J.KAU: Islamic Econ., **Vol. 8**, pp. 35-37 (1416 A.H. / 1996 A.D.)

Resource Mobilization Under the Islamic Profit-Loss-Sharing Scheme: A Note

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Resource mobilization under the Islamic profit-loss-sharing (PLS) principle has recently been a central theme for extensive discussion in academic and policy circles alike. Although the PLS scheme is widely practiced in many contemporary Muslim countries that are striving to Islamize their economic systems, its application has also seen some light in a number of non-Muslim (Western) economies;

Despite its apparent appeal and relative success at the individual levels, the impact of the PLS scheme on aggregate saving and investment remains a highly controversial topic in the literature. Critics like Pryor (1985) and De Rosa (1986), for example, have contended that the absence of a risk-free asset (with a fixed rate of return) could create a high degree of exposure risk that is detrimental to national saving and economic development.

Other researchers, e.g., Khan (1986) and Haque and Mirakhor (1987), cast serious doubts on the above conclusion and demonstrate that such argument is theoretically baseless. These researchers show that inferences are very sensitive to the model underlying assumptions. If perfect certainty and full information is assumed, theoretical analysis clearly reveals no marked differences in the response of aggregate saving (investment) to an economy-wide fixed-rate of return or a PLS arrangement. However, if the more plausible assumption of uncertainty and imperfect information is instead assumed, theory suggests that national saving and investment may be expected to increase more under the PLS principle. As Siddiqi (1981) and Zaidi and Mirakhor (1991) pointed out, the theoretical result that the PLS system promotes aggregate investment appears intuitive. Under this system, the relationship between the creditor (financier) and the debtor (entrepreneur) is harmonized since both have a vested interest in the welfare and soundness of the investment project due to the fact that the profit's share of each is directly related to the project success. Consequently, the expertise of the financier will enhance that of the entrepreneur in order to ensure efficient management and the highest possible productivity of the projects. In contrast, the fixed-rate of return arrangement induces the creditors to place their primary emphasis on credit-worthiness of the borrowers when deciding which projects to finance. It is thus conceivable that many unsound projects (with little positive effects on aggregate investment) could be financed under the fixed-rate of return system. As Zaidi and Mirakhor (1991) argued, calculations of profits under the PLS scheme do not include the fixed cost of the interest charged on borrowed capital. Hence, under profit maximization, the level of investment under PLS can easily be shown to exceed that level under the fixed-interest arrangement.

The upshot of the preceding discussion is that the effect on aggregate investment and saving of adopting the Islamic PLS system is likely to be favorable on purely theoretical grounds. Indeed, such a theoretical conclusion has received consistent empirical support from several recent empirical studies. Darrat (1988), for example, provides some empirical evidence in support of adopting the PLS principle instead of the fixed-rate of interest in a representative Muslim country (Tunisia). Based on annual time series data, Darrat's results imply that an interest-free financial system is more conducive to economic growth and development that then alternative interest-based system. In particular, abolishing fixed interest-rates from the Tunisian financial system would significantly promote structural stability of the underlying aggregate money demand function and also enhance the efficacy of monetary policy as an economic stabilization tool.

In a more recent study, Bashir and Darrat (1992), construct an equilibrium theoretical model of investment under the PLS principle in the context of a non-cooperative game in which the project participants are assumed to maximize their lifetime utility based on their different information sets. The resultant theoretical model is then empirically tested using actual quarterly time series data from a PLS representative investment bank (the Kuwait Finance House). The regression results concur with the theoretical finding that the variable representing the profit-loss share plays a highly significant simulative role in the aggregate investment model. In an expanded two-period equilibrium model of investment, Bashir, Darrat and Suliman (1993) obtain similar theoretical and empirical results revealing the key role of the profit-loss sharing arrangements in promoting investment activities.

In summary, both theory and empirical evidence suggest that the Islamic PLS scheme is both feasible and effective in promoting national saving and investment in contemporary economies.

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