain it is to belong to (or be close to) someone in the ruling elite; even then, you'll share your profits with the bureaucrats. It's far easier to seek a rent based on your position in society. Rent-seeking is particularly prevalent in countries overflowing with natural resources like oil and gas, which bring in massive revenues that reduce the incentive to diversify the economy.

Egypt exemplifies the crony-capitalist model. During the 1990s, corrupt privatizations transferred state monopolies in energy, steel, cement and other industries to private entrepreneurs most of whom were members of President Hosni Mubarak's family, top military officers and other well-connected people. Meanwhile, economist Hernando de Soto has calculated, opening a modest bakery in Cairo required two years of slogging through the bureaucracy, at each stage of which the would-be owner would need to grease official palms — and if his bakery finally opened, he would then have to pay ongoing protection money to the local police. It's no small wonder Egypt suffers from slow growth, massive unemployment and a large black market.

FAKE REFORMS

Muslim governments had tried to implement some reforms to foster free-market economy, especially privatizations. But these reforms had failed leading Muslim people to distrust the market economy. Indeed, inadequate communication, lack of transparency, absence of institutional perquisites and corruption during the mass privatization resulted in the absence of an efficient system of property rights, increasing trust in the institution of private property instead; a completely opposite situation occurred, which undermined trust in competent institutions, especially the judiciary ones. The absence of effective mechanisms for the protection of property rights and contractual liabilities increases the risk on the capital market, leading to paralysis of investments and innovations. This blocked the emergence of new entrepreneurs to stimulate the market economy. Moreover, highly skewed privatisation policies could increase social distance considerably and undermine the basis for the development of extended trust. Increased income inequality in the context of reduced income overall also increases economic risks for individuals on the lower end of the wealth scale. Higher risks will tend to fortify reliance on closed social networks at the cost of lower extended trust.

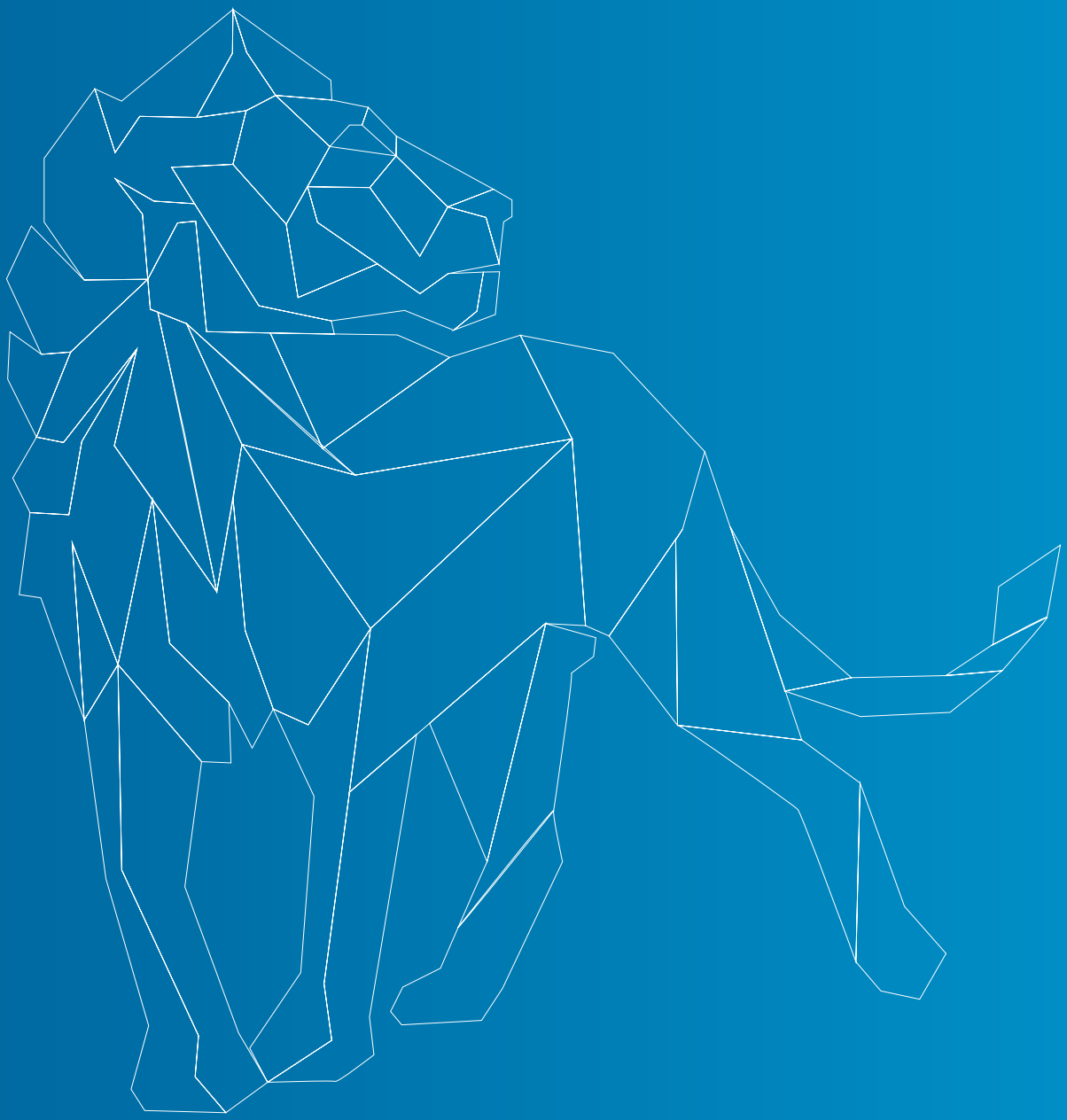
8.5 CONCLUSION

How do we strengthen market economies in the Islamic world? A market economy is an economy where decisions regarding resource allocation, production, consumption, price levels and competition are made by the decentralised actions of household and firms seeking their own interests. In other words, a market economy runs thanks to the autonomous coordination of people. In order for this decentralised system to function efficiently, participants should be free to make their decisions and coordinate their plans. In other words, people should be free to consume, to produce, to invest, to contract, to exchange with others. A market economy needs economic freedom.

Unfortunately, in Muslim countries, people haven't the freedom to choose their goods and services because economic planification and public monopolies. They haven't the freedom to produce and invest because of heavy taxation and complex and excessive regulations. They haven't the freedom to exchange because protectionism. Definitively, the weakness of market economy in Muslim countries is the symptom of deficit of economic freedom. Consequently, to strengthen a market economy in Islamic world, we should enhance economic freedom in these countries by:

- Limiting the size of the state will allow citizens to develop trust in the state, which will facilitate popular mobilization and cooperation with government, particularly when structural reforms are at stake. On the other hand, the withdrawal of the state from economic sphere will enable individuals and firms to develop cooperation and horizontal ties necessary to foster trust between closed communities. There are, of course, good reasons why countries should restrict the size of their state sectors for economic reasons. On top of this, one can add a cultural motive of preserving a sphere for individual action and initiative in building civil associations.
- Consolidating the rule of law, protecting property rights and enforcing contracts are very important to generate trust between individuals. Because it reduces the risk of cheating, conveying information about the trustworthiness of the other partner allows the truster to reduce the cost to be cheated. This aim passes through the effective independence of justice, rationalisation of laws, decentralised judiciary apparatus, specialisation in commercial and business of law and judges training.
- Fostering competition to guarantee the principle of chances equality between all the participants of market transactions. Every individual or firm gets a fair chance to succeed. The perceived fairness of the market process will lead producers to invest because the rules of the game will be the same for everybody and consumers also will be confident that they pay the fair price without undergoing anti-trust practices. To have open competition we need to liberalize markets, implement anti-trust regulations, abolish public monopolies, relax output and inputs market regulations to remove barriers to new entrants and enhance business climate to guarantee no discrimination between entrepreneurs.

The secret of Western countries in succeeding to develop free-market economies is their ability to institutionalise trust. Muslim countries should follow the same way and enhance the quality of their institutional capital by promoting economic freedom. •



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