

# ISLAMIC PERSPECTIVES ON MARKET PRICES AND ALLOCATION

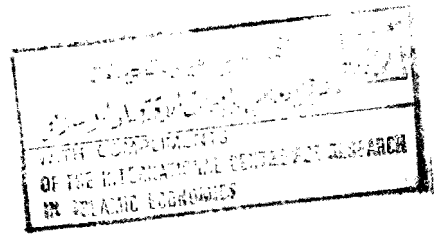
MUHAMMAD ABDUL MANNAN

338.520881761 ✓

ABD



International Centre for Research in Islamic Economics  
King Abdulaziz University, Jeddah, Saudi Arabia.



# **ISLAMIC PERSPECTIVES ON MARKET PRICES AND ALLOCATION**

**MUHAMMAD ABDUL MANNAN**

**INTERNATIONAL CENTRE FOR RESEARCH IN ISLAMIC ECONOMICS**

King Abdulaziz University, Jeddah, Saudi Arabia.

1402H – 1982

Research Series in English No. 11

© All rights reserved.

Views expressed by the author represent his personal views and do not necessarily represent the views of the International Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah, Saudi Arabia.

Produced by

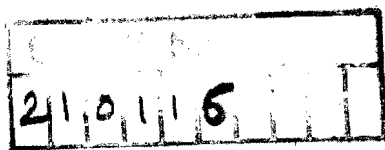
**The International Centre for Research in Islamic Economics.**

King Abdulaziz University, P.O. Box 1540,  
Jeddah, Saudi Arabia.

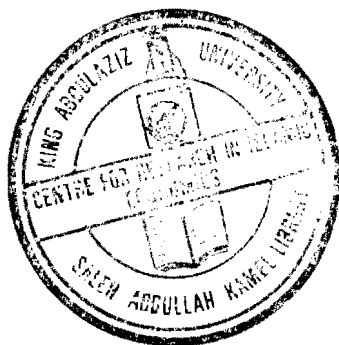
338.520881761

ABD

000434



291



Printed at  
King Abdulaziz University Press,  
Jeddah.

## CONTENTS

	Page
i Centre's General Introduction	v
ii Abstract	vi
1. Setting of the problem and objectives.	1
2. Underlying assumptions.	3
3. Need-versus-Demand.	5
4. Islamic approach to market prices.	6
4.1 Consumer's Surplus.	
4.2 Producer's Surplus.	
4.3 Inequitable distribution of income and the market mechanism.	
5. Towards understanding of Islamic theory of effective-need-based demand and potential-capacity-based supply.	15
6. The elasticity of need-based demand and capacity based supply.	20
7. Three policy options.	23
8. Policy implications and Islamic alternatives.	24
8.1 Non-price-rationing with market mechanism.	
8.2 Zero price through 'n' pricing.	
8.3 Socialisation of pricing policy.	
8.4 Guided co-operative prices.	
8.5 Nationalisation of prices.	
9. Concluding observations.	29
10. References.	30

## CENTRE'S GENERAL INTRODUCTION

The Centre's Research Series in Arabic and English are intended to elucidate ideas, clarify issues to broaden our understanding of Islamic economics. They may provoke constructive criticisms too. This is what we would welcome from our readers. This is how Islamic economics will emerge as a distinct discipline of knowledge.

In this connection, it may be mentioned that the Centre has been conducting and supporting theoretical and applied research in various fields of Islamic economics and allied areas since 1979. Under this research programme, one of our activities is to publish research papers, monographs and books on Islamic economics after due evaluation by independent reviewer(s). In order to get good quality research material, our strategy has always been to invite research proposal(s) from interested scholars around the world.

Thus on Shaban 1399/August, 1979, we sent out our first Announcement on Research Proposals suggesting a large number of suggested research topics in Islamic economics. We invited outlines of proposed papers or monographs along with a scheme of honoraria. This was done again in 1980 and 1981 and is going to be an annual feature, Inshallah.

Every proposal we receive is studied by the Academic Committee of the Centre which comprises professional economists as well as *Shari'ah* scholars. Only such proposals which have clear Islamic dimensions and are expected to add something to the existing professional Islamic economic literature are accepted. When a manuscript is received, it is sent to referees for detailed valuation and comments. Thus every care is taken to raise the professional standard of our research.

It is indeed gratifying to note that the Centre has been able to attract a high class talents towards its research work, majority of whom are university professors.

Any scholar or institution interested in our various research programmes may write to us for details. The Centre desires keenly to establish professional link with all concerned.

May Allah help us in serving His Cause.

**Dr. Omar Z. Hafiz**  
Director.

## ISLAMIC PERSPECTIVES ON MARKET PRICES AND ALLOCATION

### ABSTRACT

*In this paper the author has advocated the concept of "effective need" instead of "effective demand" as a basis for market mechanism in Islam. The former is seen as a broader concept than the later. It is demonstrated that free market mechanism based on effective demand is linked to the affluent, making resources available to those who can buy them and not necessarily to those who need them and that the market is either inefficient or ineffective or indifferent in providing all aspects of basic needs with which Islamic market is concerned.*

*Thus prices offered by the secular market are not seen as a guide to social welfare particularly in the context of Islamic economy where social concern is so great as to treat distribution as a key to productive activities. The competition as implicit in the market mechanism needs to be supplemented by conscious control, supervision and co-operation. Therefore, the paper did not support the view that the poor may be allowed to enter into the market only through direct transfer payments, thereby allowing market to operate freely.*

*It is further argued that resources allocation can not be left to the discretion of the individual when the question of collective welfare is involved. The paper stressed the need for necessary correction to all price-signals and economic incentive packages coupled with needed institutional reform and delivery system which can allocate resources directly to the poor with the view to increasing their real income through increased productivity on a permanent basis.*

*Islamic reluctance to accept market price as a true guide to a social welfare makes the function of conventional price elasticity of demand and supply limited in scope. The re-action of "need" to changes in "income" is also considered to be far more important than "price" in an Islamic economy. The main analytical task of an Islamic economy is then to analyse the factors or underlying forces that influence **origins** of demand and supply.*

*However a pricing options such as non-price rationing co-operative prices as suggested in the paper offer a limited scope for market mechanism, although the task of determining pricing policy in Islam will remain much more complicated than market or command economy. The paper is addressed primarily to students having exposure to elementary economics.*

# ISLAMIC PERSPECTIVES ON MARKET PRICES AND ALLOCATION

M.A. MANNAN, Ph.D. (Michigan)\*

## 1. SETTING OF THE PROBLEM AND OBJECTIVES :

The main hypothesis of this study is that the market mechanism, working through impersonal and "invisible" forces of demand and supply can not help achieving one of the basic and fundamental objectives of an Islamic economy, which categorically demands that each community or state, individually or collectively, must make provision for the working and non-working poor who lives below the poverty line in a particular socio-economic context.

The paper is addressed primarily to students who have been exposed to elementary economics, although they may not have any exposure to Islamic economics. Here the author tries to bring in Islamic dimensions to the problem of the market mechanism where-ever possible, thereby exposing the students to the nature of issues and problems Islamic economists should tackle.

It is argued however, that one of the basic concerns of modern western economics is the study of the price mechanism and allocation of resources, detaching economic theory from the shades of value judgement, although in most cases they are not value free. As a result, the neo-classicists de-emphasised the study of the basic egalitarian needs of man, which is so important in Islamic economics.

In spite of the fact that Islam recognises the differences in talents, differences in income among the different members of the society for the purpose of providing built-in-dynamism in social framework (*Qur'an*: 62:32) and that earning one's livelihood by hard labour is being far more preferable to asking for other people's charity, (*Bukhari*: 24:50), Islam's pragmatic and realistic concern for the poor is so severely acute that the distribution of income is the centre around which the pattern and organisation of production should revolve in an Islamic state.

The following few verses from the *Qur'an* and the traditions of the Prophet, peace be upon him, supports the above contention and provide outstanding examples of the Islamic concern for the poor:—

*"So give that is due to kindred, the needy and wayfarer. This is best for those who seek the countenance of Allah, and it is they who will prosper"*

*(Qur'an: 30:30).*

\* The author is thankful for useful comments and observations offered by two unknown referees as well as by his colleagues at the Centre Dr. Anas Zarqa, Dr. M. Nejatullah Siddiqi, Dr. Omar Hafiz and Dr. M.M. Raddady on the earlier draft of the paper. All references of the *Qur'an* and the *Hadiths* are reproduced from the English translation of authentic Arabic sources (see references).

*"And their wealth and possessions (was remembered) the right of the (needy), him who asked, and him who (for some reason) was prevented (from asking)" (Qur'an: 51:19).*

*"Righteousness is this that one believes in Allah and the last day and the angels and the Book and the Prophets, and gives away wealth out of love for Him to the near of kin and the orphans and the needy and the wayfarer and the beggars and for the emancipation of the captives, and keeps up prayer and pays the Zakāh" (Qur'an: 2:177).*

*"(Zakāh) charity is only for the poor and the needy, and the collectors appointed for its collection, and those whose hearts are made to incline to truth, and the ransoming of captives, and those in debt, and for the way of Allah, and (for) the wayfarer" (Qur'an: 9:60).*

*Abu Musa reported, The Prophet, (peace and blessings of Allah be on him) said: "Sadaqāh is incumbent on every Muslim".*

*They (his companions) said, O Prophet of Allah! And (what about him) who has not got (anything to give)? He said:*

*"He should work with his hand to profit himself and to give in charity".*

*"They said, if he has nothing (in spite of this). He said:*

*"He should help the distressed one who is in need".*

*They said, if he is unable to do this. He said:*

*"He should do good deeds and refrain from doing evil - This is charity on his part" (Bukhari: 24:31).*

*Jabir said.*

*The Messenger of Allah, (peace and blessings of Allah be on him) said:*

*"Every good deed is charity, and it is a good deed that thou meet thy brother with a cheerful countenance and that thou pour water from thy bucket into the vessel of thy brother"*

*(Mishkat: 6:6).*



*Abu Hurairah said:*

*The Prophet, (peace and blessings of Allah be on him) said:*

*"The man who exerts himself on behalf of the widow and the poor one is like the one who struggles in the way of Allah, or the one who keeps awake in the night (for prayers) and fasts during the day"*

*(Bukhari: 69:1).*

*Fatimah bint Qais said,*

*The Messenger of Allah (peace and blessings of Allah be on him) said:*

*"In (one's) wealth there is a due besides the Zakāh"*

*(Tirmidhi/Mishkat: 6:6).*

Now the Islamic position on mitigating human sufferings is very clear and categorical. We shall see that the market mechanism is either indifferent or incapable of handling adequately this Islamic concern. Thus while it is important to provide a critique of the market mechanism stressing on the essential differences between market and Islamic approaches, the heart of the problems lies in providing an Islamic alternative(s) and solution(s) to the problems. It involves not only the conceptualisation of Islamic theory of demand and supply, but also the identification of the basic issues and problems involved in the task ahead. Therefore, this study will be guided by the following three basic objectives:—

- a) to provide an Islamic perspective on prices and allocation through critique of the market mechanism;
- b) to develop an understanding of the Islamic theory of demand and supply in an Islamic framework;
- c) to identify the problems and issues, thereby facilitating the decision making processes in search for an Islamic alternative(s) to market prices where-ever it is needed.

## **2. UNDERLYING ASSUMPTIONS.**

The paper is based on the following five theoretical and operational assumptions:—

- a) The market prices, determined by the free inter-play of the forces of demand and supply may not always be acceptable in the Islamic scheme of economic affairs on the ground that it may not enable all the potential consumers and producers to enter into the market. The people are, of course, essentially free to enter and to leave the market, subject to the condition that they can not enter into any economic transaction which may come in conflict with the principles of the *Shari'ah*.

- b) Neither perfect competition nor perfect co-operation model meet the goals of an Islamic economy. An optimal mix of "supervised" competition, induced and voluntary co-operation may provide a better basis for Islamic economic analysis. The realisable synthesis of Islamic ideals should serve as a basis for workable hypothesis rather than the ideal conditions of perfect competition or perfect co-operation.
- c) The paper presupposes the existence of an institutional mechanism where interests of the different income groups and differences in social preferences are weighted, one against another and where economic decisions may not be resolved merely by economic analysis but also by a political process.
- d) The paper also presupposes the existence of a large group of people in almost every existing Muslim society who lives below the poverty line due to diverse constraints - economic, social, institutional or physical. It is an individual and collective social responsibility to make provision for them as a matter of priority. That is not to say that an Islamic economy is a "subsistence economy". It is based on implicit assumption that "investment in the absolute poor's human development is not merely more equitable social policy but very sound economies as well". (World Bank: 1980).
- e) The behaviour of the firm is to be guided by the overriding concern for public interest as viewed by the principles of the *Shari'ah*.

It is relative to social need. It is neither the profit-maximizing nor sales-maximizing behaviour of the firm that matters most. What matters is the structure of the decision-making - institutional process that affects the substance of the decisions, so that different decisions will result from different kinds of organisation, even if all else is unchanged. In such situations we may reasonably expect the firm's goal to be not maximizing profits or sales but attaining a target level, or a rate of profit or a certain level of sales or a zero profit level (revenues equal to opportunity cost) or achieving an assigned social profit target. This means that the firm could come to rest in a large number of situations rather than in only one unique equilibrium situation. The *main hypothesis is that in Islamic economic analysis, equilibrium may not be unique*. As such different theories may yield different predictions. For example, sales maximizing theory which predicts larger output and lower prices than profit-maximizing theory in particular situation do have different implications about the elasticity of demand at the firm's market price. Again, under the "satisficing" theory, a firm may content with a level of profit even when it is in a position to increase its profit due to the excess demand in consideration of public interest. There is then a need for an active participation of the state in co-ordinating and initiating the multiple objectives of the firm within an Islamic framework. The extent of state interference will however tend to vary in varying socio-economic circumstances.

### 3. NEED-VS-DEMAND.

At this stage it is important to clarify the concept of effective need and effective demand as used in the paper.

I have used the word "effective need" as an instrumental concept. The idea of instrumentality suggests that if particular goods and services are a necessary condition for the accomplishment of a desired end-state or goal, then that service is *needed*. Or if some unspecified services are necessary for an end-state to come about, that service is, in the same sense also needed regardless of the cost of the society. The source of concern about end-state is rooted in the notion of the Islamic concept of social justice and equity, the actual operational details of which is to be derived, either through "*Ijma*" or "*Ijtihad*" depending on the socio-economic conditions of the Muslim society concerned.

In an important sense, need is based on caring preferences and involve a judgement being made somewhat independently of the receiving individual. This is where "need" is different from "demand", for, demand is a want for goods and services backed by willingness and ability to buy. The "effective need" is also a desire for goods and services, backed by willingness to buy *but the ability to buy may or may not be there*. Need and demand are equal when both are backed by a willingness and ability to sacrifice resources for goods and services required. Need then becomes internal to demand. Demand and need become also equal when an individual or society or state wants something for someone else and is willing to pay for it. Here "need" is external demand. In this sense "effective need" covers more than "effective demand".

In a sense, the effective need refers to those basic human needs which an Islamic society must provide to all regardless of cost to the society. It is more "positive concept than the double negatives of eliminating or reducing unemployment, alleviating poverty, or reducing inequality. The basic needs approach spells out in considerable detail human needs in terms of health, food, education, water, shelter, transport, simple household goods as well as non-material needs like participation, cultural identity and a sense of purpose in life and work which interact with the material needs" (Streeten: 1980, p 7). The market mechanism with which the concept of effective demand is related can not offer solutions to the problems of effective need or basic needs at least in five ways.

Firstly, working poor who lives below the poverty line can not enter into the market.

Secondly, non-working poor who are incapable of earning an income - the unemployables are simply ignored.

Thirdly, the market may be indifferent to the choice of the appropriate social welfare function by which "we understand a description of the preference system of the community, consciously or unconsciously, adhered to by the policy makers". Certain features of a social welfare function may have to be imposed if the population is not aware of its full consequences. The best-known examples are obligatory schooling upto a certain age or excises on consumer goods endangering health such as tobacco, compulsory introduction of Islamic

studies into educational curriculum in Muslim countries, not to speak of imposing the complete pattern of production during wartime leaves such a gap which the market mechanism can not handle. This aspect of hidden "effective need" requires to be settled outside the market.

Fourthly, the basic needs also include non-material needs such as participation, maintaining cultural identity and a sense of purpose in life built on Islamic values for which a number of activities beyond the market are needed.

Lastly, some basic needs can not be met or can not be met efficiently or can be met at a cost much beyond the means of the poor by the market or private purchases. Such needs as health, education, safe-water, sewerage can be or more efficiently provided through public efforts.

Thus we see that the concept of effective need is a much broader concept than that of effective demand.

#### **4. ISLAMIC APPROACH TO MARKET PRICES.**

In one form or another, the allocation of goods among claimants is to be accomplished in all societies due to inadequacy of output to fill the wants and needs of the people. In traditional societies this critical allocative task is performed by the convention of the past, based mainly on the principle of social reciprocity. In command economies, the division of the social product is primarily carried out by the state management and administered prices. In market economies, this task is accomplished by the price mechanism, which reflects the inter play of the forces of demand and supply. Here we would like to confine our discussion to Islamic dimensions to the price mechanism.

The essential difference between a market economy and an Islamic economy lies in the fact that under a market economy, the prices, determined by the forces of demand and supply are taken for granted, that it is a price determined by the "invisible hand" as conceived by Adam Smith and others, whereas under an Islamic economy, the prices, determined by invisible forces of demand and supply are *not* taken for granted. The great question for an Islamic economy is *not merely how to understand, but to evaluate, economic processes* of production, distribution and consumption, in the light of the principles of Islamic economic behaviour. In the process, Islamic economy must go deeper and ask what is the meaning of market prices, that is, what do they represent? Does it reflect the poor consumer's ability to pay? Does it mean that this market price is equivalent to the social value? Since consumption is a function of income in most cases, the rich and the poor have clear difference in ability to pay. The market price is then not a good guide to social welfare as it includes the influence of income distribution on the prices offered.

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. That is what matters most in Islamic economics. Once an equitable distribution of income is established, the market prices offered can serve as a guide to social welfare.

Since the reforms of income distribution involves in many cases restructuring of the productive process, and socialisation of the all means of production, and wealth it is perhaps relatively easy to control the behaviour of market prices especially in the case of basic human needs.

The need for controlling the market prices specially in the case of essential human needs in terms of nutrition, health, housing, literacy and employment arises from the fact that in Islam, prices tend to be *personal* and human in character, whereas, in the market economy it tends to be *impersonal* in nature. In the case of the former, the economic enterprise works for combined economic, social and moral services *under constraints of profit*; in the case of the latter, it is the profitability consideration which mainly guides the behaviour of the firm. The impersonal character of the market prices arises not only from the fact that it gives a measure of a floor to expected satisfaction deriving from a value of a good and service but also from the fact that it is *indifferent* to the abilities of its buyers. The point at issue can easily be illustrated by economists' conventional doctrine of "consumer's surplus" which refers to the difference between what consumers are willing to pay and what they actually pay.

#### 4.1 Consumer's Surplus :

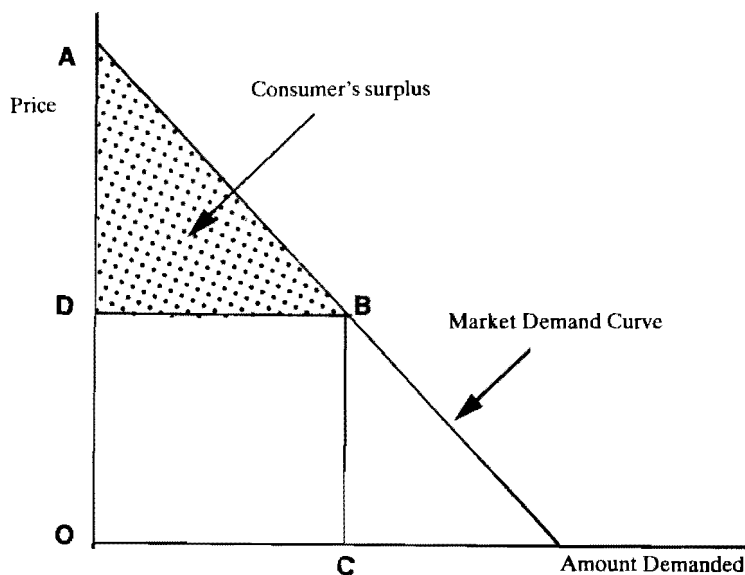


Figure I  
**Consumer's Surplus:**  
difference between willing to pay and actually paying

In the above figure I, the consumer buys OC amount at OD price, he pays the total price ( $OC \times OD$ ) indicated by the rectangular area OCB $\bar{D}$ ; but this quantity gives him total utility (expressed in terms of money) which is the whole area OCBA; the triangular ADB is his consumer's surplus. This is consistent with the underlying assumptions of the law of diminishing utility that earlier units are worth *more* to him than the last. Since in the market we pay the same price for each unit which is equivalent to marginal unit. We reap a consumer's surplus on all previous units, for, it reflects the benefit we gain from being able to buy at uniform prices. While market profitability takes no account of it, it is clearly a relevant consideration in making social decisions in an Islamic economy.

However difficult it may be, "the decision-makers may still find it useful to estimate the consumer's surplus of the non-taxed individuals and compare this with their estimate of the consumer's surplus enjoyed by the tax-payers. This process necessarily involves 'interpersonal comparisons' of utility by the policy makers. Individuals may differ in their assessments of the impacts of social decisions upon the utilities of the different members of the society, and upon the weights they assign to the interest of the different members. That is to say, in the last resort, decisions about economic affairs cannot be resolved entirely by economic analysis; where interests of different groups must be weighted, one against another, a political process is necessarily involved". (Samuelson: 1975, p 491).

It is then clear that while such a joint action is possible through public policy, it is hardly possible through the individualistic market behaviour. Herein lies a clear Islamic dimension of the problem in so far as the state consciously interferes in initiating this joint action either by fostering co-operation or by guided competition.

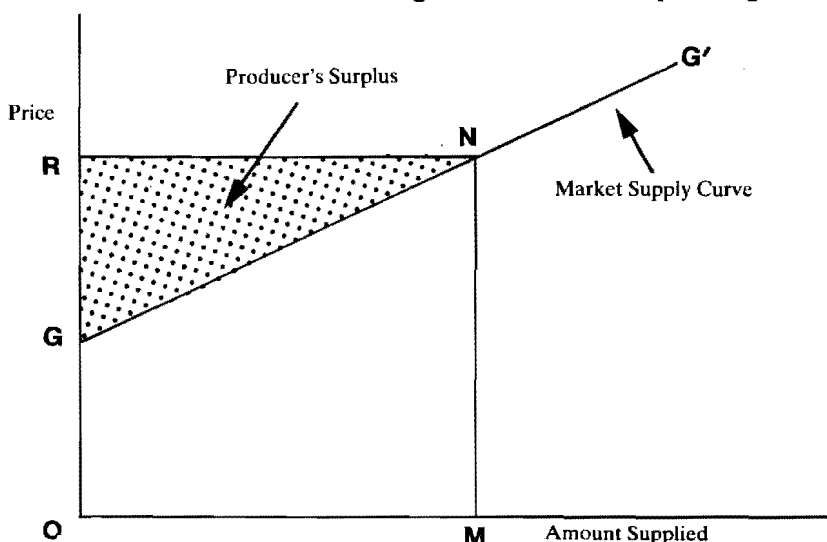
#### 4.2 Producer's Surplus :

In an analogous manner, we can also think of a "producer's surplus" - a surplus which emerges for those producers who can sell or produce goods and services *below* the market clearing price. Only the marginal producer is forced to sell at the market price as shown in Figure II:

The usual defence of producer's surplus in the market economy is that the market permits only the most efficient sellers or producers to supply goods, thereby ensuring efficiency of production through production and sale of goods and services at the least cost.

Is this result - which is made much of in the formal economic analysis - a compelling reason for recommending that the Islamic economy be guided by considerations of "producer's surplus". The answer is a decided "*no*". The basic questions we should ask are: what is this efficiency in production for? Why can some producers or sellers produce or sell below the market clearing price and why others can not? Are they handicapped due to some institutional constraints? (i.e. access to credit facilities, market facilities, social and physical capital facilities etc.).

Figure II  
**Producer's Surplus:**  
**difference between willing to sell and actually selling**



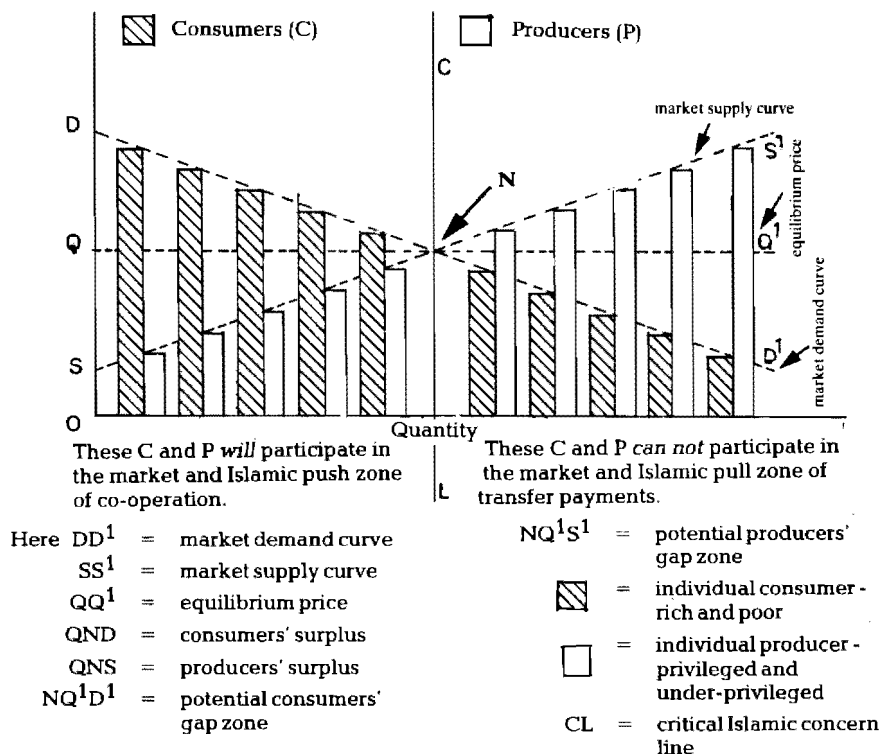
Here  $GG'$  = market surplus curve;  
 $OR$  = market clearing price for  $OM$  amount;  
 $OMNR$  = total selling price;  
 $GNR$  = producer's surplus for those who are in position to sell below  $OR$ .

Thus we can now see two things the market has accomplished in addition to allocation of goods and services and establishing an equilibrium price for it. First, it has maximized consumer's surplus. It does not mean that it establishes the best and desirable allocation of goods, for the market price does not recognise any priorities of claim to the goods and services of society except those of wealth and income. In this way the market excludes those customers with too little money or inadequate ability to buy the goods and services.

Second, the market has maximized producer's surplus. But those with income and wealth receive the goods that the economy produces, thereby permitting some sellers to do business and denying that privilege to others who are unable to operate at the market clearing equilibrium price as illustrated in Figure III.

The main task of the Islamic economy lies in converting this socially - indifferent consumer's and producer's surplus into a humane and socially concerned *use* and *exchange* as far as practicable. I am deliberately using these two words, for by "use" I mean socially productive and beneficent economic activities for which there may or may not be any "price-tag", whereas "exchange" may involve "price-tag" - a humane transaction between buyers and sellers.

**Figure III**  
**Market Price and allocation of goods and Islamic push and pull zone**



A simultaneous effort is to be made in the Islamic state to raise the poor consumer's ability to buy and small and under-privileged producer's ability to operate at a certain price through appropriate public policy. An estimation of willingness to pay will however require examination into the actual shape of the demand curve for the commodity concerned. This is a more difficult task than applying a market price, though.

However difficult it may be to quantify consumer's and producer's surplus, they are concepts relevant for many social decisions such as deciding when the community incurs the heavy initial expenses in building up the social and physical infrastructure. In the Islamic economy what is needed is to give a big push for joint action based on the principle of induced and voluntary co-operation, mutual help and sacrifice for the poor so that under-privileged consumers and producers can effectively participate in economic activities of the society. Individuals may be ready to sacrifice for the common cause or for the cause of the poor, if the society makes a conscious policy choice to do the same. Once again there is a need to imbue both the rich and the poor with the Islamic values of co-operation, individual and collective self-reliance. Once Islamic economic values are internalised, it should be possible to view increased productivity resulting from division of labour and appropriate use of



technology *not* merely in terms of efficiency, optimality, and profitability, but in terms of its social and human fulfillment. This is crucially important in understanding the dynamics of Islamic economics.

It is implicit throughout our analysis that the neutrality of the market would be perfectly acceptable, had there been an equitable initial distribution of income, for then each would enter the market on equal terms. But unfortunately this is not the prevailing reality of life.

In fact, the market, in establishing an equilibrium price has in effect permitted some consumers and producers to participate in economic transactions and business and denied that privilege to others who can not afford that price. The price offered in the market can not be seen as a guide to social welfare particularly in an Islamic economy where social concern is so great as to treat distribution as a key to productive activities. Since the market price does not include the influence of income distribution on the prices offered, it is quite legitimate to examine this issue from Islamic perspectives.

#### **4.3 Distribution of Income and Market Mechanism :**

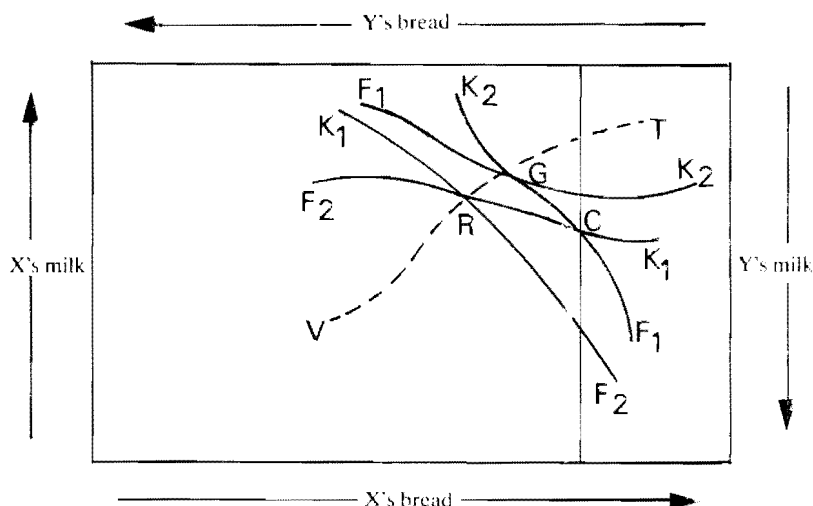
It is the equity rather than efficiency criteria of the market mechanism which plays a very significant role in an Islamic economy in the process of the evaluation of the optimality of resource allocation. The prime measure of the degree of inequality in the distribution of income and wealth. The teachings of Islam as reflected in the *Qur'an* and the *Sunnah* of the Prophet (peace be upon him) do not favour gross inequality in the distribution of income and wealth which, in its turn, largely determines the inequality in the distribution of economic, social and political power in the society. Since the market mechanism is based on material incentives of price, inequality is an inherent condition for its smooth functioning. As a matter of fact, the problem of the distribution of income and wealth is normally taken as determined outside the framework of the market analysis which is rather shy to deal with the problems of inequality. "This is not to say that orthodox economists have shown no concern for questions of inequality; there has been a considerable attention paid to the determination of profits rates in different industries. But this is insufficient: a theory of resource income distribution requires a sub-theory of resource prices. Without knowledge of the resource ownership pattern we cannot say what the distribution of personal income will be, for there are an infinite number of such distribution consistent with any one set of resource prices. Who gets what depends on who owns what, and orthodox economic theory is silent on the latter matter". (Stilwell: 1975, p 29).

Furthermore, it should be noted here that the market mechanism is often distorted by the existing inequality of income and wealth and also the inequality in the distribution of wealth is aggravated by the market mechanism. Once there are major disparities in income distribution within the country, the market mechanism ceases to function efficiently or equitably, since it is weighted heavily in favour of the rich who has the purchasing power, for wealth confers power and puts the rich and the wealthy in more favourable bargaining strategic position to influence the outcome of the market. Herein

lies an Islamic dimension of the problem in so far as it relates to a conscious intervention in the market by the government to alter the existing pattern of distribution of all credits, investment funds and essential public service in such a way so that it tends to increase earning capacity of the poor on a long term permanent basis rather than making them perpetually dependent on an adhoc and short term transfer payments.

That the rich who have the money can make the market bend to their will, can be illustrated in terms of a conventional Edgeworth box diagram analysis as shown in Figure IV:

Figure IV  
**The Edgeworth box showing initial inequitable distribution of commodities and possible inequitable outcomes of the exchange process of the market.**



Here  $K_1K_1$  and  $K_2K_2$  = two indifference curves of consumer X, showing his different level of satisfaction is convex to the origin.

$F_1F_1$  and  $F_2F_2$  = two indifference curves of consumer Y, showing his different level of satisfaction is convex to the origin.

VI = conflict (or contract) curve joining the points of tangency R and G between X and Y's indifference curves: locus of efficient allocations.

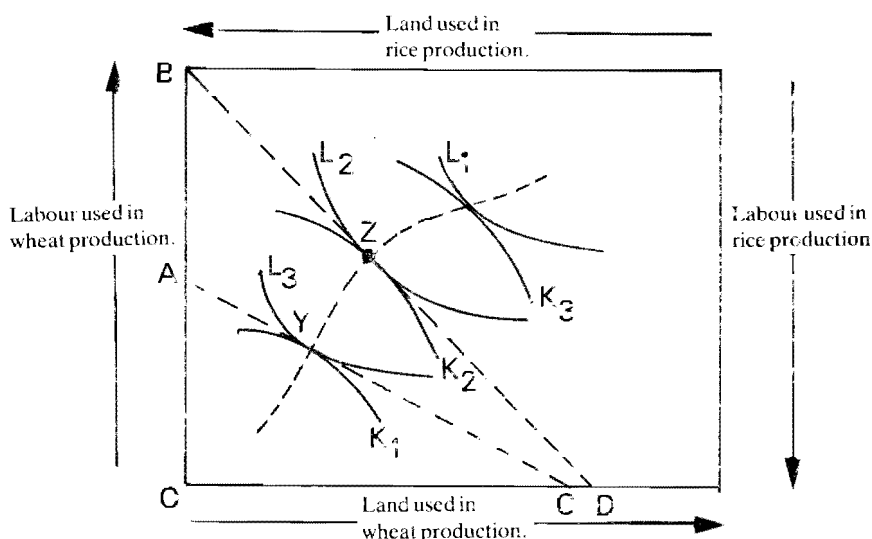
In Figure IV we are considering a simple hypothetical case: an economy featuring two consumers X and Y and two commodities, bread and milk. Now consider the point C in the Edgeworth box (in Figure IV) which represents the initial distribution of wealth where X owns most of both the commodities, and Y is poor and living almost at the starvation level, i.e. 'C' is not a stable position in the same that is *not* on the conflict curve, although 'C' is efficient in that one customer can not attain a higher indifference curve without pushing the other consumer on to a lower indifference curve. It follows then that an exchange will

take place. The outcome of this exchange process could be anywhere between R and G. The logic of equity consideration suggests that it should be near R which helps Y in attaining the higher indifference curve. Is it likely under the free market mechanism? Possibly not. The initial distribution of income and wealth in favour of X would enable him to bend the market to his will; he has also the capacity to withhold his goods from the market temporarily. In all probability, the outcome of the exchange process tends to favour X (or near G) which would enable X to attain  $K_2K_2$  - a higher indifference curve.

Furthermore, historically speaking, the income inequality in the market economy has been legitimised on the ground that the input prices depend on marginal productivity and by implication, the effort expended. This view of input prices does not take into account the value of intra-marginal units which exceed the input prices as well as non-economic social, moral factors such as the pattern and structure of resource ownership and sociopolitical power relations.

One interesting aspect of these interdependence between the structure of ownership of the means of production and the relative factor prices that can, among others, determine the distribution of income, can also be illustrated in terms of the Edgeworth box analysis as shown in Figure V.

Figure V  
**Resource ownership influencing the relative factor prices**



Here in Fig V:  $K_1K_2K_3$  = isoquants for rice production.

$L_1L_2L_3$  = isoquants for wheat production.

Y, Z = points of tangency that can be joined to form the conflict or contract curve.

The relative factor price ratio at Z (OB/OD) is different from that of Y (OA/OC). Given the initial inequitable distribution of ownership of the means of production, some have nothing but labour whereas others own land and capital. The price system under such a market economy situation will lead to have a skewed distribution of income adversely affecting both the relative and absolute level of income. This is what Islamic economy rejects. This rejection is clearly based on the teachings of the *Qur'an* and the *Sunnah*. The crucial implication is that in an Islamic economy production decision may be used to achieve some social and moral objectives. The choice of production techniques should not be made on the narrow grounds of economic and technical efficiency associated with the production of particular outputs at a minimum cost. The fact is that factor prices can not always be a function of productivity in an Islamic economy in which case input prices, for that matter, level or rate of profits, wage rates must at times be determined outside the market to achieve some non-economic goals and objectives, such as conscious policy of winning the hearts of those people, considered to be hostile of Islam, specific policy for poor community development, independence and self-reliance, setting up of a particular price-system intended either to discourage the use of a particular input or encourage the use of another, depending on the nature of social and moral objectives to achieve. The prices of goods and services in an Islamic economy is then seen as a part of the policy package which may even remain unchanged for sometime despite changes in cost and demand conditions.

The point I am conveying is that market prices in a situation of gross inequalities of income can not assure the smooth functioning of the Islamic economy either from the supply or from the demand side. It can not simply ensure the emergence of social and economic equilibrium, needed for balanced allocation of resources both at a national and an international level.

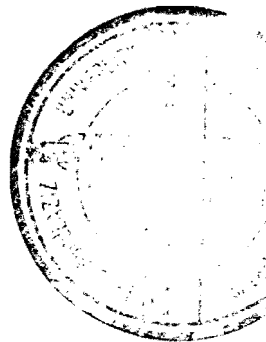
As a matter of fact, we have empirical evidence to show that the poor nations can not get an equitable deal from the present international economic structure - much the same way as the poorest section of the society within a country, for the existing inequalities of income and wealth tend to have a cumulative effect, since wealth puts the rich in a more favourable bargaining position.

"This is as true of the income gap between the developed and the developing countries as between the poorest and the richer developing countries. For instance, the absolute disparity in per capita income (in constant U.S. dollars) increased from \$2,700 to \$4,000 between developed and developing countries during 1960 to 1974 while the income disparity between the poorest (below \$200) and other developing countries (above \$200) also went up during the same period from \$330 to \$625". (Haq: 1976, P. 156).

Barbara Ward (1975) quite ably summarised the case against market mechanism in a situation of gross inequalities in income and wealth in the following words:

"To rely solely on the market system (in such a situation) has wider consequences for society in general and for resources use in particular. The capacity to sell, to have responsive buyers, becomes the overriding criterion for production goods. This raises a number of

problems. Production is geared to those who can effectively buy. Internationally, that means richer countries rather than poorer countries and nationally it means middle and high income groups rather than the poorer people. Within most developed societies, social mechanism - public ownership, redistributive income tax, welfare schemes, social insurance - try to offset this trend. No such institutions are at work at the world level, not in a number of developing countries. In such conditions, market mechanism are linked, by their own logic, to the affluent, making resources available to those who can buy them and not necessarily to those who need them. This fact generates a series of background linkages. It determines the nature of the technology needed to maintain the consumption of the more affluent. It guides the allocation of resources in research and development. This in itself creates a demand for certain types of professional know-how, rather than for others".



Now the stage is set for the understanding of the Islamic theory of demand and supply.

## 5. TOWARDS UNDERSTANDING OF ISLAMIC THEORY OF EFFECTIVE NEED BASED DEMAND AND POTENTIAL CAPACITY BASED SUPPLY:

Here our hypothesis is that the Islamic concept of market is much wider in scope than the one in the market economy in the sense that it is linked, by the very logic of Islamic teaching, to the poor and the rich, making resources available to those who can not buy them, as well as to those who can buy them. Herein lies the key to the understanding of the Islamic theory of effective need which includes both "effective demand" and basic needs as well as an Islamic theory potential supply which includes supply of normal producers and potential supply of the under-privileged producers. At this stage, it is perhaps desirable to make a very quick review of the market mechanism as understood in western economies.

By the convenient but unrealistic device of assuming that consumers and producers are identical and equal, the market mechanism has been able to isolate the efficiency aspect of the pricing decision. Since the market operates, through positive price, a change in price will bring into market new buyers and sellers. Thus a fall in price is expected to increase the demand for the goods. Conversely, a rise in price will tempt the sellers to increase the quantity of goods for sale in the market. At zero price, or negative price, the market mechanism will cease to exist.

It follows then that market equilibrium price is established when the demand function ( $Q_d$ ) is equal to supply function ( $Q_s$ ). Let us suppose that the demand function is:

$Q_d = 100 - .5(P)$  and supply function is  $Q_s = 2(P)$ . Then in order to set the

equilibrium price we have to find out what value of 'P' will make  $Q_d = Q_s$ .

$$\begin{aligned} \text{Thus if } Q_d &= Q_s \\ \text{Then } 100 - .5(P) &= 2(P) \\ \text{or } 2P + .5(P) &= 100 \\ \text{or } P &= 40 \text{ (Where } P = \text{equilibrium price)} \end{aligned}$$

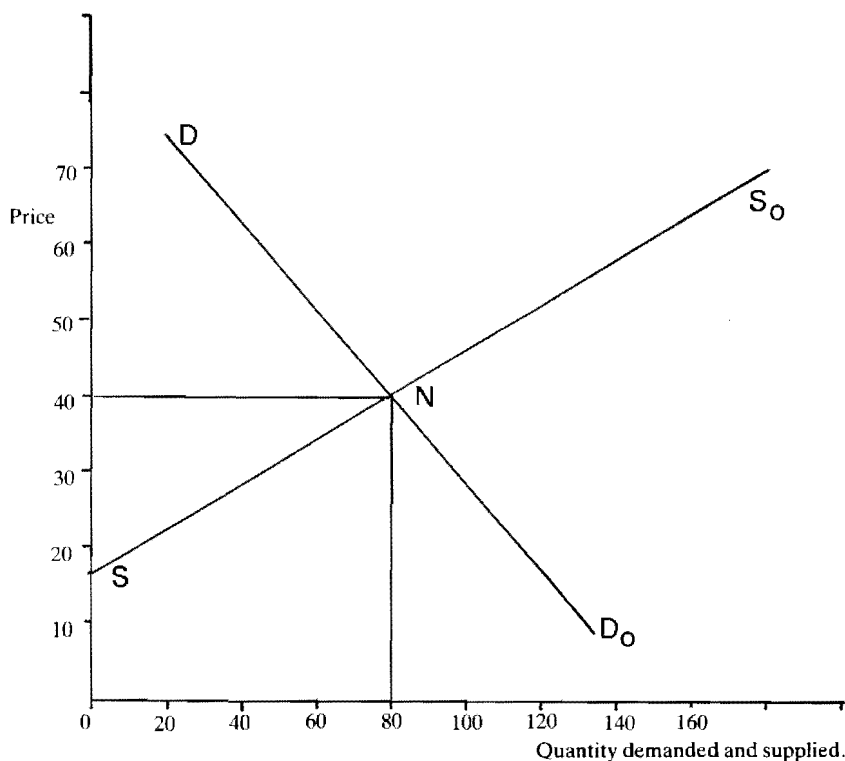
Now substituting the value of 'P' into the demand and supply equation, we get the quantity demanded and quantity supplied

$$\text{Thus if } 100 - .5P = 2(P)$$

Then quantity demanded and supplied would be: 80.

Graphically it can be shown as in Figure VI.

Figure VI  
**Market equilibrium price showing efficiency and ignoring equity**



Where  $DD_0$  = Market Demand curve.

$SS_0$  = Market Supply curve.

N = Point of equilibrium at which  $Q_d = Q_s$   
(price: \$40; Quantity: 80).

We have already noted that market in establishing this equilibrium price has achieved distributional efficiency, but ignored equity considerations. The great attraction of Islamic economics lies in its potentialities to explore and explain the problem of large-scale historical and social change which is likely to emerge from the study of the human poverty and income distribution both at the micro and macro-level. Its value loaded social, economic, political and moral inquiry with their insistent emphasis on the connectedness and relationship of economic and non-economic processes has made the boundaries of Islamic economics much more wider and deeper than the scope of the market economy. What is needed is an institutional mechanism which can ensure the operation of the Islamic market not only at a positive price but also at a zero or a negative price, if needed. This is how Islamic economic analysis can be made relevant to the contemporary Muslim communities in particular and suffering humanity in general.

Seen from this perspective, the Islamic theory of demand, based on "effective need", and supply, based on the fuller utilisation of potentialities of both the privileged and under-privileged producers have to be understood. The effective-need-based-demand-curve and effective-capacity-based-supply-curve are likely to lie to the right of the market demand and market supply curve at the going price of the goods as shown in Figure VII and Figure VIII.

In Figure VII, the DD' represents the market demand curve. At the going market price of \$2.00, X and Y can not afford to buy, Y is either unwilling or not able to buy any of the commodity. A.B.C. are willing and able to buy 7 units together. By adding the individual demand of A.B.C. we derive the market demand curve (DD'). Thus the market price is \$2.00, the total quantity demanded is 7 units.

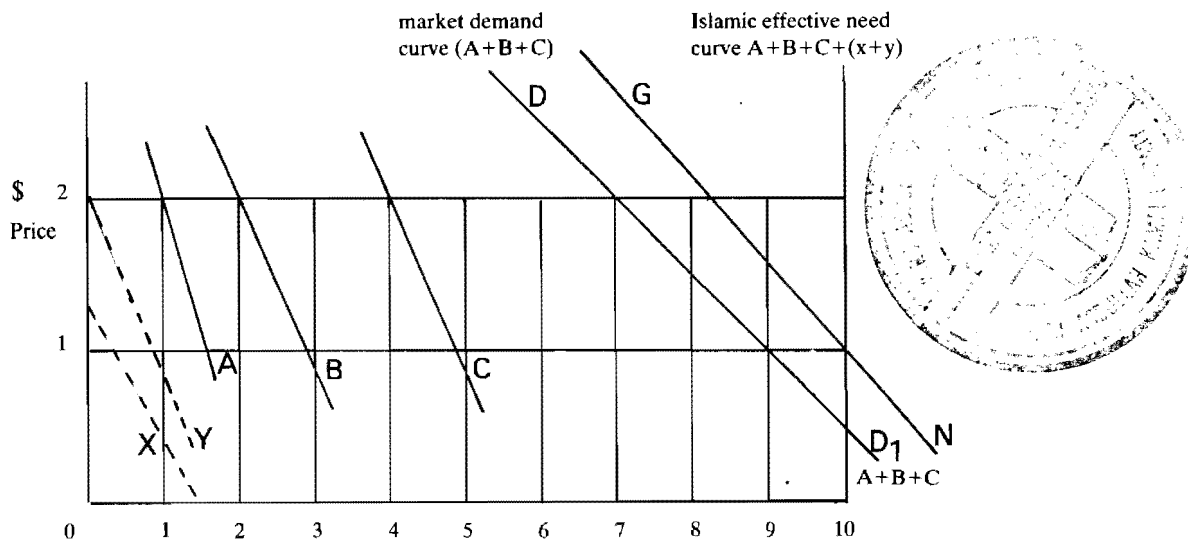
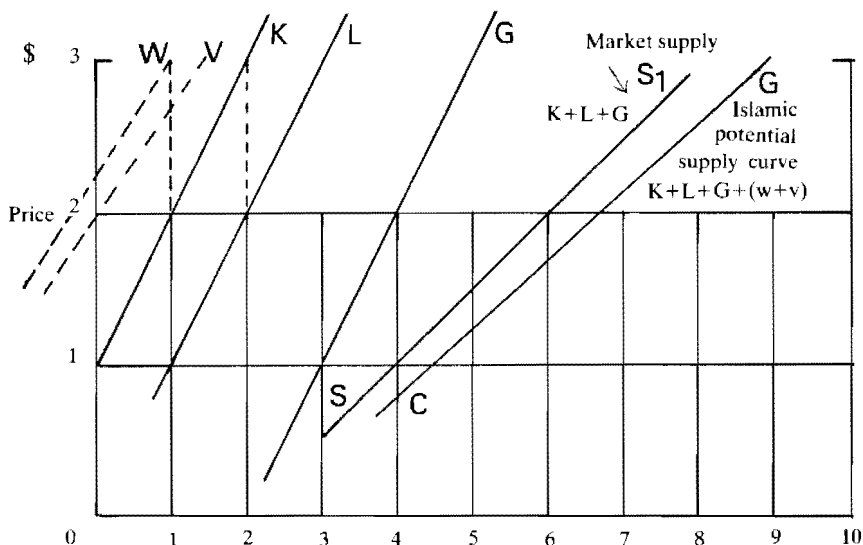


Figure VII

Individual market effective demand curve, Islamic and effective need curve

Figure VIII  
**Individual market supply curve, Islamic and potential supply curve**



Similarly, in Figure VIII, by adding the quantity of goods supplied by the three individual producers K.L.G. we get the market supply curve  $SS'$  at the market clearing price of \$2.00 which has in fact, denied the entry of W.V. producers into the market, for, they can not compete at the current price assuming that W.V. are potentially capable, and can not enter into market due to institutional barriers.

Here we see clear Islamic dimension of the problem. In Figure VII, the Islamic concern for the poor customers X and Y makes it imperative to study and examine whether the goods and services for which the poor consumers can not afford the market clearing price, constitutes the essential and basic human need relevant to a particular socio-economic framework. It calls for development programmes which are need oriented rather than market demand oriented. The effective need curve GN (in Figure VII) is most likely to lie right of the market demand curve  $DD'$  which has by definition concealed the need of the poor who are unable to offer the market clearing price.

Similarly, in Figure VIII, the Islamic concern for under-privileged and small producers (i.e. W.V.) makes it imperative to study and examine whether they have access to credit and working capital, essential infrastructure and other public services needed to participate in economic activity. The potential supply curve GC (in Figure VIII) is most likely to lie right of the market supply curve  $SS'$  once the necessary institution reforms are carried. *Contrary to popular notion the above analysis suggests that in an Islamic economy there is a built in motivation to produce more with its implications for economic development.*



Thus the study of the effective need based demand curve and effective capacity based supply curve as illustrated above deserve greater attention today than ever before. In fact, "there is an increasing realization that economic growth *does not filter down automatically* to the masses except in the modern urban sector and at very high rates of GNP growth. This has been demonstrated by now both through empirical studies and through logical reasoning. Some quantitative analysis, which attempted to differentiate the overall growth rate of the economy from the growth rate of the poorest 40 percent of the society, have shown convincingly that the poorest sections have progressed at a much slower rate relative to the rest of the economy in many developing countries.<sup>1</sup> In fact, what shocked some of the analysts was the finding that, in certain cases, even the absolute level of income of the poorest majority had declined visibly in real terms over the course of the last two decades. In human affairs, nothing convinces the skeptics so much as the sheer force and volume of quantitative numbers". (Haq: 1976, P. 60-61).

The crucial policy implications of the above analysis is that resource allocation can not be left to the discretion of the individual when the question of collective welfare is involved. It follows then that prices, established by the market mechanism, can not be accepted *as a matter of rule*. This is not to say that in an Islamic economy there is no scope for a price-system based on the market mechanism. What is in fact needed in an Islamic state is to bring about necessary correction to all price signals and economic incentive packages coupled with needed institutional reform and delivery systems which can allocate resources directly to the poor groups with a view to increasing their productivity on a permanent basis. These corrections of price signals and reforms of the institution must be geared to achieve the overall objectives of the national plan for meeting the basic human need in terms of nutrition, clothing, shelter, education, irrespective of market demand. In his *Poverty Curtain*, Mahbub-ul-Haq (1976 P. 70-71) has put forward the case as follows:-

"In many developing countries, the price system often works directly against the objective of allocation of resources to essential needs. Even when the price signals are corrected, the focus of such a policy is generally to subsidize consumption goods to the poor, which often discourages their production by the private sector and, as such, vitiates the very objective which these societies wish to pursue.

The most important part of the implementation machinery, however, is the delivery system, which can allocate resources directly to the poorer groups and, thereby, lay the groundwork for a permanent increase in their productivity. These delivery systems embrace the supply of investable resources, working capital, essential infrastructure, and other public services required by the poor in order to participate in economic growth. Most developing countries have extremely poor delivery systems for reaching the poorest sections of their societies. This is no accident. This is,

---

1. See Hollis B. Chenery, *Redistribution with Growth* (New York and London: Oxford University Press, 1974).

in fact, a reflection of the political and economic realities in these countries. Since the rich have the purchasing power and since they are the ones who are regarded as creditworthy, it is inevitable that they should control most of the institutional structures and get a major share of the services in the system. Generally, a superficial answer to this is nationalization of a whole range of services by the government. The most popular vehicle is the nationalization of banks. But the nationalization of banks, without a national credit policy, is absolutely meaningless. What is really needed is the definition of precise objectives in terms of credit - as to which income groups should get what kind of credit - rather than the symbolic ownership of the credit system. Thus, many countries have ended up nationalizing their banks, while leaving the distribution of the credit system almost unchanged.

These considerations apply even more to the rural areas which are often ruled by feudalistic power structures and where distribution of credit or other services generally ends up in the hands of the landlords and of other traditional local power groups".

The analysis will however remain incomplete without a discussion in some detail about the elasticities of need-based demand and capacity based supply.

## **6. THE ELASTICITY OF NEED-BASED-DEMAND AND CAPACITY-BASED-SUPPLY:**

Since consumers' need and producers' capacity are to be understood in a relative sense, it is crucially important to understand the nature of the factors that influence it. The purpose of measuring need-based-demand and capacity-based-supply elasticity is to discover the degree to which the quantity demanded and quantity supplied respond to a change in any of the factors influencing demand and supply showing a measure of the degree to which quantity demanded and supplied responds to price changes as the case may be, is not really helpful in understanding Islamic economics. This is not to say that they are not useful in market economic analysis. In fact, Islamic reluctance to accept a market price as a true guide to social and community welfare makes the functions of price elasticity of demand and supply limited in scope. Similarly, the conventional hypothesis that demand for luxuries are highly elastic and demand for necessities of life are inelastic does not also contribute much towards understanding of Islamic economics. Even in a market economy, this hypothesis does not describe the world of reality.

"In all the demand studies that have been made, there is no observable tendency for commodities to fall into two groups, one with very low elasticities and one with very high elasticities. There seem to be goods with all possible sorts of elasticity, a few are very low, a few high and the remainder are spread out between these extremes. To a great extent elasticity depends on how widely or narrowly a commodity is being defined. It is true of course, that food

and shelter are necessities in the sense that life cannot go on without some minimum quantity of them and it is possibly true that foods as a whole would have an inelastic demand. It does not follow from this, however, that any one food, for example white bread or cornflakes, is a necessity in the same sense. Thus, there is no reason to believe that the quantity of any one food demanded cannot and will not fall greatly as a result of a rise in its price". (Lipsey: 1975, P. 108).

Since, the market price is needed to be *supervised* in an Islamic economy, it raises a basic question for us: Which is the more important factor that determines elasticity of the need-based-demand: Is it price or income? The reaction of "need" to changes in income is far more important and significant than price in an Islamic economy which is concerned not only to mitigate the suffering of the poor but also interested in evolving a consumption style for the rich in Muslim countries.

The variability of the response of "need" to changes in income can then serve as an important guide to resource re-allocation and resource control, thereby laying the foundation of need oriented development strategies. It is therefore, possible to conceive that sales of income-elastic goods or services tend to rise proportionately faster than income; and sales of income-inelastic goods and services rise less than proportionately with income. These relationships are illustrated in the following Figure IX:

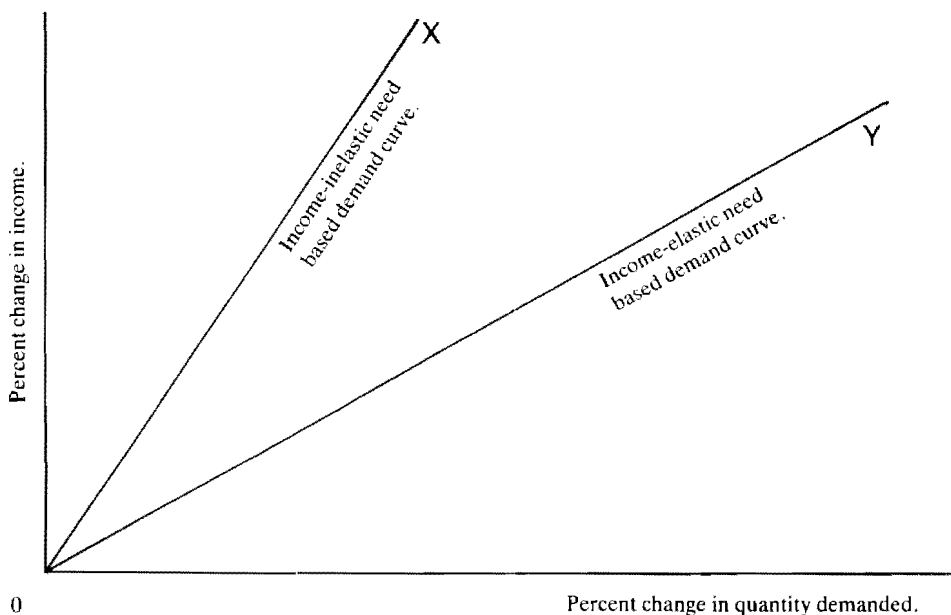


Figure IX

#### Income Elasticities Based on Need

**(Note: OX and OY are not supply curves for, they slope upwards, income demand curve and price demand curve show different functional relationship)**

It may be noted here that even in the western market economy the reaction of demand to changes in income is one of the major causes of re-allocation. Empirically viewed, in the U.K. and most of the western European countries, it is the demand for durable goods such as, cars, washing machines, colour T.Vs. that is increasing most rapidly as household incomes rise, while in the U.S.A. it is the demand for services that is rising most rapidly. The difference between Islamic and Western market economy lies however in the direction of resource allocation and its goal oriented use, based on a different value system.

Thus like income elasticity of demand, the need-based income elasticity of demand is defined as:

$$En = \frac{\text{Percentage change in quantity needed}}{\text{Percentage change in income}}$$

Symbolically it can be expressed as :

$$En = \frac{\Delta Q/Q}{\Delta Y/Y} \quad \begin{array}{l} \text{Where } En = \text{elasticity of need.} \\ Y = \text{income.} \\ Q = \text{quantity demanded.} \end{array}$$

Similarly, we have to ask: what determines the supply elasticity in an Islamic economy? It is price elasticity or *elasticity of access or ownership to the means of production or wealth*. The reaction of producers to produce to changes in the pattern and organisation of the distribution of all credit, investment resources and public and private services is far more important than price elasticities of supply in Islamic economy. We have already seen that in a market economy, some producers can produce at the market clearing price and others can not. Some have the capacity to produce and others are under-privileged. It is therefore, extremely important to examine how the cost of production behaves as the credit policy or equity line is varied to different producers. It is also important to know as to how cost behaves when access to investment resources as well as to physical and social capital changes. Even in a market economy, changes in cost usually dominate decisions on prices. It can be calculated and higher costs usually seem to be a valid justification for higher prices. If the cost per unit of production rises rapidly due to the changes in credit policy or the availability of social and physical capital facilities, then the stimulus to expand production in response to price rise will quickly be choked off by the increase in cost. It is therefore, far more important to measure credit elasticity of supply, equity elasticity of supply, supply elasticities of social and physical infrastructure than conventional price elasticities, in an Islamic economy. Once these elasticities are measured, they can serve as a guide to resource re-allocation and distribution. The main analytical task is however to isolate one effect from the other influences on the quantities bought and produced - changes in income, changes in the credit policy, changes in the prices of related goods, changes in consumption styles and so on.

One major use of measurement of these elasticities in an Islamic economy is to influence the redistribution of resources in a way which can enhance the poor consumers' ability to pay and the under-privileged producers' capacity to produce. The thrust is on the voluntary or induced co-operative and collective self-reliance on the capacity of people themselves to generate new resources,

and techniques, to increase their capacity to absorb them and to put them to socially beneficial use within the social framework of Islam. The essential difference between an Islamic economy and the market economy lies not only in de-emphasizing the role of price-elasticities of demand and supply, but also *in the direction and use of resources*, which emerges out of the measurement of elasticities and the weights assigned to the need of the different income groups living in the society. The main task of the Islamic economy is then to analyse the factors or underlying forces that influence *origins of demand and supply* so that it is possible to change them in the direction of a more equitable distribution. Perhaps what is needed more urgently, among others, is massive investment in education and an appropriate human resource development.

### **7. THREE POLICY OPTIONS :**

Now it can be said that an Islamic economy may face the following three policy options:—

- (a) to eliminate the market mechanism and control price;
- (b) to allow the market mechanism to operate freely; make direct transfer payments to the poor so that they can enter into the market; and
- (c) to allow the market mechanism to operate through necessary control and corrective measures particularly in providing effective needs to the community, not necessarily in providing goods and services beyond the basic needs.

Option (a) is clearly not permissible in Islam, as it is against the principle of basic economic freedom of the individual which Islam seeks to preserve. The economic compulsion can be applied in an Islamic society only as a special case in order to strengthen the collective social and economic responsibility of the individual members.

The option (b) is not also acceptable to the author for several reasons: Firstly, it is based on the implicit assumption that the market mechanism will automatically ensure equitable re-distribution of goods and services through invisible forces of demand and supply. Here reality is far from this theoretical possibility, Secondly, we have already noted that "effective need" is a much broader concept than "effective demand". The market is either inefficient, or ineffective or indifferent in providing all aspects of basic needs.

Lastly, there is no guarantee that transfer payments will be made available to the poor on a permanent basis. Even if the transfer payments are used to increase the productivity of the poor, it may not even guarantee an increase in their income. For example, in the case of small farmers their productivity increase may be reflected in lower food prices, benefitting the urban customers.

While the role of direct transfer payments can not be denied for the bottom 10 to 15 percent absolute poor or unemployables, the fact is that market can not always supply wage goods, particularly public services such as education, health care, safe water, sanitation etc. It is essential to expand and redistribute

public services so that the poor have access to such services. A part of the income of the rich needs to be transferred to ensure this expanded and equitable redistribution of public services - "This is no rule for the optimum which says that any rich man is permitted to spend his productive income all for himself, or the other way round, a poor individual only has the right to spend as little as his or her low productive income permits. A system of taxes and subsidies is part of the optimum. By subsidies we may also understand the supply of services at lower prices than their costs. This is true within each nation, among the richer and the poorer strata; it is equally true between nations - even more so, since primary (or productive) income inequality is much larger between than within nations. Here reality is terribly far from the optimum" (Tinbergen: 1972, p. 38).

In view of above discussions the option (c) provides a pragmatic alternative to achieve the goals of an Islamic economy. The discussions on various pricing options that follow will essentially be based on this approach.

## 8. POLICY IMPLICATIONS AND ISLAMIC ALTERNATIVES.

The preceding analysis of the market mechanism leads us to an inevitable conclusion that in an Islamic economy, prices offered by the market can not be accepted as a matter of rule. The competition as implicit in the market mechanism needs to be supplemented by conscious control, supervision and co-operation. This is where Islam enters. "Let there be amongst you traffic and trade, by mutual good-will (*Qur'an* 4:29)". The key lies in mutual good-will and co-operation, while the market prices emerge from the wholly *unsupervised* interaction of competing buyers and sellers, Islamic equitable price need to emerge from the supervised competition, conscious control and co-operative interaction of the buyers and sellers.

The drive to maximise profits as seen under the market economy is not merely an economic phenomenon: it is also the psychological as well as social phenomenon. It is the social mechanism and economic institution which create the necessary conditions to work in one way or another.

The proper implementation of Islamic socio-economic values call for a fundamental institutional reform and structural change rather than an adhoc functional and marginal changes in the price-system. The current price system is a reflection of the existing economic social and political balance of power, unless these structures are changed through socialisation of the means of production sources of the current ownership of wealth, necessary land reforms and setting up of new institutions to reach the poorest sections of the society, the short lived welfare programme for the poor can not genuinely achieve the goal of an Islamic economy.

Bearing in mind the overall goals of an Islamic economy, an Islamic government may opt for the following pricing decisions particularly for meeting the basic needs of the poorest section of the society depending on the economic conditions of the community.

### **8.1 Non-Price-Rationing with the Market Mechanism :**

By non-price rationing we mean allotment of essential goods and services through a system of coupons or publicly determined priorities. When this is combined with the limited operation of the market mechanism, it may very well take care of both equity and efficiency criteria. In many cases it is more ideal than the use of a straight price system which ignores equity considerations. While the rationing will ensure that poor customers get their basic allotment, the market would allocate some surplus part of the commodity supply to those rich customers with the greater ability to pay. Under this scheme the poor customers would not have to sell their allotment. If they need their basic allotment, they will keep it. Otherwise they could supplement their income by selling it. Under such a scheme of pricing, the need matches the demand. The point of such a plan is to use the market as a means by which individual are in a position to determine their own economic activities according to their marginal utilities within the overall framework of fairness and equity that a market can not attain. The rationing would ensure the supply of a basic minimum allocation of a commodity, but the market would enable the individuals to maximise their surpluses in a way that rationing alone may not achieve. In my view, this scheme of rationing with the market mechanism is not inconsistent with the Islamic socio-economic values.

### **8.2 Zero Price Through 'N' Pricing for Public Utilities and Services :**

Under this plan of zero to 'n' price concept, some basic quantity or unit of public services or utilities (e.g. water, electricity, gas etc.) may be provided free of charge to the very poor. The additional consumption in excess of the basic quantity is to be paid, for the relevant question when deciding between a zero price and 'n' price for such services is not: "Is such a utility (e.g. water) as necessary that we would not want to deprive anyone of all of it?" But rather "Are marginal uses for water which our policy will encourage so necessary that we want to encourage them in spite of the fact it is costly to provide the water for these uses?" Clearly, these two questions can be given different answers.

The consumption of such public utilities or services at various prices suggest that the pricing policy is to be based on the measurement of consumers' surplus. Thus the loss incurred by the discriminating monopolists in providing free services upto a certain basic limit to a very poor member of the community can be recovered by an appropriate pricing policy from the rich customer who would certainly be willing to pay extra to these discriminating monopolists, rather than forgo these essential goods and services.

We have evidence to show that most gas, electricity and water authorities in most developing and developed countries act as discriminating monopolists, and that these authorities often charge not only the uniform prices irrespective of any consideration of the consumers' ability to pay, but also offer reduced price for the additional electricity, water and gas purchased in excess of a certain basic quantity to encourage further consumption. The adoption of a two-price-system appears to have been based on the implicit assumption of the law of diminishing marginal utility. If this law is used to justify a price system

favouring the richer section of the community, it immediately comes in conflict with the principles of the *Shari'ah*. If the conflict between the principles of efficiency and equity becomes unavoidable, in the Islamic scheme of economic affairs it is the equity consideration which takes precedence over the so-called efficiency criteria. Thus an Islamic solution calls for a necessary correction in discriminating prices policies in favour of the poor.

### **8.3 Socialisation of Pricing Policy :**

By socialisation of pricing policy, I mean determination of sectoral or national "make-up policy" by the competent authorities, considered to be just and fair in a particular social context. This is important, for, the excessive profit margin or mark-up margin can be as exploitive as charging interest on loan, which Islam prohibits. A guideline for a range of mark-up may be expressed in terms of average cost. Even in the market economy, actual business operations are frequently conducted in terms of average rather than marginal quantities, for, "it is almost always harder to collect marginal cost figures than to acquire average cost data. Since it is much easier to collect the data required for average cost based on the past experience of the firm than for marginal cost based on information beyond the range of the firm's actual experience or based on future speculation". (Baumol: 1965, P. 34).

It must be noted, though, that there will be plenty of problems in agreeing upon the correct average cost (AC). For example, how should the plant overhead cost be allocated between different productions? If the process simultaneously creates joint products, how should the costs be allocated between them? or how much depreciation should be charged against current operations? These are difficult, not impossible questions for the cost accountants to answer.

Given the best guess as to average costs, a range of mark-up may be dictated by the state of authorities concerned. To be fair, this mark-up decision requires an understanding of the relationship between average and marginal cost only to recognise the circumstances under which the levels of output are in operation, for it is important to recognise whether output production is subject to increasing or decreasing returns.

If there are reasons to believe that there are economies of large-scale production, this is indicative of the falling average cost. In such cases, marginal cost (MC) will be less than average cost. This means the average cost figures need to be adjusted downwards to fix the range of mark-up. In this case, the mark-up policy will be related to a better approximation to the marginal cost figure. On the other hand if there are reasons to believe that the operation is under diminishing returns, the average cost figure must be adjusted upward to fix the range of mark-up. In the case of productivity figures, the reverse holds. Only where the average cost is neither increasing nor decreasing, average and marginal cost are equal so that average cost will need no re-adjustment to fix the range of mark-up. Even if the societal effective need requires a level of output beyond market equilibrium output, the firm should be able to supply them despite the fact that  $MC > AC$  for mark-up adjustment is to be made in terms of AC and AC is still less than MC.



It is implicit in the analysis that a firm in an Islamic economy is expected to operate under profit constraints, although it is the maximisation of social profit that matters in an Islamic economy.

#### 8.4 Guided Co-operative Prices :

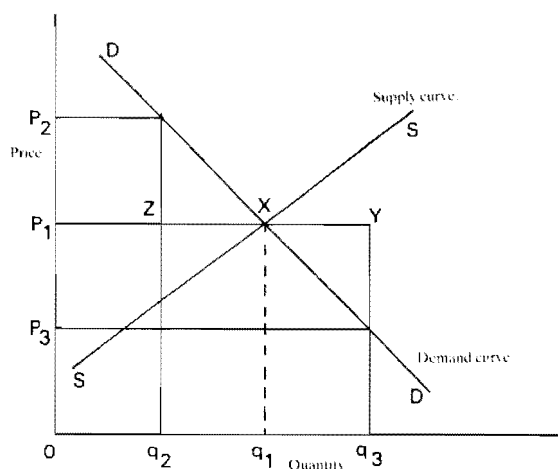
By guided co-operative prices I mean a fair price for both consumers' goods and producers' input, ensured by the passive and indirect intervention of the state, through mutually beneficial induced or voluntary co-operation. Under this scheme, the government in an Islamic economy may encourage both small consumers and small farmers to form their respective consumers' co-operatives and producers' co-operative. While the main goal of the consumers' co-operation is to ensure fair price by reducing fluctuation of key agricultural and industrial products, the goal of the producers' co-operative to reduce agricultural fluctuations and to raise the average level of farm income.

In the case of consumers' co-operative the government attempt to ensure fair price for the customers may be limited to providing guidelines for mark-up margins or level of profit to different essential and non-essential goods and services.

In the producers' co-operatives the government attempt to stabilise the incomes of farmers and to reduce the fluctuations may be limited to providing a guideline for planned production for key agricultural product as well as a range of price flexibility in response to variations in production.

Under the condition, illustrated by Figure X the producers' co-operative might be quite successful in keeping a reasonable price stability around  $P_1$ , and income at the level indicated by the area of the rectangle  $OP_1 X q_1$ .

Figure X  
Policies designed to stabilize price and income of the small farmers



Here  $Oq_1$  = planned production target (PT)  
when actual production is  $Oq_3$  ( $AT$ ); ( $AT > PT$ ), then  $q_3 - q_1$  would have to be stored unsold. When actual production is  $Oq_2$  ( $AT_0$ ), ( $AT_0 < PT$ ), then  $q_1 - q_2$  would be sold out of stocks making total sales equal to  $q_1$  at a price of  $P_1$ . This is how the producers' co-operative could keep sales, price and income stabilized, inspite of variations in production.

The Islamic distinctiveness of this plan lies not on the emphasis of co-operation among producers' and consumers themselves but on the co-operation between producers and consumers. They need to be retold that producers and consumers should not be seen as two opposing interest groups where the clash of interests are worked out by opposing forces of supply and demand and where buyers contend against buyers, sellers against sellers as well as buyers against sellers. It involves massive re-educational programmes accompanied by the structural reform of socio-economic institutions.

### **8.5 Nationalisation of Prices :**

By nationalisation of prices, I mean administered price of goods and services limited to basic human needs. When supervised competition or co-operation is not producing the desired result in provisioning for the poor, the Islamic state has the right to own the means of production and to distribute them under its direct supervision and control. No role of the market is to be recognised under such a plan. This measure can be taken only as a last resort. Its purpose is to re-educate the consumers and it must be limited to key basic human need and utilities.

The success of the nationalised prices depends on not only the efficiency of bureaucratic management but also on the commitment to Islamic ideals of justice and equity.

Since pricing in public investment projects affects different national objectives in different ways, it is therefore, necessary to examine the relative importance of the conflicting objectives so that a set of priority is established. Every price has some distributional consequences in addition to its role in allocating scarce resources. Whether the government should adopt concessional prices or scarcity prices in accordance with their productive goal. Thus if the re-distribution of income policy is intended to help poor consumers of a particular region or group, by setting a low price, the government can pass the benefit on to consumers, who gain to the extent that their willingness to pay exceeds their actual payment, determined by the price set by the government; for the price charged by the government determines directly the distribution of the corresponding benefits. Again by setting a (relatively) high price, the government may decide to reap the bulk of benefits for itself, thereby increasing the aggregate-consumption benefits for the nation as a whole.

Now the point at issue is to decide what price to be charged by the government. This can be illustrated by the following example. Suppose that the government has identified a group or percentage of small farmers and undertakes to provide fertilizers at a low price so that their productivity is increased. Suppose that the farmers' willingness to pay, measured by subtracting the all input costs other than fertilizers from the receipts for the sale of their agricultural output, exceeds their actual payments determined by the low price set by the government. This excess represents direct benefits to the rural farmers having a much lower marginal propensity to save (MPS) than the government, a greater contribution to aggregate consumption benefits for the nation as a whole would be obtained by setting a high price to keep the excess

benefits in government hands. Here we have a clear Islamic dimension to the point at issue. The Islamic choice is for low price in such circumstances in the interest of redistribution income in favour of the poor and potential aggregate consumption loss, if high price discourages small farmers not to use the fertilizer at all with the consequent fall in productivity and income.

The need to recover cost through revenue, however crucial in the investment decision of private enterprise can not play a decisive role in the allocation of public investment, particularly where it is allocated to provide the basic needs of the people.

## **9. CONCLUDING OBSERVATIONS :**

At this stage it is important to make a few concluding observations:

Firstly, the pricing options discussed earlier are intended to achieve two basic objectives:

- (a) ensure transfer of purchasing power from the rich to the poor so as to attain the goal of equitable distribution of income; and/or
- (b) ensure a level of prices (particularly the prices of basic human need) which are within the reach of the poor members of society. As long as they are achieving these objectives, they are consistent with the spirit of Islamic economic values.

Secondly, it is clearly noticeable, that almost all the pricing options offer a limited scope of market mechanism. This is clearly consistent with Islamic values of individual freedom. It is neither the approach of market economy which retains interest and private property leading to perpetual inequalities of income and wealth, nor the approach of command economy which abolishes both interest and private property, thereby pretending to solve the problem of unequal income and wealth distribution. The Islamic approach stands on its own right in the sense that it abolishes capitalists' exploitation of market prices through interest and exploitive manipulations, but retains the scope of limited private ownership property and other means of production. In economic terms, it offers incentives to individuals to work hard; in social terms it gives human dignity to individuals.

Lastly, it follows that the task of determining pricing policy is much more complicated than market or command economy. This complexity arises because of the fact that pricing policy in an Islamic economy must perform three basic functions; it must perform an economic function in so far as it relates to increased productivity and increased income of the poor through allocation and re-allocation of resources; it must perform a social function in maintaining a social balance between the rich and the poor, for dead level equality is neither desirable nor recognised in Islam; it must perform a moral function in furthering the "Cause of *Allāh*".

## 10 REFERENCES

- Al-Qur'an and Hadiths* : Abdullah Yusuf Ali's translation of the Holy *Qur'an* and *Hadiths* are reproduced from the following sources:
- A Manual of Hadith* by Maulana Mohammad Ali (1978 edition) published by Curzon Press, Humanities Press, U.K., *Sahih Muslim* (four volumes) by Imam Muslim, rendered into English by Abdul Hamid Siddiqi (1976), *Mishkat Al-Masabih*, (two volumes) English translation by Dr. James Robson, published by Sh. Muhammad Ashraf, Lahore, Pakistan, (1975) and the translation of the Meaning of *Sahih Al-Bukhari* (Arabic-English) by Dr. Muhammad Muhsin Khan, Kazi Publications, Lahore, Pakistan (1979).
- Baumol, W.J. (1965): *Economic theory and Operations Analysis*, Second Edition, Prentice Hall, U.S.A.
- Chenery, Hollis, B. (1974): *Re-distribution and Growth*, Oxford University Press, London - New York.
- Haq, M. (1976): *The Poverty Curtain*, Cambridge University Press, New York.
- Lipsey, R.G. (1975): *An Introduction to Positive Economics*, Fourth Edition, Weidenfeld and Nicolson, London.
- Mannan, M.A. (1980): *Islamic Economics: Theory and Practice*, Sh. Mohd. Ashraf Publication, Lahore, Pakistan.
- Samuelson, Paul, A. (1975): *Economics*, Second Australian Edition, McGraw-Hill, Sydney.
- Streeten, Paul (1980): "From Growth to Basic Needs" in *Poverty and Basic Needs*, World Bank, Washington, D.C. September.
- Stilwell, F.J.B. (1975): *Normative Economics*, Pergamon Press, Sydney.
- Tinbergen, Jan (1972): "Some Features of the Optimum Regime" in *Optimum Social Welfare and Productivity*, A comparative view, New York University Press, N.Y., U.S.A.
- Ward, Barbara (1975): Report on the UNEP-UNCTAD, Symposium on Patterns of Resources use, Environment and Development Strategies, Cocoyoc, Mexico, May.

## INTERNATIONAL CENTRE FOR RESEARCH IN ISLAMIC ECONOMICS

The Centre was established in 1397H (1977) to coordinate and support research at the highest level of scholarship. Some of the main objectives of the Centre are to:

- (a) Establish a specialised library that would collect scholarly works in the field of Islamic economics in various languages and issue catalogues to research scholars everywhere;
- (b) Conduct and support theoretical and applied research in various fields of Islamic economics, publish textbooks in this field for the use of Muslim universities and organise training courses needed by Muslim economic establishments;
- (c) Publish research papers and periodicals in Islamic economics.

A bilingual (Arabic and English) *Journal of Research in Islamic Economics* will be issued inshallah starting 1403H (1983).

The Centre so far published several books and papers in Arabic and English. Some of the English publications are:

1. M.N. Siddiqi: *Contemporary Literature on Islamic Economics*. 69 p.
2. K. Ahmed (ed): *Monetary and Fiscal Economics of Islam - An outline of some major subject of research*. 32 p.
3. K. Ahmed (ed): *Studies in Islamic Economics*. 390 p.
4. M.N. Siddiqi: *Rationale of Islamic Banking*. 22 p.
5. M.M. Metawally: *A Behavioural Model of an Islamic Firm*. 13 p.
6. M.A. Chawdhury: *Interest Rate and Intertemporal Efficiency in an Islamic Economy: Issue Revisited*. 46 p.
7. M. Iqbal and F. Khan: *A Survey of Issues and a Programme for Research in Monetary and Fiscal Economics of Islam*. 116 p.
8. M.A. Mannan: *Institutional Settings of Islamic Economic Order*. 12 p.
9. M.N. Siddiqi: *Muslim Economic Thinking*. 130 p.
10. M.A. Mannan: *Scarcity, Choice and Opportunity Cost: Their Dimensions in Islamic Economics*. 35 p.
11. M.A. Mannan: *Islamic Perspectives on Market Prices and Allocation*. 30 p.
12. M.A. Mannan: *Why is Islamic Economics Important?* 27 p.
13. M.N. Siddiqi: *Recent works on History of Economic Thought in Islam - A Survey*. 60 p.
14. .... *Announcement on Research Proposals*. 4th Edition.
15. M. Ariff (ed): *Monetary and Fiscal Economics of Islam*. 432 p.

All correspondence should be addressed to:

Director,  
International Centre for Research in Islamic Economics,  
King Abdulaziz University, P.O. Box 1540, Jeddah, Saudi Arabia.  
Phone: 6879202 - 6879303 - 6879033 - 6879130  
Ext. 1257, 1480, 1481, 1352, 1353