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Islamic Economics: Where From, Where To? Muhammad Nejatullah Siddiqi

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Islamic Economics should be 'Islamic' and 'Economics'.

The article from Muhammad Nejatullah Siddiqi is of utmost interest for the understanding of Islamic economics and its limits until now. It has the major benefit of giving the right perspective and being realistic about the current state of Islamic economics. It also provides directions to improve the implementation of Islamic economics. Having read this article, I would like to give a personal perspective as a Western observer.

The current state of Islamic economics in terms of implementation seems disappointing at the present time. That explains the feeling of dissatisfaction underlying Siddiqi's article. The main application has been Islamic finance, and this field also creates disenchantment. Some consider it too far from the principles of Islamic economics; others too close to conventional finance.

I would like to give some personal thoughts on the reasons for this disappointment and the possibilities to make proponents of Islamic economics happier in the long run. My thoughts conform to the very relevant remarks of Siddiqi. In a nutshell, I think the main disappointment comes from the fact that Islamic economics seems to have too much neglected the lessons from economics of the last decades. I mean that Islamic economics looks sometimes only 'Islamic' and not at all 'economics' in the sense that economic theory seems ignored in many works on Islamic economics; in particular the findings of the last decades.

Islamic economics should be at the intersection of religion and economics. Religion gives the objectives; the values to be respected. But economic theory informs on the constraints on the behavior of economic agents and the functioning of the economy. The Muslim world is not out of the scope of economics. Conventional economics and Islamic economics can differ in terms of objectives, but economic theory provides fundamental lessons to understand the implementation of any economic system. Economic theory, then, should be at the heart of Islamic economics.

What are the objectives of Islamic economics? Let's summarize them with a citation from Siddiqi: "establishment of a just, equitable and efficient economic society". Once you have the objectives in mind, the ability to reach them is strongly dependent on economics. Economic theory has made tremendous progress in the last decades and all the lessons from economic theory should be used by proponents of Islamic economics if they want an economic system able to reach the objectives of Islamic economics. Let me focus on two major fields of economic theory.

The first field is the analysis of psychology in economic behavior, following the findings of experimental economics which won Nobel Prizes in Economics in 2002 for Daniel Kahneman and Vernon Smith. One cannot summarize this field in a few sentences, but this field has shown that economic behavior is affected by psychology of the agents with some surprises in opposition to what classics had presumed. The so-called 'dictatorship game' from game theory shows, for instance, that people are not as selfish as assumed to be. They are sensitive to the situation of other people. Social norms also play a major influence on the behavior of agents. Hence, this field should be strongly studied if one wants to shape the society in accordance with the objectives and the values of Islamic economics. You can make a society more equitable by making people less selfish and more sensitive to others' situation.

The second field is the role of institutions in economic development, pioneered by Nobel Prize winners Douglass North and Robert Fogel and having notable contributions from the Turkish economists Daron Acemoglu (Acemoglu and Robinson, 2012) and Dani Rodrik, (e.g., Rodrik, Subramanian and Trebbi, 2004).North (1993) defines institutions as "humanly devised constraints that the structure political, economic and social interactions". These constraints can be either formal like laws and property rights or informal like trust. They consequently play an important role in the behavior of agents. For instance, institutional stability and good protection of investors are of major importance to enhance efficiency of the economy, which is one of the objectives of Islamic economics. People who fear expropriation or uncertainty are reluctant to invest in an economy characterized by low stability and weak protection of investors.

Islamic finance provides an excellent example of the role of institutions, as stressed by Siddiqi when he observes “could profit-sharing modes of financial intermediation flourish in environments low in trust and appropriate legal framework?” In line with this remark, I have provided empirical support to the role of institutions in the expansion of Islamic finance in two recent works. In Weill (2012), I show that better quality of institutions reduces the gap in efficiency between conventional and Islamic banks. In Weill and Godlewski (2014), I point out that better quality of institutions favors the choice of an Islamic loan. All in all, poor quality of institutions hampers the expansion of Islamic finance. As a consequence, the implementation of Islamic economics without modifying first the institutions might not work.

It has to be stressed that current indicators of formal institutions like rule of law and of informal institutions like trust show overall low levels for countries in the Muslim world. Using data from the World Bank, in my above-mentioned 2012 article I compare the ‘rule of law’ indicator between MENA countries and OECD countries. This indicator ranges from -2.5 to +2.5, with greater values associated with better quality of institutions. I then observe a mean value of -0.09 for MENA countries as compared to +1.50 for OECD countries for 2010. Concerning trust, Bjornskov (2006) uses information from the World Values Survey (WVS) based on the question ‘generally speaking, would you say that most people can be trusted or that you cannot be too careful in dealing with people?’ The respective scores for Algeria, Egypt, Morocco, and Turkey are 11.2%, 37.9%, 23.5%, and 15.7% respectively. As compared to these, the scores for France, Germany, Norway, and the USA are 22.2%, 34.8%, 65.3%, and 35.8% respectively.

Formal institutions and trust can be changed in a country. Lessons from recent economic history have shown that formal institutions can evolve as they did, for instance in former socialist European countries. Moreover, trust is influenced by the belief in others’ trustworthiness (Sapienza, Toldra-Simats and Zingales, 2013) which can evolve over time in a society.

Efforts can be made to fight corruption and hence to increase the quality of institutions that would facilitate the implementation of Islamic economics. Then one problem of Islamic economics might be that it reverses the chronology of things to do. It considers that once Islamic economics is established, the society will be equitable and efficient in line with the objectives and the values of Islamic economics. There will be no more high corruption and low trust. But to further dwell on our example of Islamic finance, the success of Islamic economics might be dependent on the initial improvement of institutions leading notably to lower corruption and greater trust between people.

Siddiqi provides another excellent example of a field of economic theory that cannot be ignored to guarantee the success of Islamic economics: asymmetric information. As has been said, there is a big difference between theory and practice in Islamic finance. Islamic banks use much more debt-based instruments like *murābaḥah* and *ijārah* than partnership contracts that are more in line with the profit-and-loss sharing principle.

Why is that the case? It is so because Islamic bankers do not have the right morale in line with Islamic economics. Thus, it becomes a question of morale to be taught. I am not sure whether that is the main reason; notably if you consider that Islamic banks take a major risk by providing financial products that can be questioned for their Sharīʿah-compliance. Clientele of Islamic banks is motivated by the fact that products are in line with their religious principles. So any criticism on the Sharīʿah-compliance of products creates the risk of losing the clientele and hence going bankrupt.

Timur Kuran (2004) has provided the most likely reason for this behavior that is based on asymmetric information. When an entrepreneur expects high returns of an investment project, he prefers fixed repayment that maximizes his profit in the likely event of success. In contrast, an entrepreneur with low return expectation has incentives to use profit-and-loss sharing instruments. So an Islamic bank proposing only profit-and-loss financing instruments would suffer from adverse selection: it would attract only entrepreneurs with low return expectations. This example shows how economic theory helps understanding the outcome of Islamic economics.

To conclude, my view is that the future of Islamic economics is in paying more attention to current economic theory to improve its implementation. Islamic economics belongs to economics, even though it has its own ethical objectives.

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