

Economic Development in Muslim Countries: A Strategy for Development in the Light of Islamic Teachings*

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The Questions

All Muslim countries fall within the category of developing countries, even though some of them are relatively rich. Most of these countries, particularly the poorer ones, are, like other developing countries, beset with a number of extremely difficult macroeconomic imbalances, which are reflected in high rates of unemployment and inflation, excessive balance of payment deficits, continued exchange rate depreciation, and heavy debt burdens. They are also experiencing extreme inequalities of income and wealth. The basic needs of a considerable portion of the population remain unsatisfied; the rich and the upper middle classes live in great affluence, corroding the social fabric and causing sociopolitical instability.

The Islamic revival, which is gaining momentum in almost all Muslim countries, forces us to pose two basic questions. The first is What is the quality of development that Islam stands for? And the second is What can Islamic teachings provide to aid in the development of this quality within each country's existing resource constraints such that their macroeconomic imbalances are reduced?

The quality of development is automatically defined by the objectives of the shari'ah (*maqāṣid al shari'ah*). They imply that, while economic growth is essential, it is not sufficient for attaining real human wellbeing (*falāh*); it must be accompanied by a rise in mental peace and a decline in crime and social tensions. This is not possible without spiritual health at the core of human consciousness, and justice and fair play at all levels of human interaction. Accordingly, the shari'ah accords a high priority to spiritual uplift, brotherhood, and socioeconomic justice. But these will remain an unrealized dream unless the scarce resources at the disposal of Muslim countries are utilized for the wellbeing of all its people

through the removal of poverty and the reduction of economic inequalities.¹ Since Islam discourages begging and makes it a personal obligation on every physically and mentally fit person to support himself and his family, the goal of 'need fulfillment' needs to be realized through the development of individual ability and the expansion of both self-employment and employment opportunities.

Because there is no significant controversy among Muslims about the objectives of the shari'ah, this paper will be concerned mainly with formulating a strategy to realize the kind of development that Islam stands for. To lay the discussion groundwork, the paper

¹ The fulfillment of basic needs is now quite widely accepted as a strategy for development (See Paul Streeten's "A Basic Needs Approach to Economic Development" in Kenneth P. Jameson and Charles K. Wilber, eds., *Directions in Economic Development*, [Notre Dame, IN: W. Notre Dame University Press, 1973]; and Frances Stewart, *Basic Needs in Developing Countries* [Baltimore, Maryland: John Hopkins University Press, 1985].) A number of other authors have also written over the last-decade on the concept of basic needs and its implications for development.

The stress on need fulfillment in Islam should, however, not be construed as an afterthought arising out of the recent Western discussion of the subject. It has received an important place in the fiqh and other Islamic literature throughout Muslim history. The jurists have unanimously held the view that it is the collective duty (*farḍ kifāyah*) of the Muslim society to take care of the basic needs of the poor. (See, for example, Abu Muhammad 'Ali Ibn Hazm, *Al Muhallā*, Beirut: Al Maktab al Tijāri, n.d., vol. 6, p. 156:725.) In fact, according to Shatibi, this is the *raison d'être*, of society itself (abu Ishāq al-Shatibi, *Al Muwāfiqāt fi Usul al Shari'ah*, ed., Abdallah Daraz, Cairo: Al Maktabah al Tijāriyyah al Kubrā, n.d., vol. 2, p. 177). All modern writers, including Mawdudi, Sayyid Qutb, Mustafā al Sab'ī, Abu Zaharah, Bāqir al Sadr, M. al Mubarak, and al Qardāwī, unanimously agree on this point. (See for a brief introduction, M.N. Siddiqi, "Guarantee of a Minimum Level of Living in Islamic State", in Munawwar Iqbal, *Distributive Justice and Need Fulfilment in an Islamic Economy* (Islamabad: International Institute of Islamic Economics, 1986), pp. 249-301; 'Abd al Salām al Abbādi, *Al Milkiyyah fi al Shari'ah al Islāmiyyah* (Amman, Jordan: Maktabah al Aqsā, 1975), vol. 3, pp. 81-95; Ibrahim Ahmad Ibrahim, *Nizām al Nafaqāt fi al Shari'ah al Islāmiyyah* (Cairo: Al Matba'ah al Salafiyyah, 1349 A. H.); and M. Anas Zarqa, "Nahwa Nazariyyah Islāmiyyah Mi'yāriyyah li al-Tawzi'", a paper presented to the Second Islamic Economics Conference at the International Institute of Islamic Economics in Islamabad).

starts with a brief discussion of capitalist and socialist strategies and exposes the fact that continued pursuance of these strategies will either frustrate the efforts of Muslim countries to realize the objectives of the shari'ah or lead to an accentuation of their macroeconomic and external imbalances. The paper then discusses the main ingredients of a strategy in the light of Islamic teachings—a strategy that will enable the poorer Muslim countries to accelerate economic development, giving it the meaning and color that Islam visualizes, and reduce the severity of their macroeconomic imbalances.

Failure of the Borrowed Strategies

If resources were unlimited there would be no difficulty in realizing the objectives of the shari'ah. However, the bitter fact is that resources are limited. This makes it necessary that the claims on these resources be reduced and that they be allocated and distributed in such an efficient and equitable manner that an optimum rate of economic growth is attained (efficiency) and the objectives of the shari'ah are realized (equity) without generating macroeconomic imbalances. It is not possible to accomplish these goals in a vacuum and, therefore, it is necessary to have an underlying philosophy consistent with the goals.

Every economic system has such an underlying philosophy even though, like the foundation of a building, it is not visible. This philosophy helps the system develop its own strategy, consisting of: (a) a filter mechanism to enable individuals to discriminate and choose among the unlimited uses of resources in such a way that the aggregate claims do not exceed supply and socioeconomic goals of the society are realized; (b) a motivating mechanism to induce individuals to contribute their best in conformity with the dictates of such a filter mechanism irrespective of whether this serves their own interest or the interest of society; and (c) a transfer mechanism to bring about resource allocation and distribution that is in harmony with social goals. Unless the underlying philosophy of the system is con-

sistent with its professed goals, a proper strategy cannot be developed and the goals will not be realized.

Muslim countries have tried to pursue development strategies conceived within the secularist and 'this-worldly' perspective of either capitalism or socialism. However, their problems have become aggravated and they have moved farther and farther away from the realization of the objectives of the shari'ah. The fundamental reason is that the strategies they have adopted have been borrowed from societies whose professed goals may be the same as those of Islam but whose underlying philosophy and strategy are in conflict with the realization of these goals.

Capitalism regards self-interest as the primary motivation behind individual initiative and enterprise. It thus assigns primary value to everything that serves self-interest, such as maximum individual freedom, unlimited rights to accumulate private property, market determined prices, and profit maximization. Freedom is also conceived within the framework of unhindered opportunity to pursue this self-interest. The willingness of the sovereign consumers to pay the price in accordance with their individual preferences will interact with the cost schedules of passive suppliers and determine not only the production of that configuration of goods and services which is socially most preferred but also the incomes earned by different factors of production in return for their contribution to output and revenue. The serving of self-interest by everyone in a free and competitive market environment will thus serve the social interest by leading to a most efficient and equitable allocation and distribution. Prices will serve as the filter mechanism in determining necessary from unnecessary and equitable from inequitable. Trying to do this in any other way requires value judgements which are an anathema. Capitalism thus sidesteps the crucial issues of ethics and socio-economic justice by asserting that market forces will be sufficient to keep self-interest within the bounds of social wellbeing. Government intervention is accordingly considered undesirable except when it is necessary to ensure the prevalence of orderly markets.

A number of assumptions are implicitly made in the above reasoning. However, usually they are not spelled out clearly in the literature. First, it is assumed that everything that needs to be done in social interest is also in self-interest, with no possibility of conflict between the two. This is a false assumption; for example, a substantial reduction in luxury consumption of the rich is in the interest of increased savings and investment and of general need-fulfillment, but may not necessarily be in the immediate interest of the rich. Similarly, eliminating the pollution in a country's rivers is in social interest but need not necessarily satisfy the immediate, this-worldly self-interest of an individual because it raises costs and reduces profits; thus, market forces would tend to benefit those who avoid such costs.

Second, it is assumed that background conditions that are necessary to bring about a harmony between self-interest and social well-being in a secularist environment are fulfilled. Two of the most important of these are: perfect competition (many buyers, many sellers, no barriers to entry, and perfect knowledge) and equal distribution of wealth, talents, education, and power. However, none of these two tacitly assumed conditions is fulfilled in any of the market economies around the world. Samuel Brittan has rightly observed that "No real world market is likely to be even approximately satisfactory in all the background conditions."² Hence, while market forces may be able to raise efficiency, they cannot, by themselves, be expected to bring about equity. Rather, they will enable the rich and the powerful to tilt the allocation of resources in their favor. Accordingly, as Samuelson has rightly indicated, market forces will only lead to "starving couples; to malnourished children who grow up to produce malnourished children; to perpetuation of Lorenz curves of great inequality of incomes and wealth for generations or forever."³

² Samuel Brittan, *Two Cheers for Self-Interest* (London: The Institute of Economic Affairs, for the Wincott Foundation, 1985), p. 17.

³ Paul Samuelson, *Economics* (New York: McGraw Hill, 1980, 11th ed.), p. 591.

Third, it is assumed that even in a secularist system committed to utilitarianism, the preferences of utility maximizing sovereign consumers would reflect social priorities. This is also not true. Without the restraint that commitment to moral values promotes in the use of resources, votes cast in the market place cannot reflect social priorities. Why would the rich abstain from diverting scarce resources from need fulfillment to the satisfaction of their preferences, whatever they be.

Given the prevailing inequalities of income and wealth and the lack of commitment to agreed social values, the price system could not but effectively contribute to social Darwinism in resource allocation and distribution. The situation is worsened by value-free advertising to promote the sales of status symbols and the relatively easy access of the rich to the enormous financial resources of the banking system through credit. The result is that in secularist market economies, the rich are able, by the sheer weight of their purchasing power, to get scarce national resources diverted to the production or import of luxuries and false symbols of prestige which do not fall within the category of needs. Thus, as indicated by Tawney, a “part of the goods which are annually produced, and which are called wealth is, strictly speaking, waste because it consists of articles which, though reckoned as part of the income of the nation, either should not have been produced until other articles had been produced in sufficient abundance or should not have been produced at all.”⁴ Nevertheless, every competitive equilibrium is declared to be a Pareto optimum, irrespective of whether the configuration of goods and services produced and the income distribution brought about is in conflict with the professed goals of society.

Therefore, the only policy alternatives left for removing poverty and satisfying needs within the capitalist framework are accelerated growth and government ‘welfare’ spending. However, two decades of unprecedented growth have failed to remove poverty and fulfill needs even in the world’s richest countries. In fact, as Adelman and

⁴ R.H. Tawney, *The Acquisitive Society* (New York: Harcourt and Brace, 1948), p. 12.

Morris have convincingly shown on the basis of a cross-section of data, "development is accompanied by an absolute as well as a relative decline in the average income of the poor."⁵ Moreover, growth has now faltered and there seems to be no hope of faster growth in the near future without rekindling inflation or accentuating external imbalances. Welfare spending, undertaken within the framework of value neutrality, has also helped the rich more than the poor because of their larger purchases and their greater access to facilities.⁶ Thus, while the single-minded pursuit of growth and welfare spending led to an avalanche of claims satisfied through deficit financing, credit expansion, and external borrowing, it did not help accomplish the desired goals; rather, it led to macroeconomic imbalances which have acquired cancerous proportions in some countries. Within the constraints of neoclassical orthodoxy, being championed by the World Bank and the International Monetary Fund (IMF), the cure lies in a greater resort to the market mechanism. This implies a package of liberalization policies including removal of price controls and subsidies, real exchange rate depreciation, and a general reduction in all forms of market intervention. While these are no doubt essential, their use within the secularist framework of value neutrality not only slows down growth but actually squeezes the poor unduly, leading to riots and socio-political instability.

Socialism, which is equally if not more secularist in its outlook towards life, has an implicit distrust in the ability of human beings to act in the interest of society. Hence, there arises the need to curb freedom and eliminate private property as well as the profit motive through state ownership of all means of production and central planning to promote efficiency and equity in resource use. The removal of profit as a direct reward for individual effort, however, erodes initiative and efficiency, both of which are indispensable for growth. Centralized decision making also makes the transfer of resources

⁵ Adelman and C.T. Morris, *Economic Growth and Social Equity in Developing Countries* (Stanford, California: Stanford University Press, 1973), p. 189.

⁶ See Richard Titmus, *Commitment of Welfare* (London: George Allen and Unwin, 2nd ed., 1976), p. 196.

slow and cumbersome and makes the whole economic machinery inefficient.⁷ Thus, the emergence of perestroika in almost all socialist countries—a move to reintroduce private profit, realistic prices, and some other elements of the market system for greater efficiency in resource allocation.

Nevertheless, the basic question that remains is, If individual human beings cannot be trusted to manage their private businesses within the overall constraint of social wellbeing, how can they manage the whole nation's means of production for this purpose? Will not the government officials come out of the same people who cannot be trusted? If so, what is the guarantee that they will not exploit the tremendous power exercised by them through the placing of all means of production at their command. Moreover, even the central planning officials need a philosophy of life and a filter mechanism of values to manage the means of production for actualizing socio-economic justice. Who will provide these values? If they themselves try to develop all values and rules, even the fundamentals, wouldn't there be arbitrariness in their decisions and a conflict of interest, particularly in a system which has dialectics (the counterpart of social Darwinism) as an essential part of its world view? Who will check them and correct them if necessary?

The logical flaws in the reasoning of both capitalism and socialism are also borne out by facts. The experience of capitalist countries indicates that even the richest and most advanced ones have not been able to remove poverty in spite of decades of development and their enormous wealth. In fact, inequalities of income and wealth have risen and unemployment has become a chronic, long-term problem. Some of these countries are also facing chronic macroeconomic and external imbalances that they are finding hard to remove. The record of the socialist countries is no different in either fulfilling needs or in reducing socio-economic inequalities, in spite of their enormous resources. Their economies have stagnated due to lack of motivation among workers as well as executives, and the inability of the system

⁷ For the experience with socialism in some Muslim countries see, Helen Desfosses and Jacques Levesque, *Socialism in the Third World* (New York: Praeger, 1975).

to respond to changing realities. The external debt of some of these countries has also risen steeply like that of a number of developing countries. The adoption of market solutions, which perestroika envisages, within the framework of the diehard secularism of these societies is bound to get them engulfed in the problems of inflation, unemployment, and other macroeconomic imbalances that capitalist societies are themselves experiencing.

Thus, both systems have failed to realize their professed goals. This is because their fundamental philosophy of life and the strategy derived from it are not in harmony with their professed goals. The goals are humanitarian but the strategies are conflict-oriented, based on social Darwinism or dialectics rather than on the concepts of brotherhood, trust, and accountability before the Supreme Being. Within the frame of reference of their world view and strategy they are unable to introduce the radical structural changes that are needed to realize professed goals without accentuating macroeconomic imbalances. Systems which have themselves failed to realize their goals cannot serve as examples for Muslim countries. Hence, Muslim countries must turn inward and see whether Islam can provide an allocation and distribution strategy that is different from those of both capitalism and socialism, while at the same time is in conformity with the objectives of the shari'ah.

The Islamic Strategy

Realization of the objectives of the shari'ah requires resources and, in view of the already existing heavy pressure on resources, it is not possible to muster resources for this purpose without reducing the flow for other purposes or, to use the proper economic terminology, reallocation. In the absence of reallocation there is bound to be an excessive resort to deficit financing, credit expansion and external debt. These exacerbate inflationary pressures, balance of payments deficits, currency depreciation, and debt-servicing burdens.

The kind of resource reallocation needed for realizing the objectives of the shari'ah cannot be brought about merely by the operation

of market forces or central planning. It is necessary to have a socially agreed upon filter mechanism of values, which only a moral system can provide. Islam is no doubt such a moral system with values that no sincere Muslim would be willing to challenge. However, values, even if they are accepted by everyone, may be ineffective unless they are acted upon. This requires a strong motivating mechanism, particularly when there is a conflict between self-interest and social interest. Islam provides such a mechanism through a set of inter-linked beliefs. The human being is the vicegerent (*khalīfah*) of the One Almighty God, the Creator of this universe and everything in it. As God's *khalīfah*, he is accountable to Him for how he uses the resources provided. He is duty-bound to look after his wellbeing and dignity in this world. But this world is not the end of his life. There is a life after death and his self-interest lies in safeguarding his interest in this world as well as in the Hereafter. Islam thus gives self-interest a spiritual, long-term direction by extending the span of self-interest beyond the confines of this life. His wellbeing in the Hereafter is ensured only by behaving in a way that does not hurt the interests of others in this world. This is because he is not the only *khalīfah* of God, there are millions of others like him who are his equals and brothers and whose needs must be satisfied through a fair share in God-given resources.

Thus the contribution that self-interest and the desire for profit can make towards individual initiative, drive, efficiency and entrepreneurship are recognized by Islam. However, the evils of greed and the unscrupulous disregard for the rights and needs of others that the secularist, this-worldly perspective of both capitalism and socialism can promote are overcome through the internal self-regulating mechanism of Islam, with its unrelenting emphasis on belief in God, accountability before Him, moral values, brotherhood and socio-economic justice. This accountability serves as a strong motivating force in preventing individuals from pursuing self-interest beyond the limits of social health and wellbeing. Competition and market forces are essential for playing a complementary role but are not adequate to ensure the interest and wellbeing of all because self-interest can tend

to be blind and find different ways of restraining competition and thwarting the operation of market forces, particularly when wealth and power are unequally distributed.

However, even in a morally charged environment, values may be violated and accountability before God ignored, individuals may tend to be oblivious to the problems of scarcity and to social priorities in resource allocation. They may simply be unaware of the urgent and unsatisfied needs of others and, if they are well-to-do, they may unconsciously divert scarce resources to the satisfaction of their relatively less urgent wants. Therefore, a certain degree of economic restructuring is indispensable if the objectives of the shari'ah are to be realized by Muslim countries without exceeding the limits of their resources and engulfing themselves in perplexing macroeconomic imbalances. The restructuring must address itself to the following:

- a. Transforming the human factor in development to enable it to play an active and constructive role;
- b. Reducing the existing concentration in ownership of means of production;
- c. Eliminating or minimizing all wasteful and unnecessary consumption at the private as well as the public level to release resources for actualizing social goals;
- d. Reorganizing investment to enable the production system to fulfill the demands of a need-based economy, increase opportunities for self-employment and employment, and expand the export surplus; and
- e. Reforming the financial system in the light of Islamic teachings to enable it to play a complementary and enabling role in the realization of the objectives of the shari'ah.

Such restructuring is not possible without the government playing a positive, active economic role. Totalitarianism, as envisaged by socialism, does not permit such a role. Islam, on the other hand, takes a complementary role, not through excessive controls, unnecessary violation of individual freedom, and abolition of property rights, but rather through the creation of a healthy environment and development of proper enabling institutions. Islam's four dimensional

approach (i.e., providing a filter mechanism of values, motivating the individual, socio-economic restructuring, and positive role of the government) should prove to be more effective in ensuring the well-being of all within society than the single dimensional capitalist or socialist approach of putting the whole burden on the shoulders of either self-interest and market forces or collectivization and central planning.

In general, the governments of poorer Muslim countries have been inwardly (though perhaps not outwardly) secularist, in step with their colonial heritage and the 'conventional' wisdom. They have not formulated a consistent development philosophy to realize the objectives of the shari'ah. Hence, their policies have lacked a firm direction and have oscillated on the waves of socialism and free enterprise, controls and decontrols that have been in vogue in development literature over the last four decades.⁸ This lack of firm direction, combined with fluctuations and inconsistencies in policies, has generated uncertainties and caused immense harm to the developmental process. Whatever development has been attained has been at a high cost in terms of macroeconomic imbalances, increased inequalities of incomes and wealth, and social tensions.

While formulating policies for Muslim countries within the framework of such an integrated approach, it is not necessary to find a precedent for all of these in early Islamic history. Although the shari'ah has prescribed the essential elements of a basic strategy, it has not spelled out detailed policy measures. These have to be developed. It may be possible to emulate the experience of other countries with respect to specific policies. However, while doing so, it is necessary to ensure that the policy measures being considered for adoption fulfill two criteria—that they make a positive contribution towards the realization of the objectives of the shari'ah without creating a conflict with the shari'ah, and that they do not lead to an

⁸ For some relevant details on the changing moods in development literature, see, Gerald M. Meier, ed., *Pioneers in Developments* (published for the World Bank by the Oxford University Press, 1987), in particular the "Introduction" by Meier himself. See also, Gustav Ranis and Poul Schult, eds., *The State of Development Economics* (Oxford: Blackwell, 1987).

excessive increase in claims on resources. The second criterion should not be fulfilled within the framework of Pareto optimality. A strategy that talks of increasing resources for a specific purpose without effectively reducing its availability for other purposes, cannot but lead to frustrations and imbalances. Hence, value neutrality must be set aside. Policies must be passed through the filter mechanism of Islamic values. This will also help in the public acceptance of these policies, particularly policies which do not satisfy the criterion of Pareto optimality.

In general, the policy measures suggested below may be familiar to those well-versed in development literature. No originality is claimed for most of these. What is important is the integrated approach within the framework of the Islamic world view and strategy to realize the objectives of the shari'ah without putting excessive pressure on the limited resources available.

The Human Factor: Motivation and Ability

Allocating resources efficiently and equitably, and removing imbalances requires a number of essential qualities in the people themselves, qualities that enable them to serve their individual self-interest and qualities that ensure social wellbeing. They must be willing and able to render their best by working hard and efficiently with integrity, conscientiousness, and discipline and must also be willing to sacrifice their personal comfort to overcome obstacles in the path of development. They must also change their consumption, savings, and investment behavior so that it is in conformity with what is needed for realizing the objectives of the shari'ah. This requires proper motivation and ability.

Motivation

Unless individuals are properly motivated, no system can realize either efficiency in resource use or equity in distribution. The present-day Muslim socioeconomic environment has become so inherently unjust that it is unable to motivate people to render their best,

either in their own interest or in the interest of society. Therefore, it is necessary to adopt policies that will help ensure both.

To make people work in their self-interest, they need to have an assurance that their self-interest is served by their hard work, creativity and contribution to output. There must, in other words, be socioeconomic justice—a quid pro quo relationship between the quantity and quality of output and reward.

If individuals, irrespective of whether they are employees, savers, investors or exporters, do not share equitably in the fruits of their contribution to output through a reciprocal reward, they become apathetic and their initiative and efficiency suffer considerably. In most Muslim countries material rewards are inequitable due to biases and lack of realism in official policies. Wealth and power is concentrated in the hands of the few in both rural and urban areas. Biases and lack of realism have distorted key prices which have unconsciously lowered the incomes of tenant farmers, small microenterprises (SMEs), and workers, reducing their demand for needs and creating a misallocation of resources against need fulfillment. The concentration of wealth and power, also due partly to official policies and partly to the exploitative economic system that has prevailed for centuries, has restricted competition, generated widespread collusion and created a climate conducive to the misery of the masses. This has reduced the willingness and ability of the individuals in the Muslim countries to do their best.

The bias against agriculture and SMEs in government policies has retarded the development of human, physical, and financial infrastructure in rural areas, thus not only reducing the rewards for the efforts of tenant farmers and workers in rural areas but also lowering their ability to invest in better seeds, fertilizers and equipment in SMEs to supplement their incomes from agriculture. This has led to an influx of labor in urban areas, thereby depressing wages and living conditions there. The bias in favor of urban development and large-scale businesses and industries, has also raised, along with heavy tariff protection, concessionary financing and subsidized inputs, along with profit rates among favored urban SMEs, further

increasing the concentration of wealth and power. While high tax evasion prevents the governments from reaping the benefit of their urban bias, urban congestion results in low wages and salaries and prevents urban employees from getting rewarded appropriately for their contribution to urban prosperity. However, while it is necessary to remove the bias of official policies against agriculture and SMEs, it is also necessary to remove other policy biases that reduce the real income of workers, savers, investors and exporters, particularly of those who are poor.

Minimum real wages in an Islamic society, not necessarily legally stipulated, should be such that a laborer is able to fulfill all his and his family's essential needs in a humane manner.⁹ In sharp contrast to this, wages in most Muslim countries are so low that, in spite of nearly 10-14 hours of hard work, a laborer is unable to fulfill his and his family's basic needs. This is due to the exploitation that results from inappropriate official policies, concentration of wealth and power, poverty, and lack of training facilities for workers and their children. Unless this pathetic situation is remedied it may not be possible to motivate workers to work conscientiously and efficiently.

The prescription of minimum wages may not, nevertheless, be the immediate solution. It would be difficult to enforce and, if enforced, may tend to exacerbate the prevailing high level of unemployment. Rather, it is better to resort to an entirely different package of policies—policies that raise the ability of workers to earn more through training and finance and also that restructure the entire economy in favor of need fulfillment and a more equitable distribution of incomes and wealth. Profit sharing and the employee stock ownership plan (ESOP) should also be made as widespread as possible.

Every firm should be required to establish a profit-sharing scheme for the employees. A certain agreed proportion of the firm's net profit should be distributed among the employees as profit-sharing bonuses and as a means to provide training facilities and improve working conditions, as well as to grant medical benefits, educational

⁹ For discussion, see M. U. Chapra, *Objectives of the Islamic Economic Order* (Leicester, U.K., The Islamic Foundation, 1979), pp. 14-16.

allowances to children, housing facilities, and food subsidies. Linking the increase in income and benefits of employees beyond a certain basic level to their firm's profitability and combining this with a more humanitarian treatment should have a number of benefits, including: (a) boosting employees' morale, thus leading to increased efficiency and productivity; (b) improving labor/management relations and promoting solidarity and the sense of worker participation that should be the characteristic of an Islamic society; (c) keeping the employees' earnings flexible and responsive to the health of the national economy and the performance of their firms—employees sharing in their firm's prosperity when profits are good but not burdening it when profits are low or the firm is suffering losses; (d) reducing tax evasion (provided that the tax system is reformed), because the employees, in their own self-interest, would keep an eye on the firm's actual profits with respect to which they are currently indifferent; and (e) maintaining the competitiveness of the economy and the firms, thus improving the general climate for investment and the macroeconomic performance of the economy.

The introduction of ESOP could also go a long way in benefiting workers and reducing concentration of wealth and power. It will enable workers to become equity owners, thus increasing their stake in the firm's success. It will raise savings, discourage the unproductive alternative of gold hoarding and help raise their social status in the company and society. When ESOP has been adopted even in some capitalist countries like France, the United Kingdom, and the United States, there is no reason why it should not receive enthusiastic support in Muslim countries.¹⁰

The low return on deposits paid by conventional banks because of administrative fiats hurt mainly the small savers; big businesses get a higher return and are, besides, alleged to keep most of their savings abroad to evade taxes, to protect themselves from the depreciation of their currency, and to get a higher international market-related return. However, for domestic investment, they borrow from local

¹⁰ See, J. W. Middendorf II, "Employee Share Ownership: An ESOPs Moral for the Third World" *Financial Times*, 25 March 1987, p. 25.

banks and government financial organizations at lower prime- or concessionary-rates. This is not a plea in favor of higher interest rates, but rather a strong case in favor of equity financing in conformity with the shari'ah because of its more positive role in rendering greater justice to both savers and investors and in bringing about greater allocative efficiency, economic stability, and growth.¹¹

Similarly, unrealistic exchange rates and unnecessary price controls hurt producers and exporters, while high protective tariffs hurt consumers. The claim that these measures are adopted in the interest of the common man and the country's development is usually a lie. They are not, rather, they serve the vested interest of the rich and powerful who have grown continually richer at the expense of the masses who have become more and more impoverished.

All measures that enrich a minority of the population at the expense of the majority cannot be defended in the light of the shari'ah. Nevertheless, since such practices have been in existence for a long time, it may not be advisable to remove them abruptly without taking measures to safeguard the interests of the poor. These measures may take the form of an increase in their incomes or relief payments, or an expansion in the supply of need-fulfilling goods and services, or a rise in income-earning opportunities. Among the needs that should be given priority are education and training, nutrition, the water supply, housing, sanitation, medical facilities, and public transportation.

Although a quid pro quo relationship between work and reward is necessary for hard and efficient work, it is not necessarily sufficient for inducing integrity and conscientiousness. It is also not adequate to motivate people to change their consumption, savings and investment behavior to be in conformity with the objectives of the shari'ah. Secularism, which has tacitly been the philosophy of most of the power elite in the Muslim world, regardless of whether their leaning is towards socialism or capitalism, has neither the filter mechanism necessary to serve social goals, nor the charisma to

¹¹ For a discussion of this, see M. U. Chapra, *Towards a Just Monetary System* (Leicester, U.K.: The Islamic Foundation, 1985), pp. 107-125.

inspire people and to motivate them to make the sacrifices required. Islam however carries a great potential for creating the desired qualities in people and for making them identify the social interest with their personal interest. Islam not only demands these characteristics in its followers, it also commands the necessary charisma and motivation to inspire and change them.¹² However, due to several centuries of degeneration and foreign domination, Muslims have lost touch with the inner core of their faith. Muslim countries could accelerate development substantially by improving the quality of the human factor through a reform program based on Islamic values. If they do not undertake such a reform, the erosion in morals will continue and contribute to a further degeneration in the quality of people, accompanied by its adverse impact on development and sociopolitical stability.

Ability

While socioeconomic justice and moral consciousness are both necessary to motivate people they are not enough for realizing efficiency and equity. Two persons may be equally motivated, yet they may be unable to contribute equally to the realization of the objectives of the shari'ah. The difference lies in ability, which is not only inborn but also acquired, partly through education and training and partly through access to finance. Hence, expansion of educational and training facilities, and the poor's access to finance are indispensable.

The invaluable contribution that appropriate education and training can make towards improvement in the quality of human beings, greater socioeconomic justice and faster growth is now universally recognized. Education opens the door to opportunity and has been rightly considered to be the great equalizer of the human condition. Nevertheless, Muslim governments have been grossly guilty of

¹² For a more detailed discussion of the moral characteristics required in Muslims see, Sayyid Abul A'la Mawdudi, *The Islamic Movement: the Dynamics of Values, Power and Change*, tr. and ed. by K. Murad (Leicester, U.K.: The Islamic Foundation, 1984), in particular pp. 93-132. See also, Marwan Ibrahim al Kaysi, *Morals and Manners in Islam: a Guide to Islamic Adab* (Leicester, U.K.: The Islamic Foundation, 1986), see particularly the "Introduction," pp. 13-53.

neglecting this important sector in their resource allocation policies. Even literacy, which is the first step on the path of education, has not become universal in Muslim countries. Such a neglect cannot continue for long without ruining the fabric of Muslim society.

The primary stress of education has to be on creating a 'good' Muslim. He must be educated about the qualities of a true Muslim and strongly motivated to create those qualities in himself. But this is not sufficient. It is also necessary to teach him the skills in demand and the most efficient production, management, and marketing techniques available.

The secular educational system in Muslim countries has failed to make its students better human beings and it has also failed to make them more productive. While qualified young men are unable to get admission into vocational training institutes and engineering and medical colleges due to a shortage of facilities, the universities, following loyally the blueprint set by their colonial masters, have been producing generations of secularized liberal arts majors for clerical and civil service jobs, which have now become more than fully saturated. There is thus a steep rise in the number of 'educated unemployed' in urban areas, in spite of a scarcity of trained manpower in several sectors of the economy. While the rich are easily able to get technical education for their children at home and abroad, the poor, who need it more acutely to raise their income and status, are unable to do so. This tends to widen the gulf between the rich and the poor, and to condemn the poor to a position of permanent misery. It is an obvious proof that the educational systems are not responding to the objectives of the shari'ah nor to the changing economic and political realities within Muslim countries.

Hence, there is need for a revolutionary change in educational curricula in order to impart Islamic values and the needed technical skills. It is also necessary to establish a widespread network of institutions such that even a poor man's child in rural areas or urban slums is able to have access to technical education and training facilities. This is an important way of removing one of the primary sources of

iniquity and poverty and providing everyone a chance to push ahead on the basis of his innate ability and the training he has acquired.

The inability of the poor to have access to finance is undoubtedly the most crucial drawback in bringing about a broad-based ownership of businesses and industries and thereby realizing the egalitarian objectives of Islam. Unless effective measures are taken to remove this drawback, a better and widespread educational system will only help raise efficiency and incomes but be ineffective in reducing substantially the inequalities of wealth, thus making meaningless the talk of creating an egalitarian Islamic society. Fortunately, Islam has a clear advantage over both capitalism and socialism through a financial system which is built into its value system and which provides biting power to its objective of socioeconomic justice. This will be discussed later.

Reducing Concentration of Ownership

The most serious obstacle to the realization of the objectives of the shari'ah is the existing concentration in ownership of means of production in Muslim countries, as it is in all market economy countries. Unless this situation is corrected through special measures adopted in the light of the shari'ah, it may not be possible to make perceptible progress in realizing the egalitarian goals of Islam. The Islamic strategy in this case is in sharp contrast with that of socialism, which has reduced human beings to a permanent state of wage slavery through collectivisation of all means of production and centralization of decision making. Proliferation of ownership and decentralization of decision making, conform to the dignity and freedom that are associated with the concept of *khalifah*. This proliferation must be brought about in both the rural and urban areas, as well as in agriculture, industry, and commerce.

Land Reforms and Rural Development

In most Muslim countries, a large proportion of the population is dependent on agriculture for income, employment, and general well-being. However, a constellation of historical and political forces has

led to a socioeconomic structure that is inherently unjust and perpetrates exploitation and misery of the rural population. Nevertheless, this sector has failed to receive the priority it deserves in official policies in order to remove the prevailing iniquities and inefficiencies. Unless measures are adopted to make the agricultural sector more efficient and equitable, the poorer Muslim countries will find it difficult to remove poverty and inequalities or to accelerate development.

A small number of absentee landlords controls large tracts of land in rural areas and a substantial part of the farming population is either landless or has an uneconomic holding. This sets the stage for exploitation by both the landlord and the money lender and serves as one of the major sources of persistent economic and political inequalities. The poverty of tenant farmers and rural laborers prevents them from adopting better farming techniques, thus freezing them into a state of permanent poverty and depravity. It also kills the incentive of the rural population to put in their best and creates in them the characteristics of indolence, dishonesty, and apathy. It also drives the rural population to urban areas in search of work. There, they face unhealthy living conditions and remoteness from their loved ones. Social control declines and, combined with low wages and other frustrations, contributes to crime and social unrest.

Realizing the objectives of the shari'ah is not possible without making land reform the corner stone of all economic policies. However, land reform revolves around the issues of size of land holdings and terms of tenancy. Unless these are settled in conformity with the demands of socioeconomic justice, it will be difficult to make significant headway.

If land had been acquired through fair means and cultivated either by the owner himself or leased to tenant farmers on 'just' terms, and if the Islamic system of inheritance had also been faithfully applied, landholding would not have become concentrated in the hands of a few families. However, since land has been acquired for centuries through unfair means and the Islamic law of inheritance has been disregarded, landholding has become inequitably distributed, subjecting most of the rural population to lives of virtual slav-

ery, poverty and misery. Given this highly unjust situation, it is important to set a ceiling on the maximum size of landholding and to distribute the surplus equitably among landless peasants.

The shari'ah does not visualize the setting of such limits on private wealth in normal circumstances.¹³ Nevertheless, the shari'ah does authorize the state to take all measures that are necessary for realizing the objectives of the shari'ah, provided that they are not specifically prohibited by the shari'ah.¹⁴ Since land ownership is concentrated in the hands of a few families, the existing exploitation, poverty, and inefficient use of land and labor will continue, and the goal of realizing an equitable distribution of wealth will remain permanently frustrated as long as the combined monopolistic and monopsonic power of landlords is not broken by imposing certain reasonable limits on the maximum size of land held by one family. Even the enormity of the present rural population relative to the limited size of total available land necessitates the adoption of such a measure. Accordingly, a number of renowned scholars have argued in favor of such limits.¹⁵ Since the shari'ah requires the payment of 'just' compensation to 'rightful' owners, the land needs not be given away to the peasants free. Rather, it should be given at a fair price, the entire value being realized by the government gradually over a number of years out of the peasants' earnings, and used partly to

¹³ See Abbādi *op. cit.*, vol. 2, p. 400.

¹⁴ Ali al Khafif, *Al Milkīyah fi al Shari'ah al Islāmiyyah*, vol. 1, p. 93.

¹⁵ See Muhammad Qutub, *Al Insān Bayna al Māddiyyah wa al Islām*, (Cairo: Isā al Bābi al Halabi, 4th ed., 1965), pp. 160-168 and 200-201; see also Mustafā al Sabā'ī, *Ishtirākīyat al Islām* (Damascus; Mu'assasat al Maṭbu'āt al 'Arabīyah, 2nd ed., 1960), p. 62; and Abbādi, *op. cit.*, vol. 2, pp. 398-420. There are many others who have expressed similar opinions, for example, Ali al Khafif, Mahmud Abu Sa'ud, Muhammad Yusuf Musa, Wahbah al Zuhayli, Abd al Hamid Mitwalli, Muhammed Anis Ibrahim. Even Sayyid Abul A'la Mawdudi, who, in his early writings, held the opinion that no 'arbitrary' limits can be imposed on land ownership, recanted later and stated that, in the light of the existing unfair distribution of land, the Islamic state should impose certain desired limits as a temporary measure to remove the inequities. See, Abul A'la Mawdudi, *Mas'alah Milkīyat al Zamin* (Lahore: Islamic Publications, 3rd ed., 1969), p. 111.

compensate the 'rightful' (and only the 'rightful') owners and partly to meet some of the costs of rural development.

In addition to reducing the size of landholdings, it is important to reform the terms of tenancy. While the objective of establishing justice between the landlord and the tenant remains undisputed by the *fuqahā* of all schools of Muslim jurisprudence, the nature of land tenancy has been one of the most controversial issues in fiqh literature.¹⁶ Some jurists (a small minority) permit neither sharecropping nor fixed-rent tenancy and require that a landowner himself should cultivate whatever land he can and grant the use of the balance to someone who can do so.¹⁷ There are others (a greater minority) who allow share-cropping but prohibit fixed-rent tenancy.¹⁸ Their contention is that although initially the Prophet, may the peace and blessings of Allah be on him, discouraged both sharecropping and fixed-rent tenancy, he later allowed sharecropping. This became a widespread practice among the Prophet's companions and their successors. A predominant majority of the jurists, however, allows both sharecropping and fixed-rent tenancy, this being consistent with the permissibility of both *muḍārabah* (partnership between one who has capital and one who has expertise) and leasing in the shari'ah. Their rationale is that the poverty of most Muslims in the early Madinese period had led the Prophet, may the peace and blessings of Allah be on him, to discourage both sharecropping and fixed-rent tenancy. However, later on when the economic condition of Muslims improved, he allowed both, and not just sharecropping as is argued

¹⁶ For a cogent summary see, Yusuf al-Qardawi, *Al Ḥalāl wa al Ḥarām fi al Islām* (Cairo: Dār al I'tisām, 8th ed., 1974), pp. 290-301; Abbādi, *op. cit.*, vol. 2, pp. 113-138; and M. Anas Zarqā "Al Siyāsah al Iqtisādīyah aw al-Takhtīt fi Iqtisād Islāmi," unpublished paper, pp. 36-39.

¹⁷ For a discussion in favor of this point of view see, Abdul Hamid Abu Sulayman, "The Theory of the Economics of Islam" in *Contemporary Aspects of Economic Thinking in Islam* (Bloomington, Indiana: The Muslim Students Association of U.S.A. and Canada, 1976), pp. 9-12.

¹⁸ For a strong defense of this viewpoint see, Ibn Hazm, *op. cit.*, vol. 8, pp. 210-214; see also al Qardāwi, *op. cit.*, p. 295-299.

by the second group.¹⁹ Nevertheless, Ibn Taymiyyah and a number of other jurists consider fixed-rent tenancy to be *makrūh* (undesirable).²⁰ According to them sharecropping is preferable because it is closer to justice; it requires both the landowner and the tenant to share in the reward as well as the risk of farming, in contrast with fixed-rent tenancy, which assures the landlord a fixed return even though the tenant may or may not be able to have any output. Hence, a number of jurists argue that since fixed-rent tenancy is undesirable, though not prohibited, it is within the competence of an Islamic state to prohibit it, at least temporarily, or to regulate it sufficiently, if it is considered necessary for realizing the objectives of the shari'ah and serving the interests of the people.²¹

Since the tenants and landless farmers are weak and powerless and are likely to remain so for some time in spite of the enforcement of a limit on the size of landholding, fixed-rent leasing of land may continue to be a source of injustice and poverty when the output continues to be uncertain. Hence, it would be desirable for Muslim governments to make sharecropping the general basis of land lease and to strive for a just sharing of the output between the landlord and the tenant. This should continue at least until the power base in rural areas has become sufficiently broadened and the exploitative edge of landholding families has been substantially curtailed.

The importance of land reforms for creating the egalitarian and democratic climate that Islam visualizes cannot be overstated. The creation of a rural sector of small, independent proprietary farmers would help provide a great boost to farmer incentives, thus raising agricultural output and accelerating development. Combined with the proliferation of SMEs (small micro enterprises), it would help reduce the migration of farm population to urban areas and the associated urban congestion, crime and violence. The reduction of

¹⁹ For a strong case in its favor, see Abu Yusuf Kitāb al Kharāj, *op. cit.*, pp. 88-91 and Ibn Taymiyyah, *Al Ḥisbah fī al Islām*, ed., Abd al Aziz Rabāh (Damascus: Maktabah Dār al Bayan, 1967), pp. 28-31; see also Mawdudi, *op. cit.*

²⁰ Ibn Taymiyyah, *op. cit.*, p. 30.

²¹ Abbādi, *op. cit.*, vol. 2, p. 128 and M. Anas Zarqā, p. 39.

inequalities of income and wealth would tend to strengthen democratic processes in these countries.

Given the flagrant iniquities that now exist, land reform is not an option which the governments may or may not consider seriously. If a meaningful land reform is not implemented, it will come ultimately through a violent revolution. Historical experience shows that when such revolutions take place, all ethical values get trampled. Landlords may, in this case, lose not only their lands through expropriation but also their lives. Therefore, it would be in their best interest to strive voluntarily for a just land reform.

Land reforms, though indispensable for reducing concentration of wealth, will not by themselves take the Muslim countries very far in realizing the objectives of the shari'ah unless there is a simultaneous effort to remove some of the other disadvantages from which the entire agricultural sector is suffering. The most serious disadvantage is the absence of an efficient infrastructure (roads, schools, electricity, and health facilities) due to neglect of the agricultural sector in government budgetary appropriations. Unlike the rich industrial countries, which encourage farmers through various incentives, including protection from imports, most developing countries discriminate against their farming sectors.²² They try to offset the inflationary impact of government budgetary deficits through overvalued exchange rates and low administered food prices. Such policies have turned the terms of trade against agriculture and SMEs, lowered agricultural output, increased dependence on imports, reduced exports, and depressed rural incomes. The depressed rural incomes, combined with the inequitable land tenure system, does not leave an adequate surplus to enable tenant farmers to undertake the necessary investments in agriculture and SMEs. This accentuates rural unemployment and underemployment. Thus, there is a vicious circle of poverty, paucity of investments, lower output, and unemployment. The pressure of population in urban areas has also consequently risen, leading to a decline in urban wages and the creation of slums. Hence, the hub of the problem in rural areas, as the authors of *Poverty and*

²² IBRD, *World Development Report, 1986*, pp. 85-109.

Hunger have indicated, is income distribution rather than agricultural technique.²³

Another serious disadvantage faced by the agricultural sector is the lack of availability of financing to small farmers and microenterprises. "Constant indebtedness to traders, informal money lenders, loan sharks, or relatives perpetuates the poverty of poor people."²⁴ The result is that small farmers do not have the financing to purchase better quality agricultural inputs and to operate microenterprises to raise their incomes and to keep themselves fully occupied. Hence, an equitable distribution of landholdings would by itself not lead very far unless suitable arrangements are also made to provide adequate financing, not only for agriculture but also for small enterprises in rural areas.²⁵ This should naturally be done within the framework of the alternative to the interest-based financial system provided by Islam.²⁶ However, it may not be possible unless the governments and

²³ IBRD, *Poverty and Hunger: Issues and Options for Food Security in Developing Countries*, 1986; see also "Can Better Farming Feed the World", *Economist*, 5 July 1986, p. 73.

²⁴ *Banking for the Poor: Alleviating Poverty through Credit Assistance to the Poorest Micro-entrepreneurs in Developing Countries*, Report of the Select Committee on Hunger, U.S. House of Representatives (Washington: U.S. Government Printing Office, May 1986), p. 1.

²⁵ In Japan, three out of four farming households now get most of their income from outside agriculture. See "When the Salt of the Earth Loses its Savour," *Economist* 20 February 1988, pp. 43-44.

²⁶ The alternative arrangement, in which cooperative societies, commercial banks and government sponsored financial institutions will have to play an important role, must avoid interest and be based on risk/reward sharing (*muḍārabah* or *mushārahah*), *murābahah* (cost-plus financing), leasing, or *bay' al salam*. (*Bay' al salam* refers to a sale where full payment is made in advance against an obligation to deliver the specified fungible goods at an agreed future date. This is not the same as a speculative forward sale because a full, not a marginal payment is required. Under this arrangement the farmer may be able to secure the needed financing by making an advance sale of only a part of his expected output. This will not get him into delivery problems if output falls due to unforeseen circumstances. For details on *bay' al salam* see Abd al Rahman al Jaziri, *Kitāb al Fiqh 'alā al Madhāhib al Arba'ah* (Cairo: Al Maktabah al Tijāriyyah al Kubrā, 1938), vol. 3, pp. 3-20 and vol. 2 pp. 302-318.

commercial banks, who have subsidized large urban enterprises for decades through concessionary or prime-rate financing, now tilt the balance in favor of agriculture. How this may be done will be discussed later.

Land reforms supported by other measures to liberate the peasants from the iniquities and inefficiencies they are suffering from, should not only help expand considerably the productivity of the agricultural sector but also dim the attraction of the bright city lights, thus helping reverse the shift of population from rural to urban areas. Nevertheless, it would be necessary to bring about a change in the attitudes and work habits in rural areas. This may be attained faster if Islam is used as a mechanism for social change and motivation. The mosque plays an important role in rural life and its proper use could open up an effective way of inculcating the desired characteristics in the rural population.

Proliferation of Small and Micro Enterprises

The counterpart of rural land reforms in the industrial and business sectors is the proliferation of efficient SMEs in rural as well as urban areas. This would complement land reforms in reducing the prevailing concentration of wealth and power in Muslim countries. It also has other advantages which occupy a place of high priority in the Islamic value frame.

It will enable man, the *khalifah* of God, to have an independent means of livelihood, thus rendering to him greater dignity and self respect, not possible in the state of wage slavery. In the capitalist world small businessmen, farmers and artists have increasingly lost their independence and bargaining power. In the United States, the proportion of population dependent on wages and salaries has risen steeply over the last two centuries from 20 percent in 1780 to 84 percent in 1970. Accordingly, the proportion of those who are self-employed or those who work as managers and officers has declined from 80 percent to 16 percent over this period.²⁷

²⁷ Michael Reich, "The Evolution of the U.S. Labour Force," *The Capitalist System* (Englewood Cliffs, N. J.: Prentice Hall, 1972); Edward S. Greenberg,

Large businesses dominate the economic and political scene in the capitalist world and the trend is decidedly in favor of even bigger businesses and farms. Competition, which was the predominant form of market relations in the 19th century in the capitalist world, has ceased to occupy that position.²⁸ Socialism sought to solve this problem through collectivisation, which increased wage slavery and alienation, while at the same time eliminating competition, worker incentive, and efficiency. Hence, the change of emphasis in Muslim countries in favor of a proliferation of SMEs should help create a healthier climate for competition and also be more conducive to the realization of greater efficiency and equity.

Wider Ownership and Control of Corporations

Nevertheless, it must be admitted that small business units, although preferable, may not be feasible for all types of economic activity. Hence, large business units cannot be avoided. Preferably, their form should be that of a corporation because of its ability to proliferate ownership. However, the corporation as it exists in the West is a primary cause of wealth and power concentration.²⁹ Even though it constitutes the dominant sector of the economy, it does not reflect the political democracy of the West in its decision-making. The corporation operates as an autocratic institution; the holding of controlling stock by a few families makes it possible for a few people to have control over all policies.³⁰ They exercise an immense power to make

Serving the Few: Corporate Capitalism and the Bias of Government Policy (New York: John Wiley, 1974), p. 244.

²⁸ See Paul A. Baran & Paul M. Sweezy, *Monopoly Capital: An Essay on the American Economic and Social Order* (New York: Modern Reader Paperback, 1966), p. 6.

²⁹ See C. Wright Mills, *The Power Elite* (New York: Oxford University Press, 1959), p. 117.

³⁰ One percent of all tax filers in 1960 owned 48 percent of all stock held by individuals (Reagan, "What 17 million shareholders share," p. 102 cited by Greenberg, *op. cit.*, p. 45). "In the 150 Companies on the current Fortune 500 list, controlling ownership rests in the hands of an individual or of the members of a family," (Robert Sheehan, "Proprietors in the World of Big Business," *Fortune*, 15 June 1967, p. 179).

basic product, price, and investment decisions that affect the entire nation and, in fact, the world.³¹

The Western corporation does not, therefore, provide a model for Muslim countries. It must be reformed drastically to reduce the concentration of power. The abolition of interest and the introduction of equity financing in place of borrowing will help remove the inverted pyramid of corporate power. The requirement to raise financing through the issue of shares rather than borrowing will enable broad-based ownership of corporate shares and set the stage for wider distribution of power. Since this may still not solve the problem of wealth and power concentration because most shareholders do not participate in board meetings, other reforms will also be needed to reduce the sweeping powers of directors.

Activation of Zakah and Inheritance Systems

The above measures for reducing inequalities of income and wealth would be more successful if they were further strengthened by the activation of Islamic zakah and inheritance systems. Unfortunately, even though the implementation of both these systems is an essential part of a Muslim's obligations, and indispensable for the realization of the objectives of the shari'ah, they have remained dormant for ages.

Islam requires every Muslim having resources in excess of a certain basic amount to pay zakah as a given proportion of his or her net worth or agricultural output, mainly for the benefit of the very poor and destitute. What could be a stronger rationale for making the needed sacrifice to meet one's social obligations than the belief that all resources are a trust from God and must be used for the wellbeing of all human beings who belong to the one human family of the One God, before whom account has to be given about how resources are utilized. This system of social self-reliance should, along with other measures discussed in this paper, enable the Muslim society to meet the needs of all without putting the entire burden on the public exchequer as socialism and the welfare state have unwittingly done.

³¹ See Gabriel Kolko, *Wealth and Power in America: An Analysis of Social Class and Income Distribution* (New York: Praeger, 1964), pp. 68 and 127.

Since it is the obligation of a Muslim to earn his livelihood, it has been considered desirable by the *fuqahā* to give priority in zakah disbursements to the objective of enabling the poor to stand on their own feet. Zakah should become a permanent income supplement of only those who cannot be enabled to earn enough through their own effort. This requirement, implemented in a socioeconomic environment which encourages SMEs, should make a valuable contribution toward the reduction of inequalities.

The distribution of a deceased person's estate in accordance with Islamic injunctions should also help reduce the skewness in wealth distribution. If necessary, the enforcement of inheritance laws should be in such a way that it does not lead to a rise in unnecessary consumption but, rather, to an increase in investment and a proliferation in the ownership of means of production.

Restructuring the Financial System

The interest-based financial system, which Muslim countries have borrowed from the capitalist countries, is one of the primary sources of the concentration of wealth and power.³² Therefore, the Muslim countries may find it difficult to bring about a reduction in inequalities and a proliferation of SMEs unless the entire financial system is restructured in the light of Islamic teachings. This subject is discussed later.

Economic Restructuring

Actualization of the objectives of the shari'ah without accentuating macroeconomic imbalances requires resources and, given the scarcity of resources, it may not be possible to allocate additional resources for this purpose without reducing their use elsewhere. Such a reallocation of resources is not feasible without a total restructuring of the economy in accordance with the Islamic world view and strategy. Such a restructuring would inevitably cover all aspects of the economy, including private consumption, government finances, capital for-

³² M. U. Chapra, *Towards a Just Monetary System* (Leicester, U.K.: The Islamic Foundation), pp. 110 and 140.

mation and production. Some of the relevant aspects of these are discussed below.

Restructuring Consumer Preferences

Since an accelerated rise in capital formation is indispensable for realizing the objectives of the shari'ah, it is necessary to increase savings by squeezing consumption. This objective poses a dilemma. The unequivocal Islamic emphasis on brotherhood and social equality requires that a reduction in consumption be brought about in such a way that the standard of need satisfaction of the poor is not only not worsened but in fact improved. It is not possible to resolve this dilemma without making a revolutionary change in the prevailing life-styles, particularly of the rich, knowing fully well that the inability of society to fulfill needs is not necessarily the result of an absolute lack of resources but rather of the failure to achieve a consumption pattern which is in conformity with its resources and ideals. If the needs of all are to be met within the constraint of scarce resources and if this is also to be accompanied by a rise in capital formation, then an offsetting reduction has to be made by holding consumption within the range of what the society can afford. Consumption cannot then be allowed to become the sole end of an individual's life as it has become under capitalism.

For decades, Muslim countries have been following a consumption pattern that has been copied from the Western consumer culture which measures a person's worth by the extravagance of his living and the frequency of his purchases. Accordingly, expensive lifestyles, which even some of the rich industrial countries can hardly afford, have become a prestige symbol in the poorer Muslim countries. The bandwagon effect of this, along with a number of unIslamic customs and ceremonies, extending from childbirth to marriage and death, have led to an unrealistic consumption pattern which is unwarranted in the light of their values as well as their resources. The victims of this competition are forced to live beyond their means. Aggregate consumption has accordingly risen, savings have lagged behind, and capital formation based on domestic savings remains inadequate. Moreover, since most luxury goods and services carrying

a snob appeal are of foreign origin, the pressure on foreign exchange resources has risen steeply. The resources gap has had to be filled by external borrowings, contributing to a higher debt servicing burden and further squeezing of resources.

The crux of the problem is how to distinguish 'necessary' from 'unnecessary' claims on resources and how to induce everyone to abstain from making 'unnecessary' claims? It is necessary to have a filter mechanism and a motivating system. The price system operating in a secular, value-free economy cannot provide either an effective filter mechanism or a complete motivating system.

Though prices are important for regulating consumer demand and generating efficiency in the use of resources, they are inadequate to realize equity, particularly if the background conditions are not satisfied. Reliance on prices alone enables the rich to buy what they want of the luxuries and status symbols, no matter how high their prices. If one family has them others consider them indispensable. Those who cannot afford them try to acquire them through suppression of need satisfaction, corruption, evading tariffs and taxes, and smuggling. In developing countries with their inefficient and corrupt tax administration, it is possible to avoid or evade high tariffs and taxes by means of under-invoicing, bribing and smuggling; however, the higher prices resulting from such tariffs and taxes yield higher profit margins and promote not only larger imports (through official and unofficial channels) but also greater domestic production of such goods. This leads to an unintentional diversion of resources into status symbols and unwittingly squeezes their availability for need satisfaction, thus making their prices higher.

This does not imply that higher taxes and tariffs should not be imposed. It does, however, mean that the effort to check unnecessary consumption merely by means of higher prices cannot be effective. It must also be reinforced by changing the preference scale of consumers by means of another layer of filter based on socially agreed values. If this is done, a substantial chunk of aggregate demand is eliminated even before it gets expressed in the market. A new equilibrium between aggregate supply and aggregate claims on resources

is then established at a lower level of general prices. This should help need fulfillment and improve the living conditions of the poor.

In central planning, the absence of a filter mechanism as well as consumer 'sovereignty' makes resource allocation subject to the whims and vested interests of the politburo members and other power elite. Moreover, the absence of realistic market determined prices removes even the secular motivation for 'efficiency' in the use of resources. However, if realistic prices and consumer 'sovereignty' are bracketed with central planning, as is now intended to be done in many socialist countries, then the absence of a filter mechanism, along with arbitrary decision making and vested interest of the high-salaried power elite, would lead to a resource allocation and price structure that are little different from capitalism.

Hence, as long as the Muslim countries continue to use the capitalist and socialist strategies, they will not be able, like the capitalist and socialist countries themselves, to prevent the use of scarce resources for inessential purposes. They will thus fail to realize the objectives of the shari'ah in spite of their increasing wealth. What the Muslim countries need to do is to distinguish the 'necessary' from the 'unnecessary' by dividing all goods and services into three categories: those that fulfill a need or reduce a hardship and thus make a real difference in human wellbeing; those that make no difference in a person's wellbeing and, being needed mainly for their snob appeal could be classified as luxuries and status symbols; and those that lie within the borders of the two and, there being a difference of opinion about their 'need', a clear-cut decision is not possible and a leeway is considered desirable.

The filter mechanism necessary for such a classification is available within the Islamic value system. There is substantial discussion in the fiqh literature about necessities (*durūriyāt*), conveniences (*hājjiyāt*) and refinements (*taḥsinīyāt*). All of these, as defined by the *fuqahā* (jurists), simply fall within the range of what is understood to represent needs (necessities and comforts) in modern economics and do not include luxuries or status symbols. Anything that goes beyond needs has been treated by the *fuqahā* as prodigality and self-indul-

gence and is strongly disapproved of.³³ The Islamic consumption norms could thus be of great assistance in defining 'unnecessary' claims on resources.

It is important to bear in mind that since Islam is not an ascetic religion, the classification of goods and services into the three categories given above, need not remain constant through time and place. Since Islam allows a person to satisfy all his needs and to partake of those comforts that increase his efficiency and wellbeing, and since the classification of goods and services into the three categories takes into account the development of technology and the shared increase in the standard of living, the definition of need is bound to undergo a change over time. In fact, most Muslim countries are richer today and can afford a higher standard of need fulfillment than previous Muslim societies. What is, however, indispensable is the satisfaction of all basic needs of all human beings in a Muslim society in conformity with their position as *khulafā* (vicegerents of God) and members of His family. This goal cannot be realized unless the differences in consumption levels which have been allowed in conformity with the status and income of individuals do not go beyond what the economy's resources can bear. They should not reflect snobbery or lead to wide social gaps that could only weaken the bonds of Islamic brotherhood. The objective should not be to create a monotonous uniformity and drabness in Muslim society. Simplicity in life-styles can be attained along side creativity and diversity. The criteria for classifying a need into one of the three categories should be based upon norms defined by Islam (i.e., the impact of its consumption on brotherhood and social equality) as well as upon availability of resources.

³³ For the definition of these terms within the perspective of fiqh, see Shatibi, *op. cit.*, vol. 2, pp. 8-12; and Anas Zarqā, "Islamic Economics: An Approach to Human Welfare", in K. Ahmad, *Studies in Islamic Economics* (Leicester, U.K.: The Islamic Foundation, 1980), pp. 13-15. Ahmad al Najjar and Anas Zarqā have in fact argued that in the light of Islamic teachings nothing that a man uses (as a consumer or as a producer) is morally free, even if it is economically free. (See Ahmad al Najjar, *Al Madkhal ilā al Nazariyah al Iqtisādīyah fi al Islām*, Beirut: Dar al Fikr, 1973, pp. 32 ff; and Anas Zarqā, *op. cit.*, p. 13).

'Liberalization' may hence be construed only within the framework of these three categories. Production, import and distribution of all goods and services falling within the first category should be liberalized. Market forces should be allowed to play their full role. The government should do all it can to ensure healthy competition and free interaction between a large number of buyers and sellers. The government should also provide all necessary incentives and facilities to increase the supply of goods and services falling within this category. Any indirect taxes that are considered necessary to impose on these goods and services should be modest and graduated inversely to their necessity. The consumption of goods falling within the third category should be discouraged through moral suasion, import restrictions, and relatively higher tariffs and taxes.

However, it would be necessary not to liberalize the use of resources for the second category of goods and services. The price system, as argued earlier, cannot by itself motivate people to use resources in a way that reflects social priorities. It is necessary to change consumer preferences through moral reform. If people understand their social obligations and their accountability before God, and realize that use of the economy's scarce resources by them for inessential purposes will deprive others of need fulfillment, they will tend to change their behavior voluntarily. However, moral exhortation may be ineffective when conspicuous consumption has become common and accepted over a long period of time. It is necessary to change the social mood. Individuals cannot change the direction of the tide and are constrained to conform. Hence, for greater effectiveness in creating the needed social environment, it would be desirable to campaign for simple living accompanied, at least initially, by an officially imposed ban on the third category of goods and services, including luxury imports, ostentatious ceremonies, unrealistic dowries and the display of status symbols. The elimination of 'unnecessary' claims on resources brought about in this manner, would release resources for greater supply of needs, thus keeping their prices at a humane level without the use of force or controls. It will also help prevent the continued depreciation of the currency

which is the obvious consequence of liberalization within a value-free framework as propagated by the IMF and the World Bank.

Efforts to reduce corruption are bound to fail unless the governments first strike at one of the major roots of corruption—ostentatious life-styles that now prevail in Muslim countries. Such life-styles almost force people to resort to unfair means of earning. Acquisitiveness and corruption may decline substantially once they realize that their effort to acquire greater prestige through conspicuous consumption only blemishes their reputation and raises questions about the source of their financing.

Responsible Government Spending

No doubt changing consumer preferences in favor of simple living will reduce private sector pressure on resources and raise the savings needed for investment and development. However it will not be enough. Governments in Muslim countries, as in other developing countries, are as blameworthy as, if not more than, the private sector for the excessive claims on resources. They have almost lost control over their public finances. The result is that, in spite of high rates of both direct and indirect taxes, they have had to resort to unhealthy levels of budgetary deficits. These deficits have been financed by monetary expansion and excessive levels of domestic and external borrowing. The high levels of inflation and the debt-servicing burden which have been generated will continue to plague them for a long time.³⁴

In spite of their excessive spending, governments have neither laid down the minimum infrastructure necessary for a balanced and accelerated development nor adequately supplied the services indispensable for realizing the objectives of the shari'ah. Rural infrastructure and agricultural extension services, on which the wellbeing of a preponderant proportion of the population depends, have been neglected. Education, which should constitute the foundation stone of an Islamic society, has also received inadequate attention. Health expenditure has been concentrated mainly in the major cities, in large

³⁴ See IMF, *Survey*, 6 April 1987, pp. 98-99.

capital intensive hospitals and on curative medicine. Yet the majority of the population lives in the countryside, needs a network of simple clinics and paramedical personnel, control of epidemic diseases, and, above all, the provision of clean water supplies, sanitary services and eradication of malnutrition.³⁵ Housing for the poor has received hardly any public sector attention and slum areas without public utilities and sanitation have mushroomed. Development of an efficient public transport system has been grossly neglected causing great hardship to the poor who have no transport facilities of their own. At the same time considerable lip service is paid to Islam and its imperative of socioeconomic justice. This sorry state of affairs is bound to perpetuate slower growth and economic inequalities, thus accentuating social tensions and unrest. It is therefore necessary for Muslim governments to restructure their spending so that they are able not only to reduce their overall spending levels but also reallocate spending to concentrate more on projects that will help accelerate development and realization of the objectives of the shari'ah.

The absence of a serious effort on the part of governments to utilize their limited resources more efficiently has a number of reasons. First, there is a lack of realization that the resources at their disposal are a trust from God. This failing, along with the expensive life style of government officials, has contributed to corruption. Only a moral reform of the society along with a restructuring of people's life-styles can remove this shortcoming. Second, the absence of an indigenous development philosophy, prepared in conformity with the country's own resources and values, has led to the absence of well-established priorities. Without the establishment of such priorities it is impossible to set up agreed criteria for judging the 'essential' from the 'inessential' and the 'productive' from the 'wasteful' use of resources. Unless a long-term commitment is made to an Islamic development philosophy, it may not be possible to remove the existing confusion and conflict in policies. Third, the price system has not been used and resources, particularly foreign exchange resources, are

³⁵ See Thomas, McKeown, *The Role of Medicine: Dream, Mirage or Nemesis?* Princeton, N.J.: Princeton University Press, 1979,; and Alastair Gray, "Health and Society: Reflections on Policy," *IDS Bulletin*, October 1983, pp. 3-9.

acquired or sold by governments and public enterprises at less than their opportunity costs. This contributes to inefficient use of resources. Fourth, the absence of an elected parliament and a free press deprive the public of a forum for criticism of government policies. This problem cannot be cured without establishing democratic processes.

Commitment to Islamic values and the objectives of the shari‘ah should help on all four counts. The objectives of the shari‘ah will in particular help reduce the existing arbitrariness in government spending decisions by providing the criteria for establishing priorities. The objectives of the shari‘ah could be further reinforced by adhering to the following six broad principles adapted from the legal maxims developed over the centuries by Muslim jurists to provide a rational and consistent basis for Islamic jurisprudence.³⁶

1. The principal criterion for all expenditure allocations should be the wellbeing of the people (Article 58).
2. The removal of hardship and injury must take precedence over the provision of comfort (Articles 17, 19, 20, 30, 31, and 32).
3. The larger interest of the majority should take precedence over the narrower interest of a minority (Article 28).
4. A private sacrifice or loss may be inflicted to save a public sacrifice or loss and a greater sacrifice or loss may be averted by imposing a smaller sacrifice or loss (Articles 26, 27, and 28).
5. Whoever receives the benefit must bear the cost (Articles 87 and 88).

³⁶ *Majallah al Ahkām al ‘Adliyyah*, briefly known as the *Majallah*, states 100 maxims of jurisprudence (*al Qawā’id al fiqhiyyah*) in its preamble. An English translation of the *Majallah* by C.R. Tyser, *et. al.*, and entitled *The Mejelle* was published in 1967 by the All Pakistan Legal Decisions, Nabha Road, Lahore. Although the *Majallah* is a Hanafi compendium codified during the Ottoman period, the maxims of jurisprudence are almost universally used by jurists of all schools of Muslim jurisprudence. See also Mustafa A. al-Zarqā, *Al Fiqh al Islāmi fi Thawbihi al Jadid* (Damascus: Matābi‘ Bā’ Alif Bā’ Al Adib, 1967), vol. 2, pp. 945-1060. The numbers given within brackets after each principle refer to the articles of the *Majallah* from which the principle has been derived.)

6. Something without which an obligation cannot be fulfilled is also obligatory.³⁷

These maxims have an important bearing on taxation and government spending in Muslim countries. To clarify some of their implications for government expenditure programs, it may be helpful to consider a few examples.

Since general wellbeing has to be an essential objective of all public spending in accordance with maxim 1, then maxim 6 would require that all physical and social infrastructure projects which help realize this objective through accelerated economic growth, job creation and need fulfillment should be given priority over those that do not make such a contribution. Even among the indispensable infrastructure projects, maxim 2 would demand the giving of preference to projects that would help remove the hardship and suffering caused, for example, by malnutrition, illiteracy, homelessness, epidemics, lack of medical facilities, clean water supply, and sewage disposal. Similarly, the development of an efficient public transport system should acquire priority in accordance with maxim 3 because its absence causes hardship to a majority of the urban population, adversely affecting efficiency and development, and leading to an excessive import of cars and gasoline. While these cars provide extra comfort to a small portion of the suburban population, a reduction in their imports and diversion of the savings to import of public transport vehicles could be justified on the basis of maxim 4. Such a measure would not only reduce the pressure on foreign exchange resources but would also provide comfortable transport services to the majority with less congestion and pollution.

If priority is to be given to serve the interest of the majority in accordance with maxim 3, then the secondary importance given to rural development programs has no foundation. Since the majority of the population lives in rural areas and the mass uprooting of manpower from their families and society causes socioeconomic problems, the development of these areas to raise agricultural productiv-

³⁷ See al Shatibi, *op. cit.*, vol. 2, p. 394; see also Mustafā al Zarqā, *op. cit.*, vol. 2, pp. 784 and 1088.

ity, expand self-employment and employment opportunities, and fulfill their needs must take precedence. This will also automatically improve urban life by reducing the population congestion.

If inequalities of income and wealth are to be reduced, it becomes indispensable, in accordance with maxim 6, to raise the ability of the poor to earn more through greater and more convenient access to better educational and training facilities and to finance. This demands the giving of priority in government spending programs to the establishment of educational and vocational training institutions in rural areas so that everyone who qualifies has an equal access to them. It is also necessary to restructure the financial system to make financing available to a broad spectrum of entrepreneurs in rural as well as urban areas to raise self-employment opportunities and to increase the supply of need-satisfying goods and services.

Given the unhealthy fiscal deficits, the objectives of the shari'ah cannot be realized without a reallocation of government spending. Hence, a decision has to be taken about areas where spending must be reduced. Without such a reallocation, either the realization of the objectives of the shari'ah will have to be compromised or else spending will exceed the limits of available resources and lead to macro-economic and external imbalances. Where can spending be reduced? It is important to identify some of the major areas where savings can be realized.

The first and the most obvious way to achieve substantial savings is to minimize corruption, inefficiency and waste, which are seriously eroding the governments' ability to utilize their scarce resources efficiently. According to the Chairman of the Pakistan National Assembly's Public Accounts Committee, "the major part of the development budget is misappropriated." Instances cited by him include: defective buildings collapsing a few years after construction, roads washed away by a single rainstorm, imported railway machinery becoming scrap without being used, imports being sold elsewhere before reaching Pakistan, and big loans extended by national-

ized banks to influential people being written off.³⁸ However, the effort to reduce corruption may have a greater chance of success if it is also accompanied by moral reform, transformation of life-styles and structural changes in the economy.

A second area where substantial savings can be made is subsidies. Even though the welfare of the poor has to be one of the primary considerations of an Islamic state, a number of subsidies provided by Muslim governments (either directly or through public enterprises, and either transparent or opaque) cannot be convincingly supported. Subsidies are usually defended on equity or economic considerations. However, on both these counts they do not stand up to the test of the objectives of the shari'ah or the maxims of public spending stated above.

If equity is the goal, the subsidy must redistribute income toward the truly needy. It does not. A lower price that does not cover the costs in accordance with maxim 5 tends to benefit the rich more than the poor because of their larger consumption and easier access.³⁹ This is not defensible in a system committed to socioeconomic justice. If value judgements are not an anathema, there is no justification for a lower price or subsidy for the rich or those who can afford to pay. Only those who are unable to pay a realistic price should be helped. Since price discrimination is administratively difficult and since it is desirable to make everyone pay the realistic price, the best way to help the poor is through substantially increased scholarships, relief payments and income supplements paid out of appropriations made for this purpose by the government or social service organizations, zakah funds, and other voluntary or compulsory donations. In this way the government may be able to provide more intensive relief to the needy by using only a proportion of the total amount spent on a general subsidy. The income supplement would give the poor the chance to determine their own priorities and the realistic price would

³⁸ "Most of Pak Funds for Development Misused": Ali Shah Details PAK Findings," Summary of a report published on the authority of Reuters by the *Saudi Gazette*, 21 June 1987, p. 7.

³⁹ In Morocco, only 16 percent of the subsidy on subsidized foods reached the lowest income group in 1984. See "World Bank Presents its Six-Point Approach to Subsidies in Developing Countries," *BIS Review*, 8 April 1987, p. 5.

help minimize the wasteful use of goods or services brought about by a general subsidy.

If efficiency is the goal, subsidy must strengthen incentives for the realization of the objectives of the shari'ah and allocate resources more effectively. It does not. Agricultural subsidy has mainly helped the big farmers "who have obtained a disproportionate share of it and have used it to amass land and other assets."⁴⁰ The subsidy paid to large-scale urban industries on the basis of infant industry argument rarely encourages them to cross the threshold of infancy. However, if the subsidy is used to enable small farmers and SMEs to adopt better technology and inputs, and to stand on their own feet, it could be justified on the basis of the objectives of the shari'ah. But the rural and urban poor "tend to be dispersed, unorganized and politically inarticulate" compared with the urban and rural elite.⁴¹ Hence they rarely get producers' subsidies of the kind obtained by large-scale industries and influential landlords. The poor nevertheless end up bearing the tax burden of subsidies because the tax systems in these countries are usually regressive.

A third important area of saving could be the gradual lifting of patronage provided to public sector enterprises. "By and large the performance of state-owned businesses in the developing world has been disappointing."⁴² They have typically failed to provide the spur to industrialization and faster growth that governments had hoped for; not only have the financial returns often been unimpressive but the social returns have been poor. This is because they have operated without competition and governments have often placed little emphasis on efficiency and have rarely been prepared to use the sanction of liquidation. Low profitability limits their ability to self-finance their investments. Consequently, they have often been a cause of large budgetary deficits and external debt. In a sample of 27 developing countries from 1976 to 1979, the net budgetary payments

⁴⁰ *Ibid.*, pp. 4-6; see also IBRD, *World Development Report*, 1986, pp. 90-104.

⁴¹ *Ibid.*, p. 92.

⁴² "Privatisation in the Third World," *Financial Times*, 3 September 1987.

to nonfinancial state owned companies were more than 3 percent of the GDP.⁴³

A fourth area where large savings can be made is defense. According to the World Bank, "evidence increasingly points to high military spending as contributing to fiscal and debt crises, complicating stabilization and adjustment, and negatively affecting economic growth and development."⁴⁴ Within the framework of the objectives of the shari'ah and the principles discussed above, the claim of national defense for the lion's share in budgetary appropriations loses its rationale in the absence of a serious threat of external aggression.⁴⁵ It is often forgotten that defense spending imposes not only monetary cost but also other costs, including reduced wellbeing of the poor, leading to social unrest and political instability. Only a few Muslim countries are seriously threatened; most of the others usually make undue fuss about defense on the basis of unrealistic assumptions. Moreover, it is always possible to have better defense with smaller spending if efficiency is ensured in the use of resources, if corruption, which is more rampant in defense than elsewhere, is removed, and if a conciliatory policy is adopted and unnecessary conflicts with neighboring countries are avoided.

⁴³ IBRD, *World Development Report, 1983*, p. 74. The net deficit of a sample of Niger's state-owned enterprises accounted for about 4 per cent of the country's GDP in 1982 (*ibid.*, p. 67). Turkish public enterprises averaged net losses equivalent to 3.9 percent of GDP during 1977-9 (*ibid.*, p. 74). One study has found that countries in which state-owned enterprises accounted for higher shares of gross domestic investment generally had lower rates of economic growth. (See IBRD, *World Development Report, 1987*, pp. 66-67).

⁴⁴ IBRD, *World Development Report, 1988*, p. 106.

⁴⁵ Although the average defense expenditure of industrial and developing countries was 14.35 percent and 14.02 percent, respectively, of total government expenditure in 1983, the expenditure of some Muslim countries was: Pakistan, 34.82 percent; Indonesia, 20.04 percent; Malaysia, 15.05 percent (1981); Egypt, 16.59 percent; Oman, 48.51 percent; and Yemen Arab Republic, 30.68 percent. See IMF, *International Financial Statistics, Supplement on Government Finance, 1986*, pp. 30-31.

Since the existence of poverty and extreme inequalities and the absence of adequate educational institutions, hospitals, and public utilities, particularly in rural areas, is subjecting a majority of the population to hardship and economic backwardness, there seems to be little moral or economic justification for spending huge sums on defense hardware. The absence of a real threat prevents the governments from demanding from themselves and the rich the financial and economic sacrifices that defense requires. Countervailing adjustments are accordingly not made in life styles and government spending, and the needed sacrifice is hence quietly passed on to the urban and rural poor through the low priority given to satisfaction of their needs on the basis of the usual plea of 'lack' of resources.

High defense spending does not even provide the security which the governments claim it does. The 'real' source of security for the poorer Muslim countries lies in internal strength attained through moral reform, economic development and socioeconomic justice. No amount of defense spending can provide security against internal disintegration which is gaining momentum in many Muslim countries. It seems that sometimes even the very objective of defense build up, ensuring national and territorial integrity, is jeopardized by 'excessive' defense spending. This is because, as Paul Kennedy has rightly argued, a strong economic base is more vital to a nation, in the long run, than military superiority; and nations which stretch themselves militarily beyond what their economies will sustain are looking for a fall.⁴⁶

Therefore, one of the most important goals of government policy in Muslim countries should be to minimize defense spending through policies of conciliation and peaceful coexistence with a view to release resources for satisfying the needs of the majority. If the Muslim countries concerned take the initiative, there is bound to be public pressure for reduced defense spending even in the neighboring countries from which the Muslim countries feel the psychologi-

⁴⁶ Paul Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict, 1500-2000* (New York: Random House, 1988), pp. xvi and 536-540.

cal threat. Every one will then be better off. The nonavailability of borrowed funds due to the Islamic ban on interest should help compel Muslim governments to resort to conciliatory and peaceful coexistence policies. They also need to derive inspiration from the Prophet, peace and blessings of God be on him, who signed a truce agreement with the Makkans on extremely unfavorable terms to get a period of peace and tranquility.

While spending needs to be reduced and reallocated the tax system, which is as guilty of fiscal mismanagement as expenditure policies, also needs to be reformed in the interest of greater equity and higher revenue. Muslim countries, like other developing countries, are not so much over-taxed as they are badly taxed. The tax base is narrow and so the tax rates are high. Tax base, tax rates and corruption are parts of a vicious circle. The narrower the tax base, the higher the rate must be to achieve a given amount of revenue. The higher the tax rate, the greater the incentive for corruption. This vicious circle leads not only to economic distortions but also to a greater reliance on indirect taxes. It is well known that "tax evasion by the well-to-do is colossal, and they are anyhow relatively very few, while the poor are many. Taxation becomes forced to rely on regressive indirect taxes."⁴⁷ The reform of the entire tax system and the collecting machinery are hence indispensable.

Muslim countries have no alternative to expenditure and tax reform; increased reliance on borrowing and foreign aid is not feasible. Borrowing does not bear a great promise because the debt servicing burden of both domestic and foreign debts of these countries has already risen to an intolerably high level. Foreign aid, although indispensable under the existing imbalances and welcome to the extent to which it helps in the realization of the objectives of the shari'ah, has its own limitations. It has gone down in real terms and, excepting for a small proportion of grants, most of it comes as

⁴⁷ Gunnar Myrdal, National Bank of Pakistan, *Quarterly Economic Journal*, January-March 1979, p. 29.

loans.⁴⁸ Even though most of these loans are at concessionary rates, they have nevertheless to be repaid with interest. The tragedy is that most foreign aid is not used ultimately to increase the rate of capital accumulation and growth; it is used to increase private consumption or recurrent public expenditure, including military expenditure.⁴⁹ In the interest of maintaining their geopolitical independence, it would be desirable for Muslim countries to seek as little aid as possible and to use effectively whatever aid they get for the realization of the objectives of the shari'ah. The Prophet's hadith saying that "The hand that is above is better than the hand that is below,"⁵⁰ should be applicable to nations even more than it is to individuals. While there may be a justification for aid that is used for realizing the objectives of the shari'ah, there is hardly any justification for aid that is used for supporting private conspicuous consumption, recurring public expenditure, and military build up in the absence of a real threat.

The Islamic injunction against interest should prove to be of great help in realizing greater efficiency in public sector spending. Since interest-based borrowing may be permissible only in emergencies or extremely difficult circumstances, governments will have to finance

⁴⁸ Total net financial flows to developing countries fell by about 15 percent in volume terms in 1986. For details see, OECD, *Financing and External Debt of Developing Countries—1986 Survey* (Paris: OECD, 1987). Except for a small proportion of grants, most of this aid is in the form of loans. See "Financial Resources for Developing countries: 1986 and Recent Trends," OECD, *Press Release*, 19 June 1987, Table 2, p. 8.

⁴⁹ Mohammad Anisur Rahman, "The Welfare Economics of Foreign Aid," *Pakistan Development Review*, Summer 1967, pp. 141-159; See also, "Foreign Capital and Domestic Savings: A Test of Haavelmo's Hypothesis with Cross Country Data," *Rev. Economic Statistics*, February 1968, pp. 137-138; Thomas E. Weisopf, "The Impact of Foreign Capital Inflow on Domestic Savings in Underdeveloped Countries," *Journal of International Economics*, February 1972, pp. 25-38; Keith Griffin, *International Inequality and National Poverty* (London: Macmillan, 1978), and "Doubts about Aid," unpublished paper, Magdalen College, Oxford University, June 1984.

⁵⁰ Bukhari, *Al Jāmi' al Ṣaḥīḥ* (Cairo: Muhammad Ali Subayh, n.d.), vol. 2, p. 133; Abu Abd al Rahman bin Shu'ayb al Nasā'i, *Sunan al Nasā'i al Mujtaja* (Cairo: Mustafā al Bābi al Halabi, 1964), vol. 5, pp. 45-46.

their budgetary spending through mainly taxation, leasing and equity finance. All current and unproductive outlays will need to be financed out of tax revenues. Since there is a limit to the extent to which tax revenues may be raised, governments will not be able to overstretch themselves. They will be forced to keep their wasteful and unnecessary current expenditures under control and to apply cost recovery methods in the pricing of goods and services supplied by them.

Since borrowing does not obviate, but rather only postpones, the ultimate need for sacrifice, the ban on interest should prove to be a blessing by removing the long-term heavy debt-servicing burden it normally leads to. The constraint it will impose on government spending in the short-run may tend to be more than offset by the healthy discipline it will impose on the governments, the sustained, steadier growth it will generate in the economy, the greater cooperation it will bring about between the governments and the private sector, and the much smaller debt-servicing burden it will create in both the domestic and external sectors of the economy. To avoid an excessive squeeze in the initial stage, the governments may apply the prohibition gradually and not in one stroke. An unscrupulous government may try to find the easy way out by borrowing excessively from the central bank. This would hurt the Islamic imperative of making money a reliable measure of value through price stability. Accordingly, it would be unrealistic for a Muslim government to talk of Islamization without making a serious effort to reduce its budgetary deficits.

Restructuring the Investment Climate

Implementation of Islamic consumption norms should help increase savings. But, savings may not necessarily get diverted to capital formation. and even if they do, just a rise in capital formation is not the apex of achievement. What is needed is capital formation that would lead to need fulfillment, export expansion and a rapid rise in self-employment and employment opportunities. Therefore, it is not enough to cut consumption; it is also necessary to foster a suitable investment climate.

In the present-day Muslim societies, a substantial part of even the existing low level of savings goes into unproductive channels like hoarding (gold, precious stones, and jewelry) and capital flight. Capital flight has become a serious problem for most developing countries. During the 11 years to 1985, about \$150 to \$200 billion of the total capital outflow of \$250 billion from capital importing countries represented capital flight.⁵¹ Capital flight of this magnitude depresses domestic investment and makes sustained growth more difficult to achieve. If the same policies continue, it will be difficult to prevent capital flight and to raise domestic investment, thus frustrating the realization of the objectives of the shari'ah.

Productive investment of one's savings so as to contribute to need fulfillment and increased self-employment or employment is the social obligation of all Muslims who are capable of saving in keeping with the already-quoted maxim: "Something without which an obligation cannot be discharged is also obligatory." It becomes even more obligatory because the Prophet, peace and blessings of God be on him, himself glorified productive effort and investment by saying: "Any Muslim who plants a tree or cultivates a field such that a bird or a human being or an animal eats from it, this deed will be counted as an act of charity."⁵² The Prophet, peace and blessings of God be on him, also discouraged disinvestment by saying: "He who sells a house [without need], but does not invest the proceeds in something similar, God will not bless the proceeds."⁵³ The Caliph Umar, may God be pleased with him, used to say: "He who has wealth, let him improve (develop) it and he who has land, let him cul-

⁵¹ See Stephen Fidler, "Third World's Missing Millions," *Financial Times*, 7 September 1987. See also C. L. Ramirez Rojas "Monetary Substitution in Developing Countries," *Finance and Development*, June 1986, pp. 35-38.

⁵² Bukhāri, *op. cit.*, vol. 3, p. 128; Muslim, *Ṣaḥīḥ Muslim* (Cairo: 'Isā al Bābi al Hālabi, 1955), vol. 3, p. 1189:12; Muhammad ibn Isā al Tirmidhi, *Al Jāmi' al Ṣaḥīḥ* (Cairo: 'Isā al Bābi al Halabi, 1956), vol. 3, p. 666:1382.

⁵³ Suyuti, *Al Jāmi' al Ṣaḥīḥ* (Cairo: Abd al Hamid Ahmad Hanafi, n.d.), vol. 2, p. 167, on the authority of Tabarāni; the expression within parentheses has been added on the basis of another hadith quoted by Suyuti on the same page; see also al Abbādi, *op. cit.*, vol. 2, pp. 96-107.

tivate it.”⁵⁴ Given these values, it should be possible to make productive investment take the place of consumption as a prestige symbol in a Muslim society such that the benefits that others can derive from savings are actualized. The levy of zakah on all net worth, including currency hoarding and gold and silver jewelry, should prove to be of great help in inducing savers to get into income-earning financial or real assets to be able to offset the impact of zakah on their savings.

However even these values may by themselves fail to promote productive investment. People do not commit funds for long-term productive investments unless there is a proper investment climate. Some of the factors which vitiate the investment climate are the absence of adequate social and physical infrastructure, an inequitable tax system, political uncertainties, continuous depreciation in the exchange rate of the country's currency and an arsenal of unwarranted controls. A reference has already been made to the need for infrastructure construction and tax reform. The remaining three factors are briefly discussed below.

There is no immediate solution to political uncertainties which are the result of poverty, sociopolitical unrest, and absence of democratic processes. These have been further aggravated by shifting loyalties of the ruling elite to capitalism, socialism, and Islam in response to the conflicting demands of their own vested interest, international power politics and the people's aspirations. This has generated confusion and contributed to an absence of firm direction in policies and strategies. Making a serious commitment to Islam and allowing democratic processes to play their full political role should help provide the needed direction and stability to policies.

The shari'ah clearly defines the rights and limitations of property holders and the legal enforcement of these should help remove the fears of investors about arbitrary seizures and nationalization. In his address delivered on the occasion of his Farewell Pilgrimage, the Prophet, peace and blessings of God be on him, declared: “Your lives

⁵⁴ M. H. Haykal, *Al Fārūq Umar* (Cairo: Maktabah al Nahdah al Misriyyah, 1964), vol. 2, p. 229.

and your properties are as sacred as this day of the Hajj.”⁵⁵ Accordingly, the jurists have unanimously ruled against arbitrary confiscation and nationalization of property by the state. Abu Yusuf epitomized this ruling by saying: “The ruler has no right to expropriate anything except by a clear and established right.”⁵⁶ This clear verdict of the shari‘ah should become reflected in the legal framework of all Muslim countries. They should define clearly and stipulate legally all those sectors of the economy where only public enterprises may be permissible and sectors where private enterprise will have a free role to play. Such a classification should be further reinforced by a legal guaranty in favor of just compensation in case of reclassification. Public enterprises will anyway have to be kept at a minimum because of the prohibition against interest and the inability of the governments to raise sufficient financing for such enterprises through taxes or sale of shares. Once such guarantees have become integrated into the country’s constitution and legal framework and it is realized that their fountainhead is the shari‘ah, it would be difficult for any government to disregard them in the interest of its own domestic popularity and international standing.

The continuing depreciation of the currencies of most Muslim countries cannot be prevented without reducing claims on resources, particularly foreign exchange resources, through restructuring of private sector consumption and government spending in the manner already discussed. Instead, most Muslim governments rely on exchange controls (overvalued exchange rates with import licensing), high tariffs, and promotion of import-competing industries.

Exchange controls, as evidence has indicated, have been largely ineffective.⁵⁷ They lead to the creation of a dual market of official and black market exchange rates. The overvalued official rate encourages imports and discourages exports, thus worsening the allocation of resources and depressing the rate of economic growth. They

⁵⁵ Muslim, *op. cit.*, vol. 2, p. 889:147; and Ibn Mājah, *Sunan Ibn Mājah* (Cairo: Isā al Bābi al Halabi, 1952), vol. 2, p. 1297:3931.

⁵⁶ Abu Yusuf, *op. cit.*, pp. 65-6.

⁵⁷ See Ramires-Rojas, *op. cit.*, p. 37.

contribute to socioeconomic injustice by subsidizing import license receivers at the expense of consumers and exporters; the consumers continue to pay for imports at the opportunity cost of foreign exchange while the exporters receive less for their output. They also promote corruption and inefficiency. The various bonus schemes adopted to promote exports in the absence of a realistic exchange rate only succeed in exacerbating injustice and corruption. The benefit of these schemes does not permeate to the actual producers; their resources do not consequently increase to enable them to acquire improved inputs and better technology. Their productivity hence continues to remain low.

Higher tariffs, unlike realistic exchange rates, constitute a single-edged weapon. If applied effectively, they can discourage imports, but do not encourage exports. However, when high tariffs are used in developing countries with weak customs administration, and without any attempt to change the social mood, there is under-invoicing, smuggling, and tariff evasion. This raises the relative profitability of highly taxed, but smuggled, luxury goods and distorts resource allocation against need satisfaction. Hence a more effective strategy would be to ban the import of goods falling in the third category of goods and services.

Promotion of import-competing industries is no doubt necessary to reduce the pressure on foreign exchange resources and to promote employment and growth. However, in the absence of a consistent development philosophy, the selection of import-competing industries is arbitrary with no relationship to the realization of the objectives of the shari'ah or the rational principles of resource allocation. Nevertheless, they receive maximum government patronage in the form of subsidized financing, high tariff protection, exemption from duties on the import of capital goods and raw materials, and tax holidays. Such industries are usually large-scale and get established in urban areas. Since most of them are capital intensive and use a more sophisticated technology, their contribution to employment is not as much as that of labor-intensive SMEs (small micro enterprises). The high tariffs imposed to protect them contribute not only to higher

prices for consumers but also, along with other privileges, to the unearned enrichment of those who receive licenses for such industries and resort to under-invoicing. More and more of the nation's resources accordingly move into such industries distorting resource allocation and enriching the urban and rural rich. In such highly protected industries, there is usually little competition.⁵⁸ Agriculture and SMEs, which should really be the candidates for protection because of their great potential for import-substitution, are neglected. They suffer from lack of government support, overvalued exchange rates, import subsidies and commodity aid. Since most units operating in these sectors are small, unorganized and inarticulate, they are unable to exert any political pressure. The result is the vicious circle of neglect and poverty of these sectors and their inability to finance investments in improved technology. This is undoubtedly in conflict with the objectives of the shari'ah.

Probably the greatest obstacle to investment in Muslim countries, like in other developing countries, is the bureaucratic red-tape. This springs from various types of unnecessary controls which lead to a waste of investor time and an unnecessary rise in costs. Unless most of these controls are dismantled, it would be difficult to improve the investment climate even if savings increase. The general spirit of Islamic teachings is the freedom of enterprise within the value-frame of Islam. Controls are an inevitable source of corruption and even the Islamization of morals may not be able to prevent the officials from succumbing to temptation. There is moreover no justification for controls on the local manufacture or import of need-fulfilling consumers' goods falling into category one (necessities) and the raw materials and capital goods needed for their manufacture.

The Islamic ban on interest will make it indispensable for Muslim countries to encourage and facilitate foreign investment. This should not raise any demurs because "equity investment is beneficial to developing countries and can be increased."⁵⁹ It makes

⁵⁸ See OECD, *The Costs of Restructuring Imports—The Automobile Industry*, (Paris: OECD, 1987).

⁵⁹ IBRD, *World Development Report, 1985*, p. 125.

available not only finance but also technology and management which can increase the productivity of capital. The readjustment of economic policies in the light of Islamic teachings, the assurance that contractual obligations will be fulfilled as required by Islam, the removal of exchange controls on all current account transactions within the range of the perspective plan, and the ease of profit remittances and capital repatriation by foreign investors should prove to be positive factors in attracting foreign investment in Muslim countries. According to the World Bank, "countries that have followed a more open development strategy have had fewer problems with direct investment."⁶⁰ However, until such time as the Muslim countries are able to attract more foreign equity investment, they may have to tolerate interest-based borrowings to the extent necessary to finance productive, self-liquidating projects that contribute to need fulfillment and development.⁶¹

Need-Based Production

Restructuring the investment climate may only help increase the volume of investments. It will be necessary to adopt measures to ensure that this increase in investment gets diverted to the production of need-fulfilling and exportable goods and services and the capital goods and raw materials needed for this purpose. All privileges and subsidies, explicit or implicit, which provide an edge to the production and import of luxuries and status symbols must be withdrawn.

⁶⁰ *Ibid*, p. 129.

⁶¹ This opinion, held by many fuqahā' is based on the Qur'anic verse related to certain specified items which have been prohibited but the use of which have been allowed in extremely dire circumstances. "He has forbidden carrion, blood, pork and that which has been slaughtered in the name of other than God. However, if one is forced by dire necessity without willful disobedience or transgression of the limit, no sin shall be on him. Certainly God is Forgiving and Kind" (2:173) (Qur'anic references are composed of two numbers—the first referring to the *surah* [chapter] and second to the *ayah* [verse].) There are a number of other verses of this same implication in the Qur'an (5:3, 6:145, 16:115, 6:119). By analogy, this principle may be applied to interest paid to foreign lenders with whom no alternative arrangement is possible, provided that it is resorted to only to the extent absolutely necessary.

Emphasis of government fiscal, monetary and commercial policies should be tilted in favor of need fulfillment and exports.

The general tendency to resort to price controls on necessities leads to long-run shortages in their supplies by reducing their profitability. This becomes a permanent source of injury to the poor. In contrast the long-term supply of luxuries rises, thus serving the interests of the well-to-do. Hence the shari'ah has not permitted price controls under normal circumstances when there is no national emergency (war or famine) or when businesses are not creating an artificial shortage through monopoly, collusion, or hoarding. The short-term harm that the removal of price controls on necessities will inflict on the poor should be undone through the adoption of a gradual approach and the use of transfer payments and other measures discussed in this paper.

The support to agriculture and rural development and to SMEs, will play an important role in encouraging need fulfillment and exports. The restructuring of the banking system along Islamic lines must no doubt be an essential element of the whole reform program.

A New Deal for the Unemployed and the Underemployed

One of the most constructive ways of realizing the objectives of the shari'ah is the efficient and productive use of manpower resources of Muslim countries in such a way that each individual is able to use his or her creative and artistic abilities to the fullest extent in the realization of the objectives of the shari'ah. This cannot be materialized if the prevailing high level of involuntary unemployment and under-employment continues. The main policy instrument available within the framework of conventional wisdom for reducing unemployment and under-employment is expansion of aggregate demand.

While the conventional policy of aggregate demand expansion is no doubt necessary, it runs into two snags. First, given the flagrant inequalities of income and wealth and the demonstration effect of western life-styles, the increased demand spills over to a substantial degree into imports of goods and services for conspicuous consumption. Consequently its full benefit does not go to the goal of expand-

ing employment and removing poverty. However, if this policy were to be pursued in a need-based perspective, the benefit would tend to permeate a greater proportion of the population. Second, given the need to reduce macroeconomic and external imbalances, it is not possible to expand aggregate domestic demand; rather, it is necessary to reduce it. This adds importance to the policies of import substitution and export promotion. But these policies do not make an optimum contribution to employment if pursued within the framework of large-scale, capital intensive, urban enterprises.

Since the poorer Muslim countries have a surplus of labor, scarcity of capital and foreign exchange, and lack the educational infrastructure for training in complex technology, it would be desirable for them to expand self-employment opportunities through the proliferation of SMEs. As Dr. Muhammad Yunus has rightly pointed out, "Wage employment is not a happy road to the reduction of poverty, and that self-employment has more potential for improving the asset base of an individual than wage employment has."⁶² It would, however, be unrealistic to expect self-employment to absorb the entire manpower, and hence wage-employment may also need to be promoted simultaneously, provided that, in accordance with the dictates of the shari'ah, laborers receive a 'just' wage, are treated respectfully and humanly like brothers, and are not reduced to the position of small cogs in a big machine, unable to give full expression to their creative and artistic potential.⁶³ The greater the possibility of such employment in SMEs, the greater may be the possibility of realizing these goals.

There is a growing realization now that "the large-scale (modern) industrialization strategies of the previous decade generally had failed to solve the problems of global underdevelopment and pover-

⁶² Muhammad Yunus, "The Poor as the Engine of Development," reproduced from *The Washington Quarterly*, Autumn 1987, in *Economic Impact* 2 (1988), p. 31.

⁶³ See M. U. Chapra, *Objectives of the Islamic Economic Order*, *op. cit.*, p. 14-17; and Hakim Mohammed Said, ed., *The Employer and the Employee—Islamic Concept* (Karachi: Dār al Fikr al Islāmi, Pakistan, 1972).

ty.”⁶⁴ Studies conducted in a number of countries by Michigan State University and host country scholars have clearly indicated the rich contribution that SMEs can make to employment and income. They create new jobs not only directly but also indirectly by expanding incomes, demand for goods and services, tools and raw materials, and exports. They are labor intensive and require less capital and less foreign exchange. They rely primarily on personal savings and retained earnings and need much less access to credit from governments and financial institutions compared with large-scale industries. They invent new products, revive lost skills and help economies move into new kinds of work. They can be more widely disbursed and thus help maintain the link between a person’s place of work and his home which large-scale industries and hectic urbanization have severed to the detriment of social health. Moreover, they are at least as efficient as large-scale industries.⁶⁵ A Michigan State University study has concluded that they consistently generate more output per unit of capital than do their large-scale counterparts.⁶⁶ Little, Scitovsky and Scott have concluded that “large scale modern industry is usually much less profitable than the small craft type industries, in addition to being more costly in terms of capital and creating less employment.”⁶⁷ In fact, some scholars doubt that large-scale industries can be suitable at all under conditions of labor surpluses and capital shortages that are typical of most developing countries.⁶⁸

⁶⁴ Carl Liedholm and Donald Mead, “Small-Scale Enterprise: A Profile,” reproduced from “Small Scale Industries in Developing Countries: Empirical Evidence and Policy Implications,” A Michigan State University Development Paper, in *Economic Impact*, 2 (1988), p. 12.

⁶⁵ An expression of this view appears in International Labor Organisation (ILO), *Employment, Incomes and Equality: A Strategy for Increasing Productive Employment in Kenya* (Geneva: ILO, 1972).

⁶⁶ Report of the Select Committee on Hunger, *op. cit.*, p. 4.

⁶⁷ Ian Little, Tibor Scitovsky, and Maurice Scott, *Industry and Trade in Some Developing Countries* (London: Oxford University Press, 1970), p. 91.

⁶⁸ See Mariluz Cortes, Albert Berry and Ashfaq Ishaq, *Success in Small and Medium-Scale Enterprises* (Published for the World Bank by Oxford University Press, 1987), p. 2.

SMEs are hence being widely viewed as “an effective way of fostering the private sector’s contribution to both the growth and equity objectives of developing countries.”⁶⁹

Even the OECD countries have realized the job-creating potential of small enterprise.⁷⁰ Over the last decade they have accounted for a disproportionate share of new jobs, and those industrial countries where they play an important role have had a greater success in achieving lower rates of unemployment. Hence, a number of these countries have introduced measures to promote them.⁷¹ “No longer are small firms seen as the ‘Cinderella’ of the business community, rather they are to be courted and encouraged by politicians of all colors.”⁷² In Italy, artisans often working in family businesses, are a main factor behind the success of Italian jewelry, gold, silver, leatherworking, embroidery, glasswork, furniture, pottery, shoemaking, and clothes manufacturing, to mention just a few sectors.⁷³ In Germany, where the family-owned concern has always played a major part in the economy, there is renewed awareness of the need to create a favorable climate for small enterprise.⁷⁴ Japan’s export success is largely due to the vigour of internal competition promoted by the producing firms through their subcontracting of a lot of work to

⁶⁹ Liedholm and Mead, *op. cit.*, p. 12.

⁷⁰ A number of books have recently been published indicating the strengths of small businesses. See, for example, Graham Gudgin, *Industrial Location Processes and Employment Growth* (London: Gower, 1978); and David Birch, *The Job Generation Process* (Cambridge, Mass.: M.I.T., Program on Neighbourhood and Regional Change, 1979); Steven Solomon, *Small Business USA* (New York: Crown Publishers, 1986); David Storey, *et. al.*, *The Performance of Small Firms* (London: Croom Helm, 1987); David J. Storey and Steven G. Johnson, *Job Creation in Small and Medium Sized Enterprises* (Luxembourg: Commission of the European Communities, 1987); and Paul Burns and Jim Dewhurst, *Small Business in Europe* (London: Macmillan, 1987).

⁷¹ OECD, *Employment Outlook* (Paris: OECD, 1986).

⁷² Burns & Dewhurst, *op. cit.*, p. 193.

⁷³ See Alan Friedman, “Italian Small Business. The Backbone of the Economy Explored,” *Financial Times*, 15 September 1987.

⁷⁴ See “Small Business,” *Financial Times*, 29 April 1987, Section III, p. 1.

small businesses on a competitive basis.⁷⁵ Small firms are very important in Japan even domestically. They account for 50 percent of Japanese industrial output and 75 percent of total Japanese employment.⁷⁶ Three-quarters of retail sales are still made in Japan through specialty retailers and small family-run stores which are protected by law.⁷⁷ This, along with the widespread use of a profit-sharing system, may be among the primary reasons for Japan having the lowest rate of unemployment among industrial countries.⁷⁸ Even in other developed countries where the small firms sector has traditionally been weak, high levels of unemployment have made governments very receptive to their promotion. There has hence been a wealth of public and private sector initiatives to boost the small entrepreneur.

The emphasis of policy in Muslim countries on decentralized production with a proliferation of capital-saving SMEs may perhaps be the most effective way of not only occupying gainfully a large part of the rural landless but also the under-occupied members (husband, wife, parents, and children) of rural families having a small landholding. This policy will serve as complementary to agricultural reforms discussed earlier and will support rural development by raising the incomes of rural population and enhancing their ability to purchase better seeds, fertilizers and technology, thus raising their agricultural output. It will also reduce the outflow of population to urban centers. This will help maintain family solidarity and be more conducive to moral uplift and crime reduction, which are among the important goals of Islam. While many Muslim countries are critical

⁷⁵ See "Worker-Friendly Programs," *Economist*, 27 September 1986, p. 20.

⁷⁶ Steven Solomon, *op. cit.*, pp. 283-284.

⁷⁷ See "Why Japanese Shoppers are Lost in a Maze," *Economist*, 31 January 1987, p. 64.

⁷⁸ For a discussion of the Japanese profit-sharing system see Martin L. Weitzman, *The Share Economy* (Cambridge, Mass.: Harvard University Press, 1984). It is surprising that while profit-sharing as applied to labor, has attracted attention in the West, profit-sharing as applied to capital, has not attracted such attention. Is it because of cultural myopia or is it because Muslims have themselves not presented the case convincingly?

of the policies of their colonial masters “who systematically destroyed all the fibers and foundations” of their societies, they have done little after independence to revive the skills and crafts that were destroyed.⁷⁹ In fact, everything has been done to stifle SMEs and to patronize large-scale industries and businesses through a high protective wall, liberal import licenses, concessionary financing, subsidized inputs and tax holidays. This is not a judgement against large-scale industry, which will be indispensable in certain sectors of the economy and which should be encouraged and undertaken where necessary, provided that the overall socioeconomic benefits exceed the costs and a heavy dose of permanent protection is not needed.

But how to encourage the proliferation of SMEs all over the country? It requires a number of revolutionary changes in the socio-economic environment. First, there must be a change in lifestyles away from imported status symbols and in favor of simple domestically-produced products that satisfy needs and utilize labor more abundantly. Second, there must be a change in official attitudes and policies towards SMEs such that they are not dismissed as inefficient small and anachronistic leftovers of the past, but are rather encouraged and helped to realize fully their rich potential. Third, they must be enabled, through help in acquiring better inputs, appropriate technology, effective marketing techniques, and other extension services to compete in terms of both quality and price with the products of large scale industries and imports. Fourth, they must also be enabled to upgrade their skills through better training facilities; this will require a complete overhaul of educational institutions to remove the existing mismatch between the skills in demand and the education offered. Fifth, they must also be provided access to finance, the lack of which constitutes the most serious obstacle to their development. Finally, it may also be necessary to eliminate, if not reverse the direction of, the existing bias in favor of large scale industries which is one of the major sore points in the expansion of SMEs.

⁷⁹ Paul Baran, *The Political Economy of Growth* (New York: Monthly Review Press, 1957), p. 149.

The objectives of import-substitution and export promotion may not be realized through the SMEs unless they are helped to acquire more efficient technology to enable them to compete effectively. It would however be preferable if such technology is simple, in which case it would have the following advantages. It would require a smaller capital outlay, thus absorbing the growing labor force with a smaller amount of capital. It would minimize the demand for high skills and be thus suitable for Muslim countries with their relatively lower standards of literacy and technical education. It would enable a greater use of locally available materials and reduce the claim on foreign exchange resources. It would be possible to develop and produce it locally, thus helping reduce the dependence on imported technology. It would also be possible to introduce it in small towns and rural areas, thus reducing regional income disparities and minimizing the concentration of population in a few large urban centers, which large-scale enterprise with its capital intensive and complex technology tends to create. It would thus be what Schumacher calls a "technology with a human face."⁸⁰ Even such a simple and inexpensive technology has the potential of leading to a "fairly rapid increase in productivity in underdeveloped countries."⁸¹ It could not only help raise incomes and standards of living but also help achieve redistribution.

Financial Restructuring

The objective of achieving a proliferation of SMEs in rural and urban areas to solve the major economic problems of unemployment and concentration of wealth would remain only a fond dream unless arrangements are made for their financing. Lack of financing constitutes the most serious drawback in the development of small farms and SMEs. The poor are poor not because of their unwillingness to work hard or lack of skill. They in fact work harder than the rich and

⁸⁰ Schumacher, *Small is Beautiful* (London: Blond & Briggs, 1973), p. 18.

⁸¹ See the report by the United Nations, Department of Economic Affairs, *Measures for the Economic Development of Underdeveloped Countries* (New York, 1951), p. 29.

have more skill than they can use. Their problem is that they do not have access to financial resources necessary for being self-employed, and wage employment either does not utilize their skills optimally or does not pay them adequately to fulfill even their needs, let alone savings for investment. Financing is a powerful political, social and economic weapon and plays a predominant role in determining the power base, social status and economic condition of a person in the modern world. Dr. Muhammad Yunus has aptly emphasized that financing for self-employment should "be recognized as a right that plays a critical role in attaining all other human rights."⁸² Therefore, reform of the financial system should constitute one of the key elements of all socioeconomic and political reforms.

The Select Committee on Hunger found that "the provision of small amounts of credit to micro enterprises in the informal sector economy of developing countries can significantly raise the living standards of the poor, increase food security and bring about sustainable improvements in local economies." The Committee also concluded that "making credit available to entry level micro entrepreneurs is one way to help end the cycle of poverty and hunger among urban and rural landless poor in developing countries." However, as the Committee indicated, "formal financial institutions in these countries do not recognize the viability of income generating enterprises owned by the poor."⁸³ Even the Morgan Guarantee Trust Company, the sixth largest bank in the United States, has admitted that the banking system in developing countries has failed to "finance either maturing smaller companies or venture capitalists," and "though awash with funds, is not encouraged to deliver competitively priced funding to any but the largest, most cash rich companies."⁸⁴

Since the deposits of commercial banks come from a wide cross-section of the population, it would be rational to consider them a national resource to be utilized for the wellbeing of all sectors of

⁸² Muhammad Yunus, "The Poor as the Engine of Growth", *op. cit.*, p. 31.

⁸³ Report of the Select Committee on Hunger, *op. cit.*, p. v.

⁸⁴ Morgan Guarantee Trust Company of New York, *World Financial Markets*, January 1987, p. 7.

the population and not for further enrichment of the wealthy and the powerful.⁸⁵ This is not possible within the framework of the conventional system in which, as Lester Thurow has rightly observed, credit is granted mainly “to those firms with large internal savings, regardless of whether they are earning above average rates of return on their capital investment.” The result is that “the winners are, as in lottery, lucky rather than smart or meritocratic.”⁸⁶ The most telling lesson about the conventional banking system comes from Catherine Shaw, a researcher at the London School of Economics’ Business History Unit, who says, “The recruitment of business leaders from one social class or a narrow social strata is an obvious symptom. It suggests that society is failing to utilize its total reservoir of ability.”⁸⁷

The adoption of the Islamic financial system could be more conducive to the harnessing of this pool of ability and the bringing to fruition the rich contribution that SMEs can make to output, employment and income distribution. The sharing of risks along with rewards by the financial institutions will substantially reduce the precariousness of a small entrepreneur’s position—he will save himself from the backbreaking burden of interest in difficult times by his willingness to pay a higher rate of return in good times. The financial institution is well qualified to share the risk, and could do so without denting its financial strength if it builds loss-offsetting reserves in good times.

However, even if the financial system is Islamized, it would be necessary to remove two of the primary causes responsible for the failure or inability of commercial banks to finance small farms and SMEs. The first of these is the serious economic disadvantages under which this sector operates, and the second is the greater risk and

⁸⁵ The noncorporate sector in developing countries generally accounts for 60-70 percent of private sector domestic saving. It is the only sector whose saving exceeds its investment (V. V. Bhatt, “Improving the Financial Structure”, *Finance and Development* (June 1986), p. 20.

⁸⁶ Lester Thurow, *Zero-Sum Society* (New York: Basic Books, 1980), p. 175.

⁸⁷ Quoted by Charles Leadbeater, “Rags to Riches—Fact or Fiction,” *Financial Times*, 30 December 1986, p. 5.

expense to which the commercial banks are exposed. The first drawback cannot be removed without eliminating the implicit bias in official policies in favor of large-scale urban enterprises and replacing it by a strong commitment to support small farmers and SMEs. The adoption and implementation of the program proposed earlier through appropriate government policies and budgetary support should help gradually divert more and more of commercial bank financing to small farmers and SMEs. The second drawback cannot be removed without reducing the risk and expense of commercial bank lending to such units.

The greater risk of financing SMEs leads to a tough and extensive collateral requirement which they are unable to satisfy. This jeopardizes their growth and expansion in spite of their greater potential for contribution to employment, output and income distribution. The financing goes mainly to the rich who are subjected to a lower collateral requirement and which they are able to satisfy without any difficulty because of their greater wealth. Mishan has rightly indicated, "Given that differences in wealth are substantial, it would be irrational for the lender to be willing to lend as much to the impecunious as to the richer members of society, or to lend the same amounts on the same terms to each."⁸⁸

It may be expected that, within the Islamic risk/reward sharing framework, banks may tend to be attracted to provide greater financing to smaller firms because of their well established greater profitability. Small firms bear a record of better performance in terms of growth in real per capita profits in industrial countries where small entrepreneurs have been encouraged.⁸⁹ Even in developing countries with their extremely difficult environment for SMEs, they have consistently generated, according to a Michigan State University study, more output per unit of capital and are generally more efficient than their large-scale counterparts. Accordingly, the economic profit of smaller firms is consistently larger than that of large firms.⁹⁰

⁸⁸ S. Mihshan, *Cost Benefit Analysis: An Introduction* (New York: Praeger, 1911), p. 205.

⁸⁹ See Alan Friedman, *op. cit.*

⁹⁰ Report of the Select Committee on Hunger, *op. cit.*, p. 4 and Chart 2 on p. 5.

The risk may be reduced by introducing a loan guarantee scheme underwritten partly by the government and partly by the commercial banks.⁹¹ In the case of Islamic banks, the guarantee scheme cannot ensure the repayment of loans with interest as is the case in the conventional system. The scheme would rather cover the 'moral' risk of financing and relieve the bank of the need for collateral from SMEs whose general credentials have been examined and certified by the guarantee scheme. A large number of SMEs would thus be able to get financing from banks without being able to offer the collateral required by the conventional banks. The bank will receive its money back from the guarantee scheme in case of moral failure of the business. In case of market failure and the resultant loss, the bank should share the consequences with the business in proportion to the financing provided by it. The scheme may also be made to include some other noncommercial risks desired to be covered for increasing the availability of funds to SMEs.

This should not create any apprehensions about the viability of the loan guarantee scheme due to heavy loan losses. As indicated above, the scheme will not bear the entire risk of loan losses. It will bear only the moral risk, the business risk being born by both the bank and the borrower. Hence, the scheme will not be as heavily burdened with losses as the conventional schemes are. Moreover, the experience of International Fund for Agricultural Development (IFAD) is that credit provided, to the most enterprising of the poor is quickly repaid by them from their higher earnings.⁹² The Report of the Select Committee on Hunger also indicates that the "micro enterprise projects have recorded significant and impressive loan repayment rates."⁹³ Testimony from the Grameen Bank in Bangladesh indicates a constant repayment rate of 99 percent since the bank's

⁹¹ Loan guarantee schemes exist in practically all industrial countries which, having realized the potential of small firms, have initiated a program to encourage them. For some relevant details about such schemes in a number of European countries, see Burns and Dawhurst, *op. cit.*, pp. 199-200.

⁹² See *Economist*, 16 February 1985, p. 15.

⁹³ Report of the Select Committee on Hunger, *op. cit.*, p. 7.

inception.⁹⁴ Other SME credit programs have yielded similar results. Therefore, there is no need to be unduly apprehensive about loan losses from such financing.

The additional expense of commercial banks in evaluating and financing SMEs may have to be partly or wholly offset by the government in the interest of realization of the objectives of the shari'ah. Big business has been subsidized by governments for a long time through various ways, including concessionary financing, import licenses, overvalued currencies, and subsidized inputs. To offset this undue advantage received in the past, the governments should now turn the table in favor of small farmers and SMEs. Both the objectives of the shari'ah and the principles of public spending discussed earlier justify a reasonable allocation of government resources for this purpose. Nevertheless, a part of the increased cost should also be recovered from banks and SMEs, at least for the sake of promoting greater responsibility and efficiency. It may be expected that once the credentials of SMEs have been established and the systems has started operating, the costs would tend to go down.

The Islamization of banks and the financing of SMEs may also help bring into their fold the savings of a large proportion of the rural population not yet absorbed by the banking system because of their lack of trust in conventional interest-based banks and the apathy of banks towards them. This will help mobilize the idle savings in the economy and generate a higher noninflationary rate of growth. It may also help reduce the attractiveness of gold as a store of value and release savings for investment.

Perspective Planning

It will not be possible for Muslim countries to actualize the objectives of the shari'ah (*maqāṣid al shari'ah*) within the constraint of their scarce resources unless all the ingredients of the Islamic strategy are enabled to play a full and complementary role. The state will have to play a crucial role if the total potential of these ingredients is

⁹⁴ See M. Yusuf, *op. cit.*, p. 12.

to be realized. This it may be able to do more effectively if a long-term perspective plan is prepared. Such a plan would enable the state to take a realistic account of all the available physical and human resources and to establish, in the light of this, a set of well-defined priorities. This will help provide a clear direction to government policies and expenditure programs and to initiate effective measures for setting in motion the required structural and institutional changes.

The plan should not be comprehensive, trying to achieve a balancing of all input and outputs and their allocation among micro-units of the economy. This is neither feasible nor necessary. If a move is made in this direction, it will not only make the economy less flexible but also kill individual initiative and enterprise, thus engulfing the economy in the same kinds of contradictions and insoluble problems that the socialist and dirigiste economies are facing. What is however necessary is to bring into operation the double layer of filter moral values as well as market prices—and the motivating system of the Islamic strategy to ensure the realization of both efficiency and equity in the use of scarce resources.

It needs to be borne in mind that motivation requires not only the inculcation of fundamental Islamic beliefs and values in the population, but also the enforcement of socioeconomic justice, as discussed earlier. Prices, wages and availability of finance must no doubt be normally determined by market realities, but in the existing situation, with wealth and power concentrated in a few hands, they reflect monopolistic or monopsonistic characteristics and are, therefore, not 'just'. They therefore tend to suffocate the drive, initiative, creativity and enterprise of a large proportion of the population. The plan must indicate the policies and institutional reforms necessary for removing the existing injustice.

The goals of the economy must be clearly defined in terms of their priority and the ways of realizing them must also be specified. The establishment of priorities within the framework of the shari'ah will help in analyzing the existing allocation of resources and in pinpointing the direction of change. It would also be necessary to articulate the Islamic consumption, savings and investment values, and

work ethics, and to devise educational programs that would help inculcate these values and ethics in the people. The plan will also have to classify goods and services into the three categories discussed earlier.

In the light of the above, the plan must indicate the structural changes that must be introduced in the economy to realize the objectives of the shari'ah without creating macroeconomic and external imbalances. The plan must also indicate the institutions that must be established or reformed to reduce substantially the inequalities of income and wealth that now exist and to bring about a broad-based ownership of businesses and income-earning assets. The reform of the banking system in the light of Islamic teachings must receive special attention of the planners. The plan should not concentrate on any single measure or rely unduly on controls; rather, it should use a range of policies and incentives for realizing the objectives of the shari'ah. It should, in short, reflect a perceptible change in the development philosophy and strategy. All policies—fiscal, monetary, incomes, import and production—should be formulated within the framework of this perspective plan.

The production, import, distribution and consumption of what fits into the perspective plan should be permitted freely through the operation of the price system without bureaucratic red tape or controls. Controls, including those on the use of foreign exchange for current transactions, should be employed only where, and as long as indispensable. A general policy of letting social and institutional reform take the place of controls will help remove iniquities in material rewards, harness people's own inner drive for development, and, not only help reduce corruption and attain greater efficiency, but also make innovation and adjustment to changing circumstances easier. However, what does not conform with the perspective plan should not be allowed—irrespective of how rich or resourceful a person is.

There should not be changes in policy from quarter to quarter or year to year because the resource perspective, needs and goals of a country do not change frequently. Frequent tinkering with policies generates uncertainties and enriches mainly those having 'insiders'

knowledge. But errors which have been made in the preparation of the perspective plan should be rectified with an open mind and without undue delay. Since the resource endowment of different Muslim countries may be different, the same perspective plan may not be suitable for all even though the objectives of the shari'ah may be essentially the same for all.

Conclusion

It may thus be concluded that economic development with socioeconomic justice, which Islam sanctifies, cannot be attained within the constraint of the resource endowment of Muslim countries unless there is a revolutionary change in priorities and a motivating mechanism to induce people to change their work, consumption, saving and investment behavior in keeping with these priorities. The secularist, value-neutral and this-worldly perspective of both capitalism and socialism, in which Muslim countries are now operating, cannot help in either establishing the right priorities or in motivating the people to restructure their claims on resources in accordance with these priorities. When the capitalist and socialist societies have failed to achieve their professed socioeconomic goals in spite of decades of rapid development and their vast resources, they cannot serve as models for Muslim countries with their scarcer resources.

What the Muslim countries need to do is to increase the allocation of resources for programs that would help actualize the objectives of the shari'ah. However, this will enlarge the claims on resources and aggravate the macroeconomic and external imbalances in other areas. The major reduction in claims on resources should come through cuts in public as well as private wasteful or unnecessary spending. This cannot be accomplished in a vacuum; it requires a filter mechanism to distinguish the 'essential' from the 'inessential' and the 'equitable' from the 'inequitable' and an effective motivating system that would induce the people, particularly the rich to forgo their consumption of the inessential to conserve resources for capital formation and general need fulfillment. Prices alone cannot provide

such a filter mechanism or motivation in a secularist society with substantial inequalities of wealth and power. They provide an edge to the wealthy and the powerful and need-fulfillment suffers.

Nevertheless, the conventional wisdom, reflected in the IMF corrective programs, assumes that liberalisation of the economy and the prevalence of market-determined prices (including devaluation of the currency) will solve the problems. They will not. Higher prices do not create any significant dent in the demand of the rich; they continue to buy what they want. There is nothing to motivate them to do otherwise; therefore, the poor get more squeezed. This accentuates socioeconomic injustice and leads to social unrest and political instability. Collectivisation does not help either, because it kills incentive and efficiency, does not leave any leeway for consumer choice even in the area of needs, and concentrates power and decision making in the hands of a few. Such a concentration of power would be dangerous.

Therefore, Islam has moved away from both systems to ensure the realization of efficiency as well as equity. While it has recognized the contribution that profit motive, private property and the decentralized decision-making process of a market economy can make to efficiency, it has introduced other important ingredients in its economic system to ensure the actualization of justice. Hence, given the macroeconomic and external imbalances along with substantial iniquities and sociopolitical tensions prevailing in Muslim countries, the only feasible alternative they are left with is to Islamize their economies. This will not only help reduce their imbalances but also make a perceptible contribution toward social harmony through actualization of the objectives of the shari'ah. The concept of accountability before God will serve as a strong motivating force for keeping self-interest within the limits of social welfare, and, along with the filter mechanism of values and realistic prices, bring about the quantity and quality of reduction in claims that the realization of the objectives of the shari'ah requires. Such a reduction in unnecessary claims on resources will help lower the prices of all need-related uses of resources which the sole reliance on the price system does

not. Thus, by giving a moral complexion to resource use in both public and private sectors, Islamization will humanize the market forces and improve and strengthen their role in the economy.

The elimination of a substantial part of total claims will release resources for investment, exports and need fulfillment. The establishment of a need-based production system, along with equitable material rewards, will create a favorable climate for greater efficiency, increased supply of need-satisfying goods and services, and lower prices. Land reform and the proliferation of SMEs along with a total restructuring of the conventional financial system in the light of Islamic teachings, should help expand self-employment opportunities, reduce poverty and lower the concentration of wealth and power. Need fulfillment and equitable distribution will tend to have the effect of harnessing the energies and creativity of a greater part of the population for accelerated development. The reduction in inflationary pressures and the containment of the continuing depreciation in exchange rates should also make a positive contribution to growth and wellbeing. Nevertheless, the interest of the poor should be attended to even further, not through a general subsidy, but rather through organized and intensified relief payments by the government and social organizations out of zakah, voluntary donations, and maximum possible budgetary appropriations.

The Muslim governments have unfortunately used Islam so far only as a slogan, failing to realize the positive contribution it can make towards the betterment of their societies and economies and to their own survival. Professor Khurshid Ahmad has rightly indicated that “there is no evidence to conclude that, generally speaking, the policy makers derived any inspiration worth the name from Islam and tried to translate its economic ideals into development policies.”⁹⁵ Even with a change in attitudes and policies the task of

⁹⁵ K. Ahmad, “Economic Development in an Islamic Framework,” in K. Ahmad, *op. cit.*, p. 173. According to Dr. Amin, even the motive for rapid economic development is weak. He says, “Rather than showing a general desire for rapid economic development Arab governments show a surprising weak will to achieve it.... A much more powerful motive than economic development is the

adjustment and reconstruction is bound to be difficult and time consuming. The sooner the policy makers read the signs of the times, the better it will be for them and the Ummah. Islamization should not, however, be conceived as an antidote to all the problems of Muslim countries. Some of the problems created by centuries of social and moral degeneration misguided domestic policies and painful external shocks are bound to persist for a long time.

motive to remain in power.” (Galal A. Amin, *The Modernization of Poverty*, vol. VIII of the *Social, Economic and Political Studies of the Middle East* (Leiden: E.J. Brill, 1980), p. 108.