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Gaps in the Theory and Practice of Islamic Economics

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Abstract. After a generation of non-professional writers in Islamic economics, professional economists entered the stage with an important ambition, which has been to introduce a third alternative to humanity in addition to capitalism and socialism that would answer some of the inadequacies of each. Moreover, the analysis of human (individual and collective) behavior towards scarcity under the teachings of Islam was itself worth pursuing. The intellectual effort is yet to produce significant practices of Islamic economics. The exceptions include some application of Islamic finance that raises many questions, and a few applications of *zakāh* and *awqāf*. The most serious challenge of Islamic finance is the rise of products of ill repute that result from determined refusal to adhere to the decisions of the International Islamic Fiqh Academy. This paper identifies several gaps in Islamic economics and proposes ways to fill them, placing such responsibility squarely on Islamic economists.

The ambitions of the economists who established the field of Islamic economics in the late seventies has been to introduce to humanity a new all-encompassing economic paradigm that presents itself as an additional option in the choice of economic systems. However, despite many daring steps towards application, Islamic economics is still to a large measure caged in books without being applied to real-life situations. A major exception is Islamic finance. In addition, a few applications of *zakāh* and *awqāf* can be found. Even in Islamic finance, the record of application does not have an unblemished record. Products of ill repute that are prohibited by decisions of the International Fiqh Academy dominate the Islamic finance industry.

Several gaps in Islamic economics need to be filled by both scholars and practitioners. When the count of such gaps started for the purpose of

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writing a keynote speech for a conference co-organized by Aston and Durham universities in September, 2012[1], it reached seven. Now, it seems to be increasing.

1. First Gap: Division of Labor between Economists and Sharīʻah Scholars

An important reason for such dilemma is that there is some disagreement regarding the nature of Islamic economics. Such disagreement has arisen during the practices of Islamic finance. Sharīʻah scholars occupied a front seat in such implementation. Then, many acquired the impression in academic and professional circles that Sharīʻah scholars are 'Islamic economists'. The media often introduces them as such. Considering the time and effort involved in studying economics, we cannot imagine that Sharīʻah scholars would instantly turn economists, once they supervised Islamic financial transactions.

The involvement of Sharīʻah scholars into Islamic finance afforded them the opportunity of rubbing shoulders with bankers. A symbiotic relationship between both parties began. Sharīʻah scholars, while being accustomed in their profession to have modest earnings, found opportunities of high remuneration for their advisory services and bankers found that the seal of approval of Sharīʻah scholars is worth a lot in the market. This encouraged Sharīʻah scholars to keep their posture as Islamic economists and to ignore bona fide economists.

Though, Islamic finance has a narrow scope in Islamic economics, yet it attracts disproportionate attention. The popular Islamic finance and investment contracts can be quickly learnt by an economist. In addition, economists would have a comparative advantage over Sharīʻah scholars in defining *maqāṣid al-Sharīʻah* in the field of economics, which is something to which Sharīʻah scholars pay little attention.

Sharīʻah scholars, are totally absorbed in assessing and insuring the formal validity of contracts, sometimes with total disregard to their consequences[2]. They seem to be satisfied with any contract, once they find a text in the old *fiqh* literature in its support. While they understand well the importance of *maqāṣid*, they pay insufficient attention to them in practice.

(1) Islamic Finance Conference (2012) September 29 - October 1, 2012, Birmingham, UK.

(2) For example, the author estimates that *tawarruq* products represent 80 percent in Saudi Arabia and 50 percent in the UAE. Products based on debt sale represent 60 percent of the total in Malaysia.

As example of this is the fact that the prohibition of *riba* would automatically indicate that any transaction that boils down to exchanging spot for future money at a premium should be prohibited. Yet some scholars claim that *tawarruq* transactions are lawful, although their ultimate result is the trade of spot for future money at a premium. Economists in contrast are principally trained in assessing the consequences of actions. Their attention is always fixed towards ultimate consequences. To do otherwise would be contrary to the methodology of their discipline.

The first gap we can find in Islamic economics is the encroachment of Sharīʻah scholars on the field of economics, without being true to its methodology, or being able to learn the basics that any economist worth his salt must know. We must insist that Islamic economics is a branch of economics and not of Shariʻah, and Islamic finance is a branch of Islamic economics. Consequently, the tone of this discipline must be set by economists.

Economists and Sharīʻah scholars must therefore agree on the division of labor. Sharīʻah scholars can continue to do the job they know best, which is ascertaining formal validity of contracts, but the more important validity of purpose must be left to economists.

2. Second Gap: Absence of an Islamic Economic System in Real Life

The second gap lies in the absence of a model of Islamic economics that is applied in the real world. We can find countries with various political systems that raise the flag of Islamic economics. Implementation, however, is limited to scattered applications, like some application of *zakāh*, *awqāf* and Islamic finance with predominance of products of ill repute, without a coherent common denominator between them. In contrast, there is one country which is under military rule, but has made some modest advances in Islamic finance and macroeconomic policies.

At the end, we notice that we do not have an economic system that approaches the application of the Islamic paradigm. Compared to economists studying other systems, e.g., socialism and capitalism, Islamic economists find themselves at a big disadvantage. Undoubtedly, the presence of a socialist and a capitalist system has helped economists to introduce realistic and purposeful models for analysis which have later become a source of intellectual innovation.

3. Third Gap: Absence of a General Equilibrium Model for an Islamic Economy

The third gap appeared when the paradigm of Islamic finance took a wrong diversion from the very start. We concentrated on the prohibition of *ribā* or interest and how to provide finance in an interest-free environment. An economist would notice that Islamic finance is based on the prohibition of trading present against future money, which means that money would have a time value only when traded against non-monetary commodities.

This would require a more detailed general equilibrium model in which there is a market for trading each commodity, either spot, against deferred payment or with deferred delivery. In such a market, markups and rentals would have difficulty finding a balance, because of the absence of an integrated debt market and the prohibition of debt trading. Arbitrage between, e.g., wheat and cotton markets for deferred payments and deferred delivery is not directly obvious and has not been considered theoretically.

Add to this, the fact that the problem of term structure in such markets was ignored. Compared with conventional finance, such agios(3) like, rates of return on *mushārakah* and *muḍārabah*, and fees on investment *wakālah* replace the rate of interest. Little has been said about whether their payment would have the same inefficiency effects that result from the substitution of real resources for money in transactions(4).

One of the reasons for such gap in our analysis lies in the way we began in the late seventies analyzing Islamic finance in a pure profit-sharing model. Somewhere along the way some of us forgot that pure models are tools of theoretical analysis rather than paradigms. Some came up with attacks on sale finance, particularly *murābaḥah* as not being consistent with profit and loss sharing.

Another reason is that Islamic economists have mostly been students of the Anglo Saxon School of commercial banking. Very few of us came to learn about universal banking. Being a model of pure financial

(3) Traditionally an agio can be likened to the difference between the nominal and actual value of currency, and later to the commission taken by money changers to convert a currency into another. The word is used here to indicate differentials earned through the sale of goods or services.

(4) Mabid Ali Al-Jarhi (1983)

intermediation between borrowers and lenders, commercial banking made the model of Islamic banking look rather impossible[(5)].

The diversion has been long and bumpy and calls for a speedy correction. Our perception of the paradigm of Islamic finance requires refocusing on the absence of spot-against-future money market. This would lead to two inevitable consequences. First, finance must be redefined to indicate the provision of required commodities through deferred payment, deferred delivery, sale of services and usufruct, partnership or investment agency. Second, banking should be redefined to include investment and trading activities. These two steps represent a good part of the revolution of Islamic economics against the received doctrine.

4. Fourth Gap: The Role of Sharīʻah Boards

The fourth gap emanates from the absolute requirement of Sharīʻah Boards in Islamic financial institutions. The function of Sharīʻah Boards is to structure Islamic financial products. This may have been necessary when Islamic finance was an infant industry. Now Islamic financial products are well defined. Most of them are considered lawful (halal) by most Shariʻah scholars. Few are considered unlawful, which I prefer to call "products of ill repute," that include *tawarruq*, debt trading, *bay' al-ʻīnah* and risk-trading products[(6)]. Sadly enough, in some countries products of ill repute dominate the Islamic finance market.

Placing the definitions of Islamic finance products into the banking and financial market laws would significantly reduce the need for Sharīʻah Boards and replace them gradually by legal experts with sufficient understanding of Sharīʻah to apply such definitions[(7)].

5. Fifth Gap: Absence of a Unified and Well-Defined Sharīʻah Methodology

The fifth gap lies in the yet to be perfected methodology of Sharīʻah scholars. On the one hand, they accept theoretically that giving the validity of purpose in Islamic financial contracts must take precedence to formal validity. The ultimate consequence of contracts would therefore

(5) **Mabid Ali Al-Jarhi** (2003)
(6) **Mabid Ali Al-Jarhi** (2007).
(7) **Mabid Ali Al-Jarhi** (2012).

become the acid test for its validity. On the other hand, most of their judgments are based on formal validity. Such an approach appears to be similar to partial in contrast to general equilibrium analysis in economics.

This calls for a revolution in *fiqh al-mu'āmalāt*. Since in this field, economics and Sharī'ah disciplines have to be used together, Shari'ah methodology must be adjusted to give precedence to *maqāṣid*, properly stated. Otherwise, Islamic finance will continue to be open to sharp differences, depending on whether scholars stress *maṣlaḥah*, *sadd al-dharī'ah*, different dosages of each, or ultimate *maqāṣid*. Once the methodological gap has been filled, Sharī'ah Boards will stop applying ingenious subterfuges to mimic conventional financial products carefully dressed in an Islamic garb.

6. Sixth Gap: Central Banks Treatment of Islamic Finance

The sixth gap is related to the way central banks define their relationship with Islamic banks. Central banks generally ignore the differences between Islamic and conventional banks. This raises two complications. One is that the investment activities of Islamic banks may escape legitimate scrutiny from central banks, which focus on financial soundness and pay little attention to investment-related activities like feasibility studies and reviews. Central banks would not like to look into such technicalities as they are outside the competence of their supervisory staff.

Another possibility is that central banks, unaware of the true nature of Islamic banks, and unaccustomed to universal banking, may force Islamic banks into avoiding investment activities as being incommensurate with central banks perception of banking. Islamic banks would substitute Sharī'ah-compliant products with other products that mimic conventional finance dressed in an Islamic garb.

The other complication lies in the fact that central banks do not wish to involve themselves into Sharī'ah matters. While they provide banks with licenses to work as "Islamic banks" that are supposed to have Sharī'ah-compliant activities, they would not withdraw such licenses from banks that violate such licenses by supplying conventional financial products carefully dressed to appear as Sharī'ah-compliant.

In the first instance, central banks must regulate and properly supervise Islamic banks' investment activities. They should review investment procedures, feasibility studies and investment worthiness of Islamic banks' use of funds. Limiting supervision to the financial review of Islamic banks is by no means sufficient.

In the second instance, central banks must make their judgment about the Sharīʻah-compliance of Islamic banks, depending on their own methods and expertise and not just those of banks' Sharīʻah Boards. This can be done through external Sharīʻah auditing, or simply applying the definitions of Islamic finance products mentioned in the banking and financial market laws to the actual products provided by banks. The reputation risk faced by Islamic banks has been rather serious and has not been fully eliminated by their Sharīʻah Boards. Such elimination would require extra actions from central banks.

7. Seventh Gap: Central Banks' Application of Capital Requirements to Islamic Banks

The seventh gap is the way central banks calculate capital requirements for risk and liquidity management in Islamic banks. It is perfectly understandable to consider equity as a highly risky endeavor by conventional banks. Their liabilities are generally short-term loans whose repayment is guaranteed (both principal and interest). Naturally, their assets must be equally short-term debt repayment of which is carefully protected with collateral and other guarantees.

Islamic banks, meanwhile, have liabilities drawn from shareholders' funds and investment deposits. These liabilities are not guaranteed debt. These are profit sharing funds. The maturities of the funds can be extended through the proper introduction of restricted and long-term investment deposits.

Equity finance itself is an investment that entitles the bank to continuous and inexpensive monitoring. It is therefore relatively free from information asymmetry and consequently protects banks from risks of adverse selection and moral hazard. In contrast to being a source of exposure to high risks in conventional banking, equity finance turns out to be an important risk mitigating factor for Islamic banks. Therefore, central banks must stop penalizing *mushārakah* finance through heavy capital requirements. Instead, they should instruct Islamic banks to use *muḍārabah* finance solely with *mushārakah*.

8. Eighth Gap: Faulty *Ṣukūk*

The eighth gap is related to Islamic financial assets and *ṣukūk* in particular. *Ṣukuk* are supposed to be Islamic financial assets that represent common undivided shares in Sharī'ah-compliant real and financial assets. *Ṣukuk* therefore would be like shares in companies that represent equity investment. However, *ṣukūk* have been handed over to the financial engineering talents of a group of Sharī'ah scholars who view them not as Islamic financial instruments but as "Islamic bonds" or fixed income instruments that have cleverly been made up to look Sharī'ah-compliant. Such perception can be traced back to the time when Islamic banks relied on British law firms in formulating contracts for international transactions, particularly syndicated finance.

The global financial crisis has succeeded in washing out the thin Sharī'ah-compliance paint from several issues of *ṣukūk*. Suddenly some *ṣukūk* appeared to be pure conventional loans indicating no title to any asset. The philosophy of Islamic financial engineering has been set from the beginning to issue bond-like instruments, paying no attention to the Islamic finance paradigm. Obviously, a revolution is urgently required to correct our thinking towards securitization in order to stop issuing titles to common shares in debt under the name of *ṣukūk*. A lot of work is required in this regard. Perhaps the International Islamic Fiqh Academy should consider issuing a *ṣukūk* standard to fill such gap.

9. Ninth Gap: The Split between Monetary Policy and Islamic Finance

The ninth gap is the absence of any measurable link between monetary policy and Islamic finance. Financial instruments issued by monetary and financial authorities are mostly conventional. Changes in the monetary base or high-powered money largely depend on the debt markets rather than the investment markets.

The mere process of issuing money and the control of money supply in a conventional economy is debt-based. The central bank issues money in order to lend it to government and banks. Islamic economics offer an alternative approach that ties issuing money with investment[(8)]. Such approach is based on two pillars. First, the central bank must attune

(8) **Mabid Al-Jarhi** (1983).

monetary growth to economic growth, and not to the requirements of financing government budget deficit. Second, all money issued must be invested through banks as investment deposits. Profits would ultimately help in financing government budget.

10. Tenth Gap: Shyness in Using Moral Values

Some Islamic economists may feel that their discipline is not value free, while economics is a positive science. Being anxious to mimic physics, economists heavily use mathematics and statistics to develop and test their theories. Along the way they forget that their unit of analysis is human. Human qualities include believing and practicing certain moral values. *Homo Economicus* in conventional economics is assumed to be a self-interested person, which may imply that he maximizes utility and wealth. This is the most important moral judgment in economics, yet not sufficiently obvious to others.

Islamic economists must therefore place economics in the right perspective. It is a social science whose unit of analysis is human being who must respond to the economic phenomenon of scarcity. Naturally, Islamic economics can make its how assumptions about its unit of analysis. They may even define a *Homo Islamicus* who abides by Sharī‘ah in his economic behavior. They may also continue to use mathematics and statistics for developing and testing theories, without ignoring that the claim of economics being a positive science is just a mirage.

11. How to Fill the Gaps

Gaps like these must be filled through the correction of our understanding, the reorientation of our analysis, and straightening of our applications. This requires extra efforts from Sharī‘ah specialists, economists, finance specialists and practitioners. It is my sincere belief that Islamic finance, when properly perceived and correctly applied, will produce a new economic order that benefits humanity. It therefore deserves proper perception and correct application.

The responsibility for filling the gaps in the field of Islamic economics lies squarely on economists' shoulders. Currently, and after the first generation of Islamic economists, we need a second generation that has a strong command of the tools of analysis as well as a good understanding of *fiqh al-mu'āmalāt*. The second generation must start with learning the contributions of the first generation and build upon them in order to present further contributions. The last step requires a selective approach to research topics. The new generation must avoid topics which are too general or relate to some limited applications. Articles regarding environment, sustainable growth and other topics in economic development usually have very little added value. Non-analytical articles about *zakāh* and *awqāf* should also be avoided.

Some possible solutions are:

First, we need to provide more scholarships to economics students to write Ph.D. dissertations in Islamic economics. The scholarship must include paying for studying Sharī'ah in the area of *maqāṣid*, policies and *fiqh al-mu'āmalāt*.

Second, it is about time to publish and distribute some of the contributions of the first generation. For example, the author feels that his article entitled, "Towards a monetary and financial system for an interest-free economy", deserves attention. No one from the younger generation has shown familiarity with it nor has built upon it to carry the analysis forward(9).

Third, appointment of some members of the first generation as professors to teach their own thought and perceptions of Islamic economics to graduate students would help is passing the flag to the next generation.

Fourth, we must provide assistance to the countries of the *Arab Spring*, which desire to introduce Islamic finance, in order to enable them to build up a credible applied model and put it to practice gradually. This will eventually provide theoreticians with real-life experiments.

(9) The article has gone through further extensions by the author, which have not been published yet.

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فجوات في نظرية وتطبيق الاقتصاد الإسلامي

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المستخلص. بعد جيل من كتابات غير المحترفين والمتخصصين في الاقتصاد الإسلامي، دخل الاقتصاديون المسلمون المحترفون مجال الكتابة في هذا الحقل بغرض تقديم بديل "ثالث" للإنسانية جنباً إلى جنب مع الرأسمالية والاشتراكية، مع تقديم إجابات مناسبة في المجال الاقتصادي عجزت تلك النظم عن الإجابة عنها. علاوة على ذلك فقد كان التحليل الاقتصادي الإسلامي للسلوك الإنساني (فرداً كان أم جماعة) إزاء ظاهرة الندرة أمراً يستحق النقاش والتحليل. إن الجهود العقلية التي بذلت لحد الآن لا تزال بحاجة إلى تقديم نماذج تطبيقية ذات أثر. الاستثناء في هذا المضمار تمثل في تطبيق التمويل الإسلامي الذي تحوم حوله العديد من التساؤلات، وبعض التطبيقات المحدودة في مجالي الزكاة والأوقاف. إن التحدي الاكبر الذي يواجه التمويل الإسلامي يتمثل في طغيان المنتجات "سيئة السمعة"، بعدم الانصياع لقرارات مجمع الفقه الإسلامي الدولي الذي رفض هذه المنتجات. تحدد الورقة عدداً من الفجوات في الاقتصاد الإسلامي، وتقترح بعض الحلول لردمها مع التأكيد على المسؤولية الرئيسة الملقاة على عاتق الاقتصاديين المسلمين في هذا المضمار.