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### **The Political Economy and the Perennial Underdevelopment of the Muslim World**

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## **The Political Economy and the Perennial Underdevelopment of the Muslim World**

### **Abstract:**

The ongoing political turmoil in the Muslim world necessitates an investigation of the factors leading to centuries of underdevelopment. This essay studies the various perspectives (for and against) attributing Islam as a factor holding back the progress of the Muslim economies. We critically appraise why 'Islamic' banking is not truly Islamic to identify: (i) the retrograding outlook of the jurists (*fuqahā*); and (ii) their flawed *ijtihād* (interpretation or deduction of the divine sources of law) as the prime factors responsible for the paucity of development of financial instruments, markets and institutions. We also scrutinize the co-option of the jurists by the ruling elite, thereby legitimizing their autocracy. Finally, we conclude the paper recommending the rectification of these issues to develop institutions fostering economic growth and development.

**JEL Codes:** G20, O16, Z12

**Key Words:** flawed *ijtihād*, economic underdevelopment, *'hīlah* (ruse), intellectual stalemate, *ribā* (Islamic injunction protecting property rights).

## 1. Introduction

*“The Muslim world trails the West in job creation, education, technology, and productivity; however, many of the economic troubles of the Arab world are still blamed on globalization and Western economic domination...”*

*(Tyler Waywell, 2006, p. 167)*

The ongoing political upheaval in several Muslim countries in the MENA against autocratic regimes highlights, among other things, the frustration of the masses towards decades, possibly even centuries, of economic, political, and social underdevelopment. Recent research on the political economy and the underdevelopment of the Muslim world such as that by Haber and Menaldo (2010), rationalizes the ‘democratic deficit’ in the Muslim world to desert institutions. They argue that moderate rainfall engenders agriculture, thereby promoting urbanization, trade and state-building. In contrast, arid land undermines the evolution of the modern state, an essential necessary condition for democratisation. Malik and Awadallah (2011) identify the cause of the Middle East’s long term failure to a “*static model of development,*” which is “*financed through external windfalls and rests on inefficient forms of intervention and redistribution.*” Chaney (2012) attributes the lack of democracy in parts of the Muslim world to its conquest by the Arab armies following the death of Prophet Muhammad. For him, this impacted on the conquered societies for centuries into autocratic ones.<sup>1,2</sup>

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1 The above mentioned first and third papers stem from ‘endowment’ and ‘law’ perspectives respectively, while the second paper amalgamates the two perspectives. The aim of our essay, however, is radically different from that of the above studies. We focus on the errors of the *de facto* religious authorities (*fuqahā*), who made the Muslim world submit passively to the *de jure* autocratic leaders. This impacted on the lack of institutions and thus on economic development. Our perspective is consistent with the hypothesis of Stulz and Williamson (2003) and Acemoglu et al. (2005) that emphasizes the impact of culture (i.e., values extracted from religious scriptures) on policies and institutions. Stulz and Williamson (2003, p. 346) contradict the perspective of Chaney (2012) by stating that “*indigenous culture eventually can reassert itself* (against that of the conquering or colonising one) *with a bang.*” We also provide examples in Section 4.4 of countries deemed ‘democratic’ by either Haber and Menaldo (2010) and/ or Chaney (2012), where the judiciary is so emasculated by the meddling of the Executive branch that it leads to the weakening of property rights and thus underdevelopment.

Fifty-seven Muslim countries, consisting of a total population of 1.3 billion people, comprise of roughly 21 percent of the world's population. Yet, these countries lag far behind other nations with their total Gross National Product (GNP) of only 8 percent of the world's GNP. Identically poor results are revealed from an analysis of the Human Development Index (HDI), as defined in the United Nations Development Program (UNDP).<sup>3</sup> Out of fifty-seven Muslim countries, twenty-one received low scores, thirty-one countries secured medium scores and only five Muslim countries attained high scores on the HDI (see Chapra, 2008).

According to some analysts, the underdevelopment of the Muslim world, far from being a recent phenomenon, reaches back as far as the Middle Ages; rather than being a consequence of Western imperialism or other such external force, they attribute it to a variety of internal systemic problems linked to religion, society and politics. One such theory, proffered by Kuran (2004, 2005, 2011), holds that the Muslim world failed to develop robust civil institutions that could both serve as a check on the power of the ruling classes and facilitate economic growth. He finds that Islamic law, in particular, was a major impediment to economic development in the region. As with other studies within this topos (Bagehot, 1873; Schumpeter and Opie, 1934; Goldsmith, 1969; and McKinnon, 1973), the thrust of Kuran's thesis is premised on the view that a developed financial system contributes significantly towards a nation's growth. Indeed financial systems do play a vital role in advancing intermediation by mitigating market frictions, facilitating efficient investment decisions, allocating scarce capital and transmitting financial transactions (Coase, 1937; King and Levine, 1993). This in turn stimulates capital accumulation decisions and technological

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2 Samuel P. Huntington in *The Third Wave* attributes the lack of democracy in the natural resource rich Arab states to the 'lack of accountability' emerging from an absence of taxation. That is, citizens are denied representation when they are not taxed (see Huntington, 1991).

3 HDI owes its origin to the UNDP. It incorporates three variables: life expectancy at birth, educational attainment and effort, and per capita income. See <http://hdr.undp.org/en/statistics/hdi/>

innovation that are crucial in delineating a nation's long term economic path (King and Levine, 1993).

Kuran's study contributes to the broader question about the nexus between religion and economic development, a debate which is traced back to the publication of Max Weber's opus, *The Protestant Ethic and the Spirit of Capitalism*. The debate is ongoing, not least because it is fundamentally difficult to test whether and to what extent religious beliefs influence economic behaviour. Since however religion encompasses both faith (and by extension dogma) and practice (rites and rituals, places of worship, politics and institutions), the impact of at least the latter dimension of religion on economic development is empirically testable.

We therefore evaluate the value of Kuran's thesis by critically examining the reasons why the 'Islamic' financial intermediation system is not truly in keeping with the foundational principles of Islam. This leads us to discuss the problem of the involvement of Muslim jurists (*fuqahā'*) in the field of Islamic banking and finance, an involvement which has led to disenchantment among many associated with the field. We conduct our appraisal by first surveying the literature on religion and economic development, giving special consideration to those studies that have problematised Islam in the chronicling of Muslim underdevelopment. In particular, we focus on the following issues: (i) do culture and religion play a role in economic development? (ii) what factors (in terms of internal or external) have held back the progress of the Muslim world for centuries?<sup>4</sup>; (iii) what is required of the Muslim world if it is to recover some degree of economic parity with the Western world?

Our efforts yield the following results: first, evidence that points to a causal relationship, between religious beliefs (or convictions) and behavioral outcomes and

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4 The external factors relate to trade barriers and lack of external financial resources; while the internal factors include the failure of government, economic policy or institutions including corruption, culture, religious policies and practices, which constrain the potential of these countries to grow and achieve economic development.

economic performance at an individual, group as well as at a country level, is at best speculative (see Keeley, 2003). That culture and convictions play a role in ‘shaping policies and institutions’ cannot be as easily dismissed (Stulz and Williamson, 2003; Acemoglu et al., 2005); furthermore, in the case of the Muslim world, these beliefs are shaped by jurists who hold a *de facto* monopoly over interpretation.<sup>5</sup> The quality of their interpretations impacts on the quality of institution building in the Muslim world, which in turn impacts on economic development. This result is consistent with Fish (2002, p. 37), who states that “*it is therefore as dubious to try to locate the source of social practice and order in scripture in Islamic settings as it is to try to locate them there in Christian and Jewish settings, because as with all holy injunctions based on sacred text, interpretive traditions are powerful and ultimately determine practice.*”

Second, with the recognition of the role of religion in economic development, there is a heated debate in the literature on the link between Islam and underdevelopment of Muslim countries. The contention is whether Islam is an impediment to or a facilitator of economic growth and thus overall development. There are economists who associate the relative poverty of Muslim countries with their religious beliefs. They contest that Islam is an impediment to growth (see Kuran 2003, 2004, 2005, 2011; Guiso, Sapienza and Zingales, 2006); there are others, of course, who do not support this notion, arguing that there are factors other than religion which are responsible for the persistent underdevelopment of Muslim countries (see Noland, 2005; and Chapra, 2008). Our results, however, attribute the persisting economic underdevelopment to: (i) the retrospective outlook of the jurists; and (ii) the inability of the jurists to undertake adequate and robust *ijtihād* (jurisprudential reasoning).

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5 In fact, the jurists took over the reins of religious authority only after the theologians (*mutakallimin*), who were the first formulators of Islam, experienced their historic fall from grace in the early Abbasid age. Whereas the theologians were more concerned with delineating doctrinal orthodoxy and heresy, the jurists spent most of their efforts delineating ‘correct’ practice, or orthopraxy, from ‘incorrect’ practice. They were therefore less interested in doctrinal heresies, although of course ritual practice and theological disputes were sometimes intertwined (see Van Ess, 2006).

This result reconciles the two opposing views, whilst at the same time suggesting Islamic law is not accountable for impeding the advancement of the Muslim world.

Third, for the Muslim world to advance, there needs to be greater sophistication in the manner that *ijtihad* is performed. An overhaul of the educational institutions (*madāris*), which currently serve only to perpetuate the intellectual stagnation, could facilitate this. This recommendation is derived from the Lipset-Prezeworski-Barro hypothesis, elaborated in Glaeser et al. (2004). It needs to be followed up by structuring: (i) institutions promoting property rights and encouraging good governance; and (ii) a financial architecture (compatible with Islam, as endorsed in Stulz and Williamson, 2003; and Acemoglu et al., 2005) that promotes growth.

This paper is organized as follows: The following section discusses the theories and empirical evidence regarding religiosity and the role of religion in economic development. The third section presents the theoretical literature on the role of Islam in economic performance of Muslim countries. The fourth section attempts a diagnosis of what has gone awry with the Muslim world, in terms of economic underdevelopment. The fifth and final section provides concluding remarks along with a strategy for stemming the tide of economic malaise and reviving growth.<sup>6</sup>

## 2. Religion and Economic performance

Since the late-nineteenth century, economic theory has largely been uninterested in the influence of religious consciousness and belief systems on economic choices and economic performance.<sup>7</sup> However, recent literature has begun to re-examine the explanations of earlier modernization theorists who subscribed to the secularization thesis, recognizing the role of

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6 It should be noted that our study cites recent edition of works by classical scholars. We also provide a glossary at the end of the essay translating the Arabic terminology employed.

7 Neoclassical economists believe that economics is unable to contribute to the study of choice and preferences, including study of religion. Marxists, in contrast, are convinced that religion has no future.

institutions in intermediating values and outcomes.<sup>8</sup> As Iannaccone (1998) maintains, “*social scientists have little choice but to take account of religion, because religion shows no sign of dying out*” (p. 1465-66). More economists, especially those with multidisciplinary interests, are introducing religion and other measures of culture as determinants of economic performance with the aim of evaluating the impact of religiosity on individual behavior and hence economic performance (see Barro and McCleary, 2003; Guiso et al., 2003; Noland, 2005).

Religious activity may influence economic performance at the level of the individual, group, or country by virtue of at least two channels (see Noland, 2005). The first approach associated with Adam Smith’s 1776 classic treatise, perceived religion as an instrument to augment human capital. He advocated that the adherents to certain religious sects may enjoy two economic advantages, namely reduction in risk and establishment of trust, both of which in turn improve efficiency. This is especially important where the legal infrastructure upholding property rights is weak. Adam Smith’s argument is independent of the actual nature and beliefs of the religious sects, and so could apply to different voluntary associations and clubs.

The second approach is mainly connected to Max Weber (1905), who contested that it is the content of religious belief that is important in influencing economic performance. He asserted that the Protestant Reformation was vital to the onset of capitalism through its effect on belief systems.<sup>9</sup> This perspective contrasts with the human capital approach in which

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8 Modernization theorists subscribing to the ‘secularization hypothesis,’ regard economic development as a process that results in a reduction of religious institutions, beliefs and practices.

9 Weber (1905) contends that the Calvinist doctrine of predestination and the related notion of the ‘calling’ are critical for transforming attitudes. Although Calvin reinforces predestination, he perceives that economic success and religious faith provide signals that a person has been chosen for salvation. It is the emphasis on asceticism, focusing on personal diligence, thrift, frugality, responsibility, risk taking, efficient economic activity, financial improvement and non-ostentatious accumulation of wealth, which proves to be the basis of modern capitalism.



belonging to a certain sect and attendance at formal religious services affects growth. According to Weber (1905), religious denominations cannot be regarded as social clubs. In the Weberian framework, the distinctive feature of religion is in its potential impact on belief systems that then foster particular outcomes such as a strong work ethic, honesty, trust, thrift and charity. The argument in short is that greater religiosity and commitment to particular religious beliefs can influence (positively or negatively) productivity, investment, growth and economic performance by affecting these traits.

### **2.1. Empirical evidence:**

Some economists with multidisciplinary interests have attempted to empirically investigate the Weberian line of argument, aiming to determine if there is a relationship between particular religious beliefs and economic performance in cross country analysis, by using World values survey data.<sup>10</sup> They recognize that intermediating institutions may be the mechanism through which religious beliefs are linked to economic performance (see Barro and McCleary, 2003; La Porta et al., 1997; Guiso et al., 2003; Noland, 2005).

In one such study, Barro and McCleary (2003) investigate how religion - by which they mean church attendance and religious beliefs - affects economic growth by fostering religious beliefs that influence individual attitudes such as honesty, thrift, work ethic and openness to strangers. In a cross-country growth regression framework, they used international survey data on religiosity for a broad panel of 59 mostly developed countries.

They found that Hinduism, Islam, Orthodox Christianity and Protestantism were each negatively associated with per capita income growth relative to Catholicism. They claimed

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Weber's work, nonetheless, has been contested by Novak (1993, p. xiii), who states that: "*The Japanese have proved conclusively that in order to embody the spirit of capitalism, human beings do not have to be Protestant.*"

10 The World Values Survey is a worldwide investigation of sociocultural, moral, religious and political change. A total of four waves of survey have been carried out since 1981 making it possible to carry out reliable global cross-cultural analysis and analysis of changes over time (see [www.worldvaluessurvey.org](http://www.worldvaluessurvey.org)).

that economic growth “*responds positively to religious beliefs, notably beliefs in hell and heaven, but negatively to church attendance. That is, growth depends on the extent of believing relative to belonging. These results accord with a model in which religious beliefs influence individual traits that enhance economic performance. The beliefs are an output of the religion sector, and church attendance is an input to this sector*” (Barro and McCleary, 2003, p.760). Bizarrely, they also suggested that the fear of hell is more effective for economic growth than the hope of heaven (see Barro and McCleary, 2003, p.779).

La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997) conducted a similar study investigating the impact of trust on the performance of large organizations, proxy by government effectiveness, size of the largest firms relative to GNP, participation in civic organizations, and the performance of society in general. They view that trust or social capital affect propensity of people in a society to cooperate, which determines the superior performance of all institutions in a society. They further perceive that hierarchical religions, such as Catholicism and Islam, inhibit ‘horizontal’ ties among people and hence the establishment of trust, testing this hypothesis on cross-section of 40 countries. Among their most interesting findings was that “*countries with more dominant hierarchical religions have less efficient judiciaries, greater corruption, lower-quality bureaucracies, higher rates of tax evasion, lower rates of participation in civic activities and professional associations, a lower level of importance of large firms in the economy, inferior infrastructures, and higher inflation*” (La Porta et al., 1997, p. 336-337).

Guiso, Sapienza and Zingales (2003) extend the research of La Porta et al. (1997) by exploring the relationship between intensity of religious beliefs and many economic attitudes toward cooperation, legal rules, working women, thriftiness, the government and the market economy in a cross-country analysis. They interpret their findings as a justification of Weberian hypothesis. They conclude that “*on average, religious beliefs are associated with*

'good' economic attitudes, where 'good' is defined as conducive to higher per capita income and growth." (Guiso et al., 2003, p.225). They affirm "on average, Christian religions are more positively associated with attitudes that are conducive to economic growth, while Islam is negatively associated" (Guiso et al., 2003, p.280). Although they point to the problems they encounter when analyzing results about Islam, ironically they still maintain that among the major religions, Muslims being the most 'anti-market' and Islam being negatively related to economic growth.<sup>11</sup>

In response to Guiso et al.'s results, Keeley (2003) points out that variation in performance is also "due to the presence of multiple equilibria and difference in initial conditions across countries. Those initial conditions may be correlated with religions, but are distinct from them" (Keeley, 2003, p.287). Therefore, "careful documentation of religious institutional differences to suggest an association between classes of religious institutions and attitudes" is required. This "association might, eventually, suggest a link between a certain institutional feature and economic performance." It is suggested to focus on religious institutions rather than religious beliefs, as it is easier to establish causality, and is beneficial for policy recommendations to alleviate countries' performance.

Noland (2005) focuses on the impact of religious institutions, the mechanism through which religious beliefs affect economic performance. In case of Islam, Noland (2005) examines the claim by Kuran (2004) that the Islamic institutional constraints (e.g. inheritance rules) inhibit the development of commercial institutions, and as a result, disadvantage Islamic enterprises in competition with their counterparts. He dispels the contention that Islam is a drag on growth. He concludes, "the results with respect to Islam do not support the

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11 Guiso et al. (2003, p. 229) acknowledge that "While the Sunnah prohibits the formation and conclusion of aleatory contracts based on chance, many verses of the Qur'an encourage effort and improvement. Thus, the underdevelopment of many Islamic countries cannot be attributed to Islam per se, but is possible due to the development, somewhere in between the ninth and the 11<sup>th</sup> century, of inflexible political and legal institutions in the Islamic world designed to discourage growth values and practices and aimed at preserving the status quo."

*notion that it is inimical to growth. On the contrary, virtually every statistically significant coefficient on Muslim population shares reported in this paper - in both cross-country and within - country statistical analysis - is positive. If anything, Islam promotes growth”* (Noland, 2005, p. 1215).

The brief survey of empirical literature related to religion and economic performance illustrates that, in general, religious beliefs may be related to economic attitudes. However, the impact of religious beliefs on economic attitude and performance varies amongst different religious denominations. The conclusions drawn and policy implications depend on a broad array of factors including countries considered, data and definition of variables. In case of Islam, religious beliefs are contingent on the virtue of interpretation of Islamic sources (*Qur'ān* and *Sunnah*) by the jurists. Therefore, it is recommended that focus be put on religious institutions as opposed to religious beliefs. It is not only easier to establish causality, but is valuable regarding policy implications to boost economic growth and development.

### **3. Islam and Economic Performance of Muslim countries**

This section examines the two opposing views in the literature on whether or not Islamic law is an impediment to growth. Finally, we reconcile the two perspectives to attribute the underdevelopment of the Muslim world to a lack of sophistication in the application of *ijtihād*.

#### **3.1. Islam is an impediment to growth**

There is a long-standing argument attributing the underdevelopment of Muslim countries to Islam. The basic contention is that underdevelopment stems from certain Islamic beliefs, out of which have developed teachings, practices, laws and institutions (see Kuran 2003, 2004, 2005, 2011). Since the mid-1990s, Timur Kuran has focused on the problem of

underdevelopment in the Middle East, a region which once enjoyed a high standard of living by global standards.

The main theme of Kuran's criticism is that certain Islamic laws and institutions have been obstacles to long run economic growth and development in the Middle East historically (see Kuran, 2003, 2004, 2005, 2011). He attributes the Qur'an's ban on interest-based contract as a key factor for the failure of financial modernization and the development of financial institutions that could compete with the European economies and therefore prevent European domination of the region (see Kuran, 2005).<sup>12</sup> In particular, according to Kuran: (i) the Islamic law of commercial partnerships, "*limited enterprise continuity*;" (ii) the Islamic inheritance system, "*hindered capital accumulation*;" (iii) the waqf (pious foundation) system, "*inhibited the pooling of resources*;" and (iv) the Islamic legal system's aversion to the concept of legal personhood "*enfeebled private organizations*" (Kuran, 2005, p. 594).<sup>13, 14</sup>

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12 In the light of the ongoing subprime crisis, this criticism is not convincing. The rationale for prohibiting interest based (*ribawī*) contracts stems from three issues (see Salleh et al., 2012). First, interest-based contracts have the capacity to expropriate the assets of either borrower or lender (see Qur'an 4: 161). This ensues from the conflict of interest (agency issue) between borrower and lender. Second, interest bearing contracts do not give respite to borrowers (Qur'an 2: 280). Technically speaking, they are fragile and convey frailty to short funded financial institutions. Islam, on the other hand, encourages financial contracts, which are risk sharing and are fairly priced. In the current subprime crisis, a number of proposals have ensued, from the likes of Robert Shiller of Yale University, espousing the use of continuous workout mortgages to finance homes (see Shiller, 2008). Third, interest bearing contracts are onerous to the poor, leading to their financial exclusion. This is again derived from the Qur'anic verse (2: 278) which contrasts *ribā* with charity.

13 Chapra (2008) retorts that the answer lies not in Islamic teachings but rather in weak property rights due to political illegitimacy. The insecure property rights hampered the growth of large enterprises and consequently firms remained small. He further stresses that "*if this had not been the case, the absence of primogeniture should have in fact had the effect of leading to the establishment of corporations by motivating people to put together their capital as shares to form bigger and viable business enterprises. ...In the 20<sup>th</sup> century when development started once again in the Muslim world, the need arose for large business establishments and the jurists had no difficulty in approving the corporate form for business organization. If there was anything in Islam against it, there would not have been such great unanimity in its acceptance*" (p.852).

Chapra's perspective on weak property rights leading to economic inefficiencies is also substantiated empirically in Classen and Laeven (2003).

14 On the issue of *waqf*, Chapra (2008) responds that it made an important contribution to the development of Muslim societies. During the early days of Islam, they supplied a number of social services, e.g. education, science, laboratories, hospitals, mosques, orphanages, lodging for students, teachers and travellers, wells, the construction of bridges and roads etc. He contends that "*..this happened when the waqfs were properly regulated and supervised. However, when effective regulation and supervision did*

He explains that some of these institutions became sources of inefficiency because of “*unintended interactions among Islamic institutions designed to serve laudable economic objectives, such as efficiency and equity*” (Kuran, 2004, p. 72).

Kuran is of the view that “*if the impetus for financial modernization ultimately came from abroad, the fundamental reason is that Islam’s traditional institutions blocked indigenous paths to financial development*” (Kuran, 2005, p.612). In contrast to the Middle East experience, the West, according to Kuran (2003), had an inheritance system (primogeniture) that resulted in large and durable partnerships, which stimulated further organizational transformation and advancement in Europe.<sup>15</sup>

Kuran, in his 1998 essay on the weakness of Arab states, is sympathetic to the thesis postulated by Nazih Ayubi (1995).<sup>16</sup> Though Kuran (1998) does not disagree with the Ayubi thesis, his opinion is that it is misleading to attribute the observed repression only to the

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*not continue and led to corruption, loss of original deeds, lack of proper maintenance, and misuse and misappropriation of waqf properties, they became dysfunctional*”. He also points out, “*..tax system also played a significant role in hindering the further development of the waqf system. Islam cannot be blamed for what happened*” (p.853).

15 Chapra (2008) responds that, “*Kuran has not substantiated his contention that primogeniture contributed to the development of large enterprises in the West.*” Primogeniture mainly served the needs of feudalism by ensuring that the fief did not break down among the many heirs and that only one person remained responsible for providing services to the lord. The collapse of feudalism, during the course of the American Revolution in America and French revolution in Europe, weakened the primogeniture except among the ruling families. He further points out, “*..if primogeniture had been a useful institution, it would not have been swept away in both Europe and America*”. He contends that the onset of economic development in Europe laid upon the transformation of ‘feudal property relations’ into ‘capitalistic relations.’ He emulates that “*hardly any scholars, therefore mentions primogeniture among the causes of industrial revolution. The causes that are emphasised include the enforcement of property rights by democratic governments and the boost that the spread of education, research and technology provide to the development*”. He states that the inventions helped provide technology required for the revolution in agriculture, manufacturing and transport, which enhanced the fortunes of capitalistic employers. He claims, “*it was this fortune, along with the technology, and not primogeniture, that made the establishment of large businesses possible*” (pp.850-851).

16 According to the ‘Ayubi thesis,’ all Arab states are ‘hard states’ that lack the ability to break traditional patterns, adapt to changing condition and enforce laws. They do not have the capacity to accomplish their objectives through persuasion and economic incentives. It recognizes that there are individuals in the Arab world who favor the virtues of democracy and free enterprise as well as genuine economic and political unification. The reason why Arab states have not brought ambitious liberalization, privatization, democracy and economic unification lies in their political weaknesses. It identifies three interconnected factors that limit the Arab states’ capacity to control. These include vested interests against political or economic liberalization, cultural dispositions favorable to authoritarianism and inhibitions against reforms liable to fuel uncontrollable and self-augmenting demands for redistribution.

abuses of state officials. He argues that responsibility lies also with ordinary Arab who remains silent or even supports the political status quo in the face of tyranny and inefficiency. This issue is rationalized earlier in his 1997 article, where he discusses ‘public discourse’ and ‘preference falsification.’ Ironically, Kuran further identifies possible scenarios regarding the timing and nature of regime changes. He argues, provided the ‘right shocks,’ widespread discontent may lead to coalitions toppling the incumbent regimes.

Balla and Johnson (2009) contrast the evolution of French and Ottoman fiscal institutions, where both countries employed tax farmers as private agents to collect revenue. Each of these countries faced fiscal crisis in the beginning of the seventeenth century leading to predation of the contracts. The uncertainty in property rights in each country led to different institutional impact. In France, a coalition of tax collectors were successful in restraining the monarch from imposing collective action costs. In contrast, tax collectors in the Ottoman Empire faced excessive transaction costs in organizing the same. Thus, fiscal contracts were more secure in France than in the Ottoman Empire. This would explain why Christian-French institutions strengthened, while those of the Muslim-Ottoman Empire crumpled in the eighteenth century. This eventually led to the collapse of the Empire in the nineteenth century.

Rubin (2011) argues that institutional differences in Islam versus the Christian West contributed to the broader economic divergence. This is demonstrated through a game theoretic approach, modeling the conflict between the political and religious authorities in both the Middle East and the West. The outcome of the model is contingent on the extent to which early Islamic political authority derived their legitimacy from religious ones. This involves a feedback mechanism where improving economic conditions in Europe led to the relaxation of interest restrictions, simultaneously diminishing the capability of the Church.

These interactions did not take place in the Muslim world despite similar economic conditions.<sup>17</sup>

### 3.2. Islam is not an impediment to growth

Kuran's study has several flaws, as has been highlighted in the extended critique of Malik (2011), who holds that *The Long Divergence* is essentially a historical argument based on deductive reasoning and a set of hypothesized claims. Whilst some claims are supported by "*selective empirical evidence*" – work conducted by Kuran and his team of researchers on Ottoman archives – the central argument of Kuran remains unsubstantiated. Thus in Malik's view, Kuran's analysis at best highlights various coextensive phenomena but without empirically proving a causal relationship between them, whether of a unidirectional or of a bidirectional kind. Malik's (2011) critique is compelling, as he contends whether Europe ever achieved industrialization and modernization through its economic institutions alone. According to Malik, there was a configuration of reasons that underpinned the success of some European nations, such as geographical advantage, trading success and political economy. Europe's commercial success was not achieved by 'internal processes alone' but was "*aided by a combination of commerce, coercion and colonization*" (p. 5). It is in this backdrop of inter-state competition, overseas expansion, and long-distance trade that European firms invented new organizational forms and financing mechanisms that ultimately manifested in such Western corporate inventions as impersonal and permanently lived organizations, the separation of ownership and control, and the mobilization of long term capital through joint stock

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17 Rubin's (2011) analysis departs from the usual welfare approach studying the conflict of interest between borrowers and lenders, from an agency theoretic perspective, as depicted in Salleh et al. (2012) and discussed in Footnote 12. This is because it studies the economic disparity between the Muslim and Christian worlds by modelling the conflict of interest between the ruling elite and the religious establishment. His theoretical result, however, deviates from the contemporary real world practice. This is because the cooption of the religious establishment by the political elite, especially in the economically well-off Arabian Gulf countries, should result in the diminution in 'Islamic' banking services. The opposite result, i.e. an upsurge in the demand for these services is a stark contrast to the prognosis of Rubin (2011). This necessitates a revisit of the 'long divergence' theory as elaborated in Section 4.4 of this paper.



companies. Many of these legal and corporate innovations were partly a response to the needs of war-making states and overseas commercial ventures. Malik (2011) cites the rise of the East India Company as a pertinent example.

In some ways, Chapra's 2008 essay – tackling the reasons for the underdevelopment of the Muslim world – avoids the reductionism of Kuran insofar as he determines to assess a constellation of possible causes, political and social as well as economic, which have led to laggard Muslim societies. He applies the model of the well-known Andalusian historian Ibn Khaldun to: (i) explain the continuing impoverishment of the Muslim world; and (ii) critically analyze the development literature that attributes Islam to be a cause for the consistent underdevelopment of these countries.<sup>18</sup> He rejects the contention that institutions related to Islam being responsible for the decline of Muslims (see Kuran 2003, 2004, 2005 and also Section 3.1) contending “*as for Islam is concerned, it is itself a victim rather than the trigger mechanism*” (Chapra 2008, p.846).

Chapra (2008, p. 848) explains further that the ‘trigger mechanism’ of Muslim decline, in accordance with Ibn Khaldun's model, was “*the political illegitimacy, the introduction of hereditary succession*” without the consensus of the community, particularly when Mu'awiyah bin Abu Sufyan started hereditary succession by appointing his son, Yazid, to the Caliphate in 679 A.D.<sup>19</sup> He further explains that the “*the virus of*

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18 Ibn Khaldun's development theory posits that the rise or fall of a society depends on the interdependent linkages between all important economic, social, moral, historical and political factors in a circular manner; where each variable affects the other and in turn is affected by others. The analysis involved is dynamic in nature as the operation of cycle takes place over a long period of time (almost three generations). In the long-run analysis, there is no *ceteris paribus* assumption, as no variable is assumed to be constant. This theory espouses that one of these factors acts as the trigger mechanism. If others respond in the same direction, development gains momentum through a series of interrelated chain reactions such that it becomes difficult to distinguish the cause from the effect. However, if the other sectors do not respond in the same direction, then the rise/decline of the society may be much slower (see Chapra, 2008, p. 839).

19 In contrast, we offer another perspective. The decline started when the Muslims fell prey to the institution of *taqlid* (blindly following the rulings of religious authority without examining their scriptural basis) as elaborated in Section 4. This deprived them of the ability to independently develop institutions protecting property rights and fostering good governance. This in turn left them vulnerable to predation by dictators and subsequently the colonial powers. Our assertions are consistent with both the

*political illegitimacy gradually infected all other aspects of the society and economy through circular causation. The Muslim world started losing the momentum of development, that had been triggered by Islam, to the extent that it could not successfully address the external shocks that it encountered. It could not, therefore, prevent its colonization by the European countries”* (Chapra, 2008, p.849).

Chapra (2008) further alleges that political illegitimacy and absence of genuine democracy were responsible for the continuing underdevelopment of the Muslim world. He explains that lack of democratic values in the political field gradually affected other socio-economic and political institutions of the Muslim countries through the operation of ‘circular causation.’ He explains that it has strong negative implications on the freedom of the press contributing to lack of transparency, abuse of public funds, corruption, poor governance, and injustice. It reduces the confidence between the government and the people, leading to social and political instability, which is one of the important factors that hamper economic development (see Chapra, 2008, p. 854).

Chapra further maintains that illegitimacy in the political field affected the development of *fiqh* (Islamic jurisprudence), which had a far-reaching adverse consequences on Muslim society. Chapra (2008) explains that the disregard of Islamic values in the political field always remained a root of dissent between the jurists and the rulers. The more conscientious and vocal got penalized and persecuted. As a result, they confined themselves to their religious schools and lost touch with the rapidly changing environment. Consequently, *fiqh* could not develop with the demands of the time and became stagnant. It inhibited the

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‘development’ and ‘institutional’ perspectives of Glaeser et al. (2004) and Acemoglu et al. (2005) respectively.

dynamism of the Muslim community which it had enjoyed in earlier centuries. All these factors adversely impacted rate of development.<sup>20</sup>

### **3.3. Synthesis and concluding Remarks**

Despite the polarized views regarding the causes of underdevelopment of the Muslim world, a common theme arising from the above discussions is the inadequacy of those performing *ijtihād*. This potentially absolves Islamic law as the bearer of responsibility for the degeneration of the Muslim countries. The Muslim peoples have for too long followed the rigid rules of *taqlīd* (blindly following the rulings of earlier religious verdicts without examining establishing their appropriateness) instead of carrying out *ijtihād*. *Ijtihād* has been stripped of the dynamism it was characterized by in the earliest centuries of Islam, with the resultant effect that Islamic Law became stagnant. This closed-mindedness has contributed to an inability of the Muslim community as a whole to grasp their situation in a rapidly changing environment. It has made them languid with respect to establishing institutions protecting property rights, and has contributed to their eventual subjugation by either colonial masters or indigenous dictatorships, with little might to control their own destiny.

## **4. Rationalizing the Underdevelopment of the Muslim World**

This section delineates in some detail the factors responsible for the cessation of dynamic *ijtihād* and the areas where inquiry is required to boost the growth and development of the Muslim world.

### **4.1. The Crucial Role of *Ijtihād* in the Development of the Muslim World.**

A development strategy for the Muslim world, which is dissociated from the indigenous culture (and through which religious, moral and ethical values are protected), is bound to end

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20 Our major disagreement with Chapra's analysis is his absolving the jurists from blame. Historically, however, political rulers have derived their legitimacy from the religious elites. This contentious issue is discussed in Section 4.

in frustration. In contrast, a strategy with a proper understanding of the Islamic *Weltanschauung*, a clear appreciation for the objectives of Islamic law, and a consideration for Muslim culture, may have a greater chance of success, leading to the overall advancement of these countries (see Chapra, 2008; Iqbal, 1977). Furthermore, a policy leading to political reforms and restoration of genuine democracy may ultimately empower human resources, including women, and improve the environment for open and honest exchange of ideas, scientific research and the reopening of the gates of *ijtihād* (see Chapra, 2008).

*Ijtihād*, the focus of this subsection, can be perceived as the elixir of Muslim legal thought. Describing the principle of movement in the structure of Islam, the well-known philosopher-cum-poet of the Indian subcontinent, Muhammad Iqbal (d. 1356/1938) explained that the ultimate spiritual basis of all life, as conceived by Islam, is “*eternal and reveals itself in variety and change, that is, in an ever dynamic universe*” (Iqbal, 1977, p. 148). Accordingly, though a society based on a religious conception of reality must possess eternal and unchanging principles to regulate its collective life, it must also allow for the inevitability of movement and change which is so characteristic of the human experience. Iqbal was absolutely correct when he stated that the key principle which allows for movement in Islam – that is, which allows for Muslims to adapt to their changing reality - is *ijtihād* (Iqbal, 1977, p. 148).

Lexically meaning ‘to exert,’ in the terminology of Islamic legal theory, *ijtihād* is “*the total expenditure of effort by a mujtahid, in order to infer, with a degree of probability, the rules of the Shari‘ah from the detailed evidence in the sources*” (Kamali, 2008).<sup>21</sup> The idea is most clearly adumbrated in the Prophetic tradition recorded in the *‘hadīth* compilation of

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21 Kamali also reformulates the definition of *ijtihad* in a recent monograph on Islamic Law with a view to overcoming what he describes as “*difficulties which encumber the conventional theory of ijtihad and to properly make it an integral part of the contemporary legislative processes*”; thus in Kamali’s new conceptualisation, *ijtihad* is a “*creative and comprehensive intellectual effort by qualified individuals and groups to derive the juridical ruling on a given issue from the sources of Shari‘ah in the context of the prevailing circumstances of society*” (Kamali, 2008, p. 165).

Muslim: “when a judge gives a decision, having tried his best to decide correctly and is right, there are two rewards for him; and if he gives a judgment after having tried his best (to arrive at a correct decision) but erred, there is one reward for him” (see *Sahih Muslim*, translated by Siddiqui, 1986, Chapter 692, ‘*Hadīth* No. 4261-4263). Moreover, traditions in which the Prophet is reported to have openly encouraged independent thought, or tacitly approved of it, are too numerous to ignore. His Companions, both in his presence and after his death, would apply their reason to problems in a relatively unencumbered way. Yet the student of Islamic history is fully aware that opportunity for unfettered *ijtihād* was eventually circumscribed, a process beginning with the first significant political expansion of Islam. The doctors of the law, both independent scholars and appointees of the State, would largely agree upon what was considered the ‘correct method’ of *ijtihād*, limiting it thereby to several schemas as well as delimiting the type of person able to perform it. Once the accumulated wealth of legal thought found a final expression in the orthodox schools of law, there came to be recognised only three degrees of *ijtihād*: (i) complete authority in legislation which is practically confined to the founders of schools; (ii) relative authority which is to be exercised within the limits of a particular school; and (iii) special authority which relates to the determining of the law applicable to a particular case left undetermined by the founders.<sup>22</sup> Since the theoretical foundations of Islamic law are laid by one vested with complete authority in legislation, and at a practical level Sunnī Islam made the qualifications for this post nigh impossible to attain, the possibility of developing and evolving new theoretical and hermeneutical frameworks became virtually impossible.

*Ijihād* by the time of the jurist and legal theoretician al-Shāfi‘ī (d. 820) virtually became synonymous with analogical reasoning (*qiyās*), in large part due to his own efforts to

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22 For more information on the construction of orthodoxy by the *‘ulamā*, see El Shamsi (2006).

circumscribe unfettered use of opinion (*ra'y*).<sup>23</sup> A rudimentary and almost unconscious analogical method was, of course, always present in Islam. When faced with a new or refined and complicated issue, wherever the Qur'ān and the *Sunnah* gave no clear and unequivocal decision, a verse of the Qur'ān or a general principle or a specific case in the *Sunnah* was taken and a decision was made on its strength with regard to the present issue. But in both, choice of the model and the discernment of the point of resemblance, almost unbridled liberty was taken and the results varied between sound analogy on the one hand and almost complete arbitrariness on the other. Inductive reasoning (*istiqrā'*) was another widely employed method of legal reasoning prior to the second-half of the eighth century. However, by al-Shāfi'i's time, it was seldom utilised, as it was a casualty of the sustained attempt of mainly the Shāfi'i jurists to create analytical consistency and standardise the law.<sup>24</sup> The ratiocination of jurists, with very few exceptions, would hereafter revolve around the effective cause (*'illah*) of an existing legal judgement, rather than constitute an applied attempt to extend the law on the basis of the objectives (*'hikmah, maqāsid*). This was since the *'illah* was believed to be an objective attribute that did not vary from person to person, or change with circumstances. It was therefore deemed the most suitable (*mun«sib*) foundation for developing the law (Nyazee, 1994).

In many legal cases, this textualist approach to legal reasoning would result in glaring errors of judgement (see Fazlur Rahman, 1984). Here we cite the case of the literature in

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23 For this development, see Rahman (2002) and Hallaq (2005). On al-Shāfi'i's role in the early development of Muslim legal theory, see Schacht (1964, 1967). It should be noted that jurists of the Z«hir» school of law, Shī'ah jurists and some Mu'tazil« theologians were opposed to analogical reasoning as a method in law. The Zahir« jurists Ibn Hazm (d. 456/ 1064) is worthy of note for his lengthy polemic against *qiy«s* in his treatise on legal theory, *Ihk«m al-usul fī usūl al-fiqh* (1997, vol. ii: 359-404 and passim).

24 Inductive reasoning did find continued life, to some degree, in the doctrine of *ma·la'`ah* (public interest), and *isti'hs«n* (equity). For more on these two juristic tools, see Kamali (2000). The 14<sup>th</sup> century Andalusian jurist, Al-Shatibi, developed significant polemical argument in defence of the inductive method in his famous treatise, *al-Muwafaqat*. Although there is no English translation of the Arabic original, Hallaq (1999) provides a very useful introduction to al-Shatibi's main thesis.

Islamic commercial law. In line with the drive for measurability, predictability and seeking an objective attribute,<sup>25</sup> jurists failed to establish the correct rationale for the prohibition of *ribā al-fadl* - namely the expropriation of wealth – as the *ratio legis*, and instead determined the *ratio* as an attribute (*wasf*) intrinsic to the specific commodities stated in the well-known hadith. Thus the *Shāfi'īs* identified the '*illah*' with foodstuffs of the same category; the *Hanaftīs* determined it as weight and volume; and the *Mālikīs* determined it as stored foodstuffs of the same category (see Ibn Rushd, 1996). With respect to *ribā an-nasī'ah*, the jurists uniformly prohibited it for loans, believing the rationale for this to be the fact that money is not productive and therefore no interest, however insignificant, can be charged for credit. It is curious that these views were never challenged by reformers until the 19<sup>th</sup> century – the reason is the reverence with which the juristic positions of the founding scholars and the early schools were held.

Yet when boundaries were not drawn clearly enough due to the poverty of philosophical or indeed economic insight, or perhaps from an unwillingness to allow morality an individual basis, the prohibition of *ribā* was circumvented with the use of carefully structured methods of exchange such as *tawarruq*. The outcome was that unequal exchanges, with the exception of those that the jurists had delineated as non-*ribawī* commodities, would be legalised.<sup>26</sup> Had expropriation of assets – or, in other terms, the protection of property rights – been identified by the jurists as the categorical *ratio*, history may have unfolded in a different way. Though the short-term consequences of the jurists' failure were perhaps not as severe given the pre-modern economies were not developed like today, in the long-term, as modernity brought with it more complex market structures, the effects would be devastating.

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25 This is based on the conditions of the '*illah*' in *usul*-theory see Kamali (2003).

26 For example, it was deemed permissible to exchange five cubits of a specific cloth for six of the same, or an egg for two, or a sheep for two, on condition that the exchanges are on the spot. Only a deferring of payment of either counter-value would render the exchange impermissible. See Al-Zuhayli (2006, p. 28).

Indeed with the onset of modernity, the lack of enterprise on the part of jurists, and, more importantly, the entering of traditionally trained jurists into spheres of human life which demanded technical knowledge, would begin to have implications for the development of Muslim societies (see Table 1). To date, there is still no clear formulation by the jurists of the economic rationale behind the prohibition of *ribā*. This has hindered the progress of distributive justice in Muslim societies and the development of a truly ‘Islamic’ financial infrastructure, as critiqued by Khan (2010). This is elaborated below.

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**Insert Table 1 Here**  
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#### **4.2. The apparent incoherence of ‘Islamic’ Banking and Finance.**

This subsection scrutinizes the literature to demonstrate the absence of an economic rationale for the injunctions of the *Sharī'ah* pertaining to financial transactions. This has led to misconception on issues pertaining to economic vitality (see El-Hawary et al. 2005; Kuran, 2005; Khan, 2010 and Rubin, 2011). This literature, critiquing Islamic banking and finance, does not: (i) adequately address the crucial issue of why ‘Islamic’ banking is not Islamic, especially in the light of persisting underdevelopment of the Muslim world; and (ii) critically evaluate whether the guidelines (constraints) on ‘Islamic’ banking make economic sense, especially in the current economic environment, where the contagion from the subprime crisis has engulfed most developed nations.

The literature cites four basic guidelines mandated for the Islamic financial intermediation (IFI) (see El-Hawary et al., 2005; and Khan, 2010). This is described as follows: Islamic financing should: (i) exclude any form of ‘exploitation’ of either party; (ii) involve risk-sharing with a ‘symmetrical risk/return distribution’ amongst participants in a transaction; (iii) be linked to a real economic transaction (i.e., it should involve ‘material-finality’); and (iv) shun projects forbidden in the *Sharī'ah*. These guidelines, however, are



not critically analysed from an economic perspective. This issue is of import, as it impacts on the efficiency of financial intermediation and thus on growth of Muslim countries. Another reason for investigating these guidelines is to inquire whether Islamic principles have anything to offer for the economic development of humankind.

Islamic financial contracting necessitates the avoidance of the following: (i) *ribā*; and (ii) *gharar/ maysir* (explained below). Salleh et al. (2012) illustrates that the basis behind the injunction of *ribā* is to promote property rights, which is an essential ingredient for advancing economic development and thus growth (see again Acemoglu et al. 2005; and Table 2). This eschews any kind of expropriation of assets of both parties of a contract. The *ribā* pertaining to deferred financial claims (termed as *ribā an nasī'ah* explained below in detail) necessitates the pricing of a financial facility to avoid financial repression as well as negative leverage.<sup>27</sup> Salleh et al. (2012) elaborate the above result based on the *Shari'ah* (Islamic Law as deduced from its primary sources, i.e., the Qur'ān and the *Sunnah*) and economic fundamentals.

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**Insert Table 2 Here**  
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The rationale behind the first constraint, of avoiding expropriation (misstated as ‘no exploitation’) clause in the Islamic finance literature, e.g. El-Hawary et al. (2005), and Khan (2010), is to avoid unsustainable equilibria leading to depletion of resources of either party. This is of import to regulators who need to ensure that financial products do not extricate (or ‘exploit’) wealth of their investors (see Bond et al., 2009; and Henderson and Pearson, 2011).

The reason for invoking the second constraint of risk-sharing financial contracts (stated in El-Hawary et al., 2005 and Khan, 2010) is to avoid fragility. This issue is of import given the devastation caused by the ongoing banking crisis (see Reinhart and Rogoff, 2008). The

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27 The *ribā* pertaining to spot exchanges of assets (termed *ribā al-fadl*) also eschews any kind of expropriation of the assets of a counterparty (see El-Gamal, 2006).

well-known economist Franco Modigliani had forewarned about this roughly four decades ago: “*as long as loan contracts are expressed in conventional nominal terms, a high and variable rate of inflation- or more precisely a significant degree of uncertainty about the future price level – can play havoc with financial markets*” (Modigliani, 1974, p.1).

The profit and loss sharing (PLS – i.e., *Mushārahah*, *Mudhārahah*) contracts (with a ‘symmetrical risk/return distribution’) recommended in Siddiqi (2002) are *not* ideal, as they are pareto-inferior (see again Salleh et al., 2012). A quasi-equity (and not a pure equity) contract, which is *Sharī’ah* Pareto-efficient is the optimal way of financing. It should be noted that it construes a range or a family of vehicles each suited for projects of different characteristics. This will be discussed in future research.

Another critical constraint missed by almost all researchers in the field is the emphasis of the *Sharī’ah* on subsidizing financial services to the underprivileged and poor by employing charitable funds in the intermediation system. This is also elaborated in Salleh et al. (2012).

The injunction of *gharar* is misconstrued by most economists (such as Kuran, 1983; Khan, 2010). It is defined by Thomas (1995, p. 23) as “*deception based on the absence of knowledge on the likelihood of delivery with the prospect to do harm.*” The two injunctions of *ribā* and *gharar* are inextricably linked, and the purpose behind them is to deter incomplete markets, as explained below.

The basis for the third constraint of ‘material finality’ stemming from the issue of *gharar*, is intuitive. That is, it espouses a common sense perspective on real economic transactions. In other words, it *allows* the employment of derivatives for the purpose of hedging, contrary to the view of El-Hawary et al. (2005) and Khan (2010), as it involves

mitigation of risk (see Kamali, 1996).<sup>28</sup> However it does not allow naked option writing or short selling (without the underlying resources to meet the obligation in the worst state of the economy), as the defaults of investors result in a domino effect leading to freezing of security markets. This is attributed to the inability of securities to span each state of the economy on an ex-ante basis stemming from incomplete markets (see Flood, 1991). This result is affirmed in the case of credit markets in the recent subprime crisis (see Reinhart and Rogoff, 2008; and Shiller, 2008).<sup>29</sup>

The motive for the final constraint, i.e. precluding the financing of activities contrary to the *Shar'ah* is also intuitive as Islamic banking and finance is a value based system (see again Stulz and Williamson, 2003 and Acemoglu et al., 2005).

#### **4.3. The divergence between the rhetoric and the implementation of Islamic principles.**

This subsection rationalizes: (i) why Muslims historically were involved in transactions involving plain vanilla interest bearing contracts; and (ii) why ruses (*hiyal*) were endorsed and still continue to be practiced in what constitutes as 'Islamic' banking. We also shed light on: (i) whether Islamic banking and finance makes sense in the twenty-first century; and (ii) the extent to which the jurists have the requisite background and training to bring into fruition the needed financial development to reverse centuries of underdevelopment.

Our explanation for the employment of ruses (as elaborated below in Section 4.3.2) is different from standard ones involving asymmetric information, as advanced in Kuran (1993) and Khan (2010). Here we initially address the standard reasons advanced by posing the following questions to the notable scholars who advance the asymmetric information (adverse

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28 It should be noted that the alleviation of risk through hedging can be rationalized from the Qur'anic verses (4:71; and 4:102) espousing Muslims to undertake 'precautions' to protect them.

29 Ibn Taymiyyah (1951) linked *gharar* with *maysir* (gambling). This is exemplified in the case of hedge funds that were badly burned as a result of short selling Volkswagen stock without realizing that the Porsche family had secretly accumulated a huge stake which left very few outstanding shares to cover their position (Rayner, 2008).

selection and moral hazard) argument. We then follow it up to rationalize the employment of ruses from the perspective of Muslim jurists and theologians. Next, we investigate the practicality of an Islamic financial architecture and comment on the ability of the jurists to extend their *ijtihad* for its implementation.

#### 4.3.1. Is Information Asymmetry (as advanced by economists) the Prime Reason behind the Ruses?

Here we explain this issue by posing the following questions to our esteemed colleagues in academia.

##### Question One:

Can we not control for adverse selection, i.e. decipher any proprietary ex-ante information held by borrowers (agents in a debt contract) through: (i) staged financing and board representation, as conducted in the venture capital industry, as described in Gompers and Lerner (2001); (ii) trading financial claims over a multi-period horizon, as illustrated in Cooper and Hayes (1987), and Hosios and Peters (1989); and (iii) amortization in a financial contract, as demonstrated in Wu (1993)?

##### Question Two:

Can we not control for moral hazard, ensuing from ex-post information asymmetry, by underwriting iron-clad covenants in a financial contract, as depicted in Smith and Warner (1979) and Billet et al. (2007)?

The above exemplifies the mechanism to alleviate both adverse selection and moral hazard. Thus, our puzzle deepens as to why Islamic banking resorts to ruses. Feisel Khan (2010) terms it a “*de-facto conventional financial transaction*” under an “*Islamic terminology*” (p. 805). He also terms it as “*duping*” in his conclusion (p. 818). The reason behind the asset backed financial facilities is not asymmetric information, as rationalized in

Kuran (1993), but: (i) a mechanism to control for the agency cost of the financial facility; and (ii) a failure of *ijtihad* (deduction of Islamic laws), as elaborated below.

*Response to Questions One and Two:*

The rationale for asset-backed debt security is primarily to reduce the agency cost of debt. This refers to the distortion in managerial decision making that are caused by conflicts of interest between stock holders and debt holders. This is substantiated in Besley and Ghatak (2010, Section 2.2.2) as follows:

*“In the presence of agency costs, effective property rights can facilitate the use of assets to mitigate agency costs, thereby facilitating trade. A prime example of this is in the credit market; when agency or enforcement costs are important, lenders may not be willing to lend an efficient amount or, in some cases, lend at all. Property rights improve the ability of borrowers to pledge their assets as collateral, and thereby relax credit constraints.*

The finance literature generally attributes agency issues to the presence of asymmetric information (see Allen, 2001). However, financing of real assets in a venture constitutes a special case where the lenders (principals in a contract) can decipher any proprietary ex-ante information (i.e., adverse selection) held by borrowers (agents in a contract) through the mechanisms described earlier in this subsection.

4.3.2. What is the Key Reason behind the Ruses Employed by the Jurists?

Islamic law assesses every action, whether of the limbs, mind or heart, as characterized by *‘husn* (seemliness or conformity) or *qubh* (unseemliness or deformity). Furthermore, these qualities (according to the majority of Muslim theologians and jurists) cannot be known by reason or natural law but rather by divine revelation alone (see Stelzer, 2008). This holds true whatever the action is, and even when it is self-evidently a crime, such as murder and theft.

Anderson (1957, p. 14) asserts that the Ash'arīs (who represent the dominant theological school in Islamic history) “*firmly denied that man’s reason is competent to apprehend the differences between virtue and vice, or even that such categories exist of themselves, or have any meaning at all, apart from divine revelation.*” In essence, God does not command or prohibit an act because it is either intrinsically good or intrinsically evil, but rather his commanding an act *makes* that act good and his prohibiting an act *makes* that act evil.

The most serious implication of this for the Muslim world is that no system of ethics has been worked out by its theologians and jurists that may serve as a foundation for natural law or human positive law. Furthermore, since Islamic law very early in its history became a static edifice of strict laws, there arose a cleavage between theory and practice. And although customary law had no official *locus standi* in jurisprudence (Anderson, 1957, p. 14), the fact is that people act on the basis of what conforms to their predilections. This is often outside of the legal framework, conducting their day-to-day dealings as are appropriate to the real world in which they live. The jurists, in their attempt to respond to the need of people to dispense with the strict rules of the law, began to produce the extensive literature of *‘hiyal*, or legal devices, or transactions. By these means, the interested parties, who were confronted by strict laws, were able to achieve desirable results by perfectly legal means in the economic conditions of their time. This is elaborated by Schacht (1960) as follows:

*“The earliest ‘hiyal were merely simple evasions of irksome prohibitions by merchants, but very soon the religious scholars themselves started creating little masterpieces of elaborate juridical constructions and advising interested parties in their use.”*

[Joseph Schacht, 1960, p. 102]

The position of the overwhelming majority of jurists was one of acceptance.<sup>30</sup> Even Ibn Qayyim al-Jawziyyah (d. 751/ 1350), otherwise a staunch advocate of the law, in his *A'lām al-Muwaqqi'īn* (2004, pp. 671-740 and passim), discusses *'hiyal* at great length, citing numerous works dedicated to this theme. He distinguishes 'lawful *'hiyal*' (by which a lawful end is to be achieved by lawful means) from those which are 'forbidden' and which he declares invalid. The first group comprises numerous devices in the field of commercial law. Schacht (2012) explains that the followers of the Hanafī school have not traditionally been concerned with the moral evaluation of *'hiyal* in detail, and take their being legally valid for granted. This is despite their stance that *'hiyal* which cause prejudice to another are forbidden. According to them, many *'hiyal* are not even reprehensible. Included in this are those which aim at evading the right of pre-emption (*shuf'a*) and the stratagem of sham marriage (*tahlīl*). These have been widely practiced, by followers of the Hanafī, Mālikī and Shāfi'ī schools of law down to the present generation (Schacht, 2012).

This is most troubling, since *'hiyal* which are devised to circumvent divine law cannot be accepted as licit and ethical devices. Yet if we recall the aforementioned – namely that actions are not deemed either intrinsically good or evil – it becomes intelligible as to why the jurists would perceive there to be no ethical problem with devising *'hiyal*. For the jurists, neither the original law that demands observance, as in the case of interest bearing debt (*ribā an-nasī'ah*), nor the strategy designed to circumvent it, such as the double (*'īnah*) sale, are intrinsically good or evil. (For more information on the acceptance of *'hiyal*, and in particular the jurists' acceptance of their employment, see Hallaq, 1999, p. 173, pp.185-186; For further information on the employment of *'hiyal* in loan contracts, see Mandeville, 1979).

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30 The Traditionists (*ahl al-hadīth*), in keeping with their general approach to questions of religious law, rejected *'hiyal*. Bukhārī (d. 256/870) too devoted a whole 'book' (no. 90) of his *sahīh* to combating them (Schacht, 2012). According to Schacht (2012) some followers of the Hanbalī school too, are on record as opponents of *'hiyal*. Prominent among them are *qādī* Abū Ya'lā (d. 458/1066) who wrote a *Kitāb Ibtāl al-hiyal* and Ibn Taymiyyah (d. 728/ 1328), who penned a special work on *'hiyal* in general, and the so-called *tahlīl* in particular, called *Bay'«n al-dalīl alā ibtāl al-tahlīl* (manuscript held by King Saud University).

4.3.3. Will a Real Islamic Financial Architecture (accompanied by Political Reforms) Reverse Centuries of Underdevelopment in the Muslim World?

The essential ingredients for a financial infrastructure to promote economic growth are as follows. One, it is mandatory to have an information architecture, where property rights, foreclosure procedures needed for assets to serve as a collateral, along with accurate methods of valuing the underlying assets are well established (see Levine et al. 2000). This issue goes beyond the mere titling of assets. It must be followed by a number of politically challenging steps. That is, it should incorporate the efficiency of judicial systems, re-writing bankruptcy codes, restructuring financial market regulations, etc. (see Woodruff, 2001). Empirical studies document the link between a strong [weak] legal system and high [low] corporate valuations, corporate finance and the efficiency of capital allocations (see Levine, 2005). That is, countries with more [less] effective investor protection laws tend to make shareholders and creditors more keen [reluctant] to invest in firms, thereby driving up [down] the price of corporate securities and decreasing [increasing] the cost of capital.

Two, financial innovations should yield efficient organizational forms, allowing them to deliver products demanded by their customers at the lowest price by mitigating transaction costs (see Coase, 1937; and Alchian, 1950). This result is derived from the Miller (1977) study which connects organizational forms with its underlying capital structure.

The appalling economic state of the Muslim world is attributed to autocracy – with weak property rights (condoned by the jurists), as well to the issue of *taqlīd* – which stifles creativity (again attributed to the jurists). Both negative factors are ascribed to the religious establishment as elaborated in this and the following section. This is in contrast to the fact that the *Sharī'ah* guarantees property rights and bestows the freedom on Muslims to think independently (see the economic basis of the injunction of *ribā* and *gharar* in Section 4.2; and the principle of unfettered *ijtihād* discussed in Section 4.1).



Thus, an Islamic financial system will only redeem the underdevelopment of the Muslim world if it is able to: (i) strengthen the legal infrastructure; and (ii) allow Muslims to develop efficient financial instruments, markets and institutions. For the first contingency to be satisfied, the Muslim world will need to promote political institutions that: (i) impose checks and balances on those holding political authority; (ii) bestow political power on a broad group with significant investment opportunities; and limit the power holder's ability to extricate economic surplus from the remaining members of society (see Acemoglu et al. 2005). The second contingency, on the other hand, leads us to the crucial discussion given below.

#### 4.3.4. Do the Jurists have the Capability of Advancing an Efficient Islamic Financial Architecture?

We respond to this issue by documenting a number of stark errors of jurists which illustrates their incomprehension of matters pertaining to financial economics. One particular fundamental error involving a *'hīlah* (ruse) is that of the banking *murāba'hah* (i.e., a sham 'credit sale' imitating a collateralized interest bearing loan). This ruse was first proposed by Sami Hassan Hamoud in his PhD. Dissertation by adapting the historic credit sale facility of *murāba'hah* to replicate an interest bearing (*ribawī*) loan. Hamoud was subsequently awarded the Islamic Development Bank Prize in Islamic Banking for this development in 1987 (see Kahf, 2004).

We first cite the rationale provided by the early jurists (*fuqahā'*) for permitting the historic instrument of *murāba'hah* (comprising of a credit sale) and contrast it with the economic one missed by them. We then critique its extension to the banking *murāba'hah* and the facility of *tawarruq* (i.e., a ruse to replicate a non-collateralized *ribawī* loan) from an economic perspective.

The jurists misconstrued the injunction of *ribā* literally as an ‘increase’ or ‘growth’ only; and segregated goods (or assets) with and without the characteristics of *ribā* (*māl-ribawī* and *māl-ghair-ribawī*) respectively (see again Table 1). The *ribawī* assets were generally used in lieu of money or commodities, which provided sustenance. Some schools defined *māl-ribawī* as fungible goods which are measurable by volume or weight (see Al-Zuhayli, 2006). This again erroneously led them to conclude that the historic *murāba’ah* was permissible, as it involved an exchange of an asset devoid of *ribā* (like a property) on the spot with an asset endowed with *ribā* (like money) deferred. They rationalized this based on the Qur’ānic verse (2: 275): “*Allah has permitted trade (implying credit sale) and forbidden ribā (implying fragile debt facility with the potential of expropriation and financial exclusion),*” (see again Al-Zuhayli, 2006).

The early jurists were basing their decision in an era of bare subsistence where there were no financial intermediaries (as we have in modern times). They did not realize the economic implications of the credit sale as we do today. This is because economics as an independent field of inquiry had not yet developed. Credit sales fundamentally enhance the demand for goods in the real sector of the economy as it is contingent on the elasticity of demand of an asset being sold (see Rashid and Mitra, 1999). Financial economists rationalize credit sales to the absence of financial markets in the era of the Prophet Muhammad and that of the following generations (*salaf sāli’heen*). This is articulated in Sen (1998, p. 435) as follows: “*when financial markets are imperfect, a seller can find it optimal to offer a menu of deferred payment plans.*”

The banking *murāba’ah*, on the other hand, does not incorporate the elasticity of demand of the asset supposedly being ‘sold.’ It is priced using an interest based index and suffers from the same flaws as *ribawī* debt (see again Salleh et al., 2012). That is, it is a fragile facility endowed with the capacity to extricate assets and financially exclude the

underprivileged. Although it alleviates adverse selection, moral hazard and the agency cost of debt due to the collateralized nature of debt, it is *not* economically efficient as discussed in Ebrahim and Sheikh (2012).<sup>31</sup>

Legitimization of the banking *murāba'ah* by the jurists has led to yet another violation of the *Sharī'ah* in the form of a non-collateralized *ribawī* loan termed as *tawarruq*, (literally, monetization). This facility is structured by employing a banking *murāba'ah* (involving a sham sale of a real asset) in conjunction with a simultaneous sale of the same asset to a third party (see Imber, 1997). The consequence of this stratagem is that it yields a facility suffering from not only from adverse selection and moral hazard but also high agency cost of debt (as it is not collateralized). It also ranks lower than a banking *murāba'ah* on an efficiency scale resulting in a high cost of funding thereby yielding low debt capacity (see again Ebrahim and Sheikh, 2012).

The above illustrates that the current practice of Islamic banking, which is based on implementing medieval (and often inefficient) Islamic financial instruments, is nothing less than the failure of the religious establishment to engage in *ijtihād*. This issue is reiterated in Ebrahim and Rehman (2005), who document the inefficiency of the medieval Islamic forward sale (i.e., *Bai' al-Salam*) in contrast to conventional futures on Islamically permitted commodities.

In summary, the errors of the jurists illustrate their lack of understanding of the basics of finance. This has led to the accusation that they are “*duping*” the masses (see Khan, 2010).

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31 A banking *murāba'ah* is generally more expensive than a *ribawī* debt contract due to reduced economies of scale and the incremental expenses of documenting the subterfuge, i.e., paying *Sharī'ah* scholars for their approval.

This subsection demonstrates the inability of jurists to guide the Muslim world in temporal matters, especially in the area of financial economics.<sup>32</sup>

#### 4.4. The perennial economic underdevelopment of the Muslim world.

This subsection attributes the intricate issue of “*the long divergence*” to the lack of understanding of the economic aspect of injunctions like that of *ribā*, which basically enjoins property rights and co-operation (*ta’awun*). This is explained in Salleh et al. (2012) and elaborated earlier in this paper. This deficiency in understanding the crucial injunction led the Muslim world to: (i) give in to autocratic rule for centuries without resisting it; (ii) eschew the development of independent judiciary to protect the property rights of the masses; and (iii) avoid the development of institutions for their economic advancement.

First, autocratic rule in the form of monarchy is censured in the Qur’ān as well as the *Sunnah*, as it serves to advance the economic interest of a narrow elite at the expense of the majority.<sup>33</sup> At certain points in Muslim history, the jurists, who were often co-opted by the ruling elite, legitimized the expropriation of wealth by monarchs and autocrats. This is in contrast to the vital check provided by many of them on the power of the rulers in early Islamic history (see Feldman, 2009). Over time, however, due to the effect of reforms, the jurists have been integrated into the ruling class’s regime. This has allowed unbridled and unchecked executive power to be the norm. The *Shari’ah* thus plays less of a force for legitimate rule and more of a specialized role pertaining to family and civil matters (see Feldman, 2009). This *modus vivendi* (between the two classes) has helped in legitimizing the

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32 There are many instances where the *fuqahā* have stumbled badly. This list is not exhaustive and includes their failure to structure and thus implement: (a) interest-free (*qardh ‘hasan*) loans; and (b) integrate charitable institutions in development finance (see again Kuran, 2005).

The reasons behind the flagrant errors of the *‘ulamā* are elaborated in the Appendix.

33 The Qur’ān (27:34) quotes the Queen of Sheba (Bilqīs) as saying “*Kings, when they enter a country, despoil it, and make the noblest of its people its meanest.*” The *Sunnah*, on the other hand, predicts ‘distressful’ conditions of Muslims at the hands of monarchs (see Book No. 17 – The Office of Commander and *Qādi*, Mishkat Al-Masabih, translated by Robson, 1981).

ruling classes monopoly over wealth and helped them to further extract economic surplus from their citizens, thereby reducing the cost of collecting taxes. In short, the jurists have dutifully supported the diverse policies of the ruling elites, even when they lacked a basis for this in Islamic law (see Coşgel et al., 2009).<sup>34</sup>

In addition to expropriation, various monarchs and autocrats have also endeavored to weaken the private sector in order to deter the emergence of an autonomous social group.

This is elaborated in Malik and Awadallah (2011, p.3) as follows:

*“A singular failure of the Arab world is that it has been unsuccessful in developing a strong private sector that is connected with global markets, survives without state crutches and generates productive employment for its young. With few exceptions, the private sector is generally weak and dependent on state patronage; success in it is determined more on patronage than entrepreneurship. With the public sector acting as the main avenue for job creation, the region suffers from a precarious employment strategy and is left unprepared to deal with the demographic challenge.”*

Thus, the jurists at various points in history have supported the ruling elite by failing to condone their tyrannical behavior and by failing to admonish them when their laws have been unjust. Apparently they have been adhering to the *'hadīth* of Prophet Muhammad commanding Muslims to obey rulers *“as long as they pray”* (see Sahih Muslim, translated by Siddiqui, 1986, *'Hadīth* no. 4569). They have failed to grasp the deeper meaning of the *'hadīth* which broadly implies observance of the *Sharī'ah* (in spirit as well as in the letter). This includes the upholding of property rights.<sup>35, 36</sup>

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34 For more on the political role of the *fuqahā'* in Muslim societies generally, see Hallaq (2001), and Lambton (1980). On the corruption of the Ottoman learned institutions see Zilfi (1988, 2006).

35 Footnote no. 2318 of Sahih Muslim translated by Siddiqui (1986) elaborates this very succinctly as follows:

*“The upholding of prayer, says Muhammad Asad, “has a wider meaning than the mere holding of congregational prayers,” it denotes – as it does at the beginning of the second chapter of the Qur'ān – a positive upholding of the faith.”*

[Siddiqui, 1986, p. 1033].

Second, in most Muslim countries, the judiciary is still not independent of the ruling elite.<sup>37</sup> In early Islam there is a precedent for the separation of the judiciary from government, as in the case of the second caliph of Islam Umar Ibn al-Khattab, who appointed ‘Ubāda ibn Sāmit as a judge (*qādi*) and preacher of Syria to ensure upholding of just and proper governance (See Footnote no. 2028, ‘*Hadīth* no. 3852, Sahih Muslim, translated by Siddiqui, 1986).

Third, financial innovations, which give rise to efficient organizational forms delivering goods to their customers at competitive rates, have failed to keep pace in the Muslim world. This has been alluded to by Kuran (2005). This failure can be attributed to a failure to undertake dynamic *ijtihād* on the part of elites which are out of touch with reality. The ramification of this error has been profound: it has impacted on the competitiveness of Muslim entrepreneurship and has, furthermore, led to a failure to establish financial institutions promoting the economic interests of the poor and underprivileged as highlighted in the Qur’ān (30: 39) (see again Ibn Taymiyyah, 1951; Kuran, 2005; and Salleh et al., 2012).

The result of the above three issues has been devastating for the Muslim world, as it has led to ‘poverty traps’ emanating from a sequence of Pareto-inferior equilibria.

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36 The French tax farmers, in contrast to their Ottoman counterparts, had the ability to organize and restrain their monarch from preying on their property rights, as illustrated in Balla and Johnson (2009). The Muslim tax farmers failed to undertake similar action due to the literal interpretation of the ‘*hadīth*’ of Prophet Muhammad.

37 Even in countries such as Malaysia, identified as ‘democratic’ by the nomenclature of both Haber and Menaldo (2010) and Chaney (2012), the judiciary is still subservient to the politicians after constitutional amendments made by former Prime Minister Mahathir Mohamad in the 1980s. Another example is that of ‘democratic’ Pakistan in the context of Haber and Menaldo (2010). Here, the suspension of Chief Justice Iftikhar Muhammad Chaudhry by former President Pervez Musharraf on November 3, 2007, sparked civil unrest leading to the downfall of his regime and the reinstatement of Chief Justice Chaudhry along with several senior justices and judges. The emboldened judiciary has recently convicted the country’s Prime Minister Syed Yusuf Raza Gilani in contempt of court for defying an order to reopen a corruption case against President Zardari. This has resulted in Mr. Gilani being disqualified as a member of Parliament, leading to his dismissal as Prime Minister.

The economic and intellectual decline along with a repressed majority made the Muslims countries vulnerable to colonization by European countries. This led to a further economic decline, as elaborated in Acemoglu et al. (2005) as follows:

*“European colonialism therefore led to an institutional reversal, in the sense that the previously-richer and more-densely settled places ended up with worse institutions.*

*To be fair, it is possible that the Europeans did not actively introduce institutions discouraging economic progress in many of these places, but inherited them from previous civilizations there. The structure of the Mughal, Aztec and Inca empires were already very hierarchical with power concentrated in the hands of narrowly based ruling elites and structured to extract resources from the majority for the benefit of a minority. Often, Europeans simply took over these existing institutions. Whether this is so is secondary for our focus, however. What matters is that in densely-settled and relatively developed places, it was in the interests of Europeans to have institutions facilitating the extraction of resources, thus not respecting the property rights of the majority, while in sparsely-settled areas, it was in their interests to develop institutions protecting property rights. These incentives led to an institutional reversal.”*

[Acemoglu et al. 2005, pp. 414-416]

The aftermath of colonial rule has still not improved the status of the Muslim world, as explained by Waywell (2006) as follows:

*“Colonial powers further claimed that they would modernize the political institutions, thereby bringing them closer to the status of a modern state. Despite these claims, European occupation did little for the mandate territories. In addition to damaging the traditional lives and customs of the people, they were often used for the exploitative gathering of raw material. Overall, colonialism not only hindered modernization efforts through military and commercial domination, but also encouraged autocratic tendencies by repressing the liberties of the people and limiting the expression of opposition to the government.*

*Many Muslims allege that human rights violations are not frequently challenged, and that regimes with atrocious human rights records, such as Libya, have been elected to the Human Rights Commission of the United Nations. Indeed, America is often accused of turning a blind eye towards tyrannical regimes, provided they do not interfere with the goals of government policy. This was especially true*

*during the Cold War, when the Soviet Union was seen as the far greater enemy, and as a result, fundamentalist mujahedeen in Afghanistan were funded and supported by the American government. America also tended to ignore the human rights abuses of friendly regimes, including Egypt, Saudi Arabia and Turkey. Overall, this indifference creates an impression that to the West, human rights simply do not matter in the Muslim world.*

*The United States has a tarnished record in its support of democracies in the region, particularly when these democracies resulted in the election of religious parties. Indeed events, such as the overthrow of Mossadeq, show that America is often only committed to democratic principles benefitting the interests of the United States. The underlying suggestion of these actions is that America does not view Middle Eastern countries as capable of running democracies, and therefore their only concern is whether or not autocratic rulers act in the interest of America.”*

[Tyler Waywell, 2006, pp. 176, 184]

Thus, the above attributes “*the long divergence*” stemming from the economic growth of the Muslim world versus the West to the retrogressive outlook of the jurists, their flawed *ijtihad* and co-option by the ruling elite.

## **5. Concluding Comments on the Development strategy for Muslim countries**

The Arab Spring which began in earnest in the early months of 2011 is currently faltering. With the exception of Tunisia, a country now well on its way to becoming a model democracy, the remaining countries that have witnessed revolutions are still facing huge impediments, whether in the form of military establishments (in case of Yemen) or rival militias (in case of Libya).<sup>38</sup> This affirms the observation of Malik and Awadallah (2011, p. 26) that “*elites have a remarkable ability to endure.*”

The path to establishing a civil society for both the Arab and Muslim world will inevitably present hurdles. An intellectual infrastructure will have to be established first and

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38 The call for democracy in Bahrain has been brutally suppressed. Meanwhile two more fronts have been initiated in Syria and Sudan.



foremost in accordance with the Lipset-Przeworski-Barro hypothesis (see Glaeser et al., 2004). This is since intellectual dynamism has atrophied, leaving the Muslim world vulnerable to fundamentalisms, extremisms and other modes of retrograde thinking. This article has established the errors of a particular type of intellectual stagnation, one which has beleaguered Muslim jurists. It has critiqued ‘Islamic’ banking as it is practiced today, developing into a model far from the Islamic ideal. Yet, far from seeking to deride the religious establishment, the aim of this article has been simply to articulate the point that their retrogressive and reductionist outlook in the domain of economics has had significant bearing on the lack of development in the Muslim world.

The Muslim world is perhaps in denial regarding the gravity of the situation it faces; it has, after all, yet to shape sound economic policies and lay the groundwork of institutions that can stimulate economic growth. This is the reason why the studies that demonstrate a causal link between Islamic beliefs, behavioral outcomes and economic performance are at best speculative (see Keeley, 2003). This study also reconciles the two views in the literature whether Islam is an impediment or a facilitator of economic development and thus of growth. We, however, absolve Islamic law from holding back the progress of Muslims.

If the Muslim world is to make any headway out of its current morass, it is clear a new approach will need to be taken by Muslim jurists who have for centuries been the *de facto* formulators of correct practice in Islam. This necessitates: (i) reformulating the way in which *ijtihad* is undertaken in Islamic Law; (ii) reforming the educational institutions (*madāris*), which presently continue to perpetuate a retrogressive outlook. Restructuring the educational institutions should include: (i) the exchange of ideas between the various legal and theological schools without sectarian bias; (ii) the inclusion of the social sciences and humanities; (iii) the promotion of creativity and a clear position against uncritical acceptance of medieval jurisprudence; (iv) the separation of normative Islam from historical Islam, as

recommended by Fazlur Rahman (1984). This final recommendation is in agreement with Ali (2002) and the development perspective of Glaeser et al. (2004).

Finally, we recapitulate our central finding – that the jurists have jeopardized the very survival of the Muslim world by entering a technical field without seeking the guidance of experts. This is in contravention of the Qur'ānic verse (16: 43). Furthermore, it constitutes a violation of the *Maqāsid* (objectives) of the *Sharī'ah*, which the jurists are tasked with safeguarding (see Kamali, 2003). We therefore recommend that in matters pertaining to financial economics, the jurists should desist from making unilateral decisions without consulting specialists trained in the field. They should conduct a joint *ijtihād* working with financial economists by: (i) developing institutions that enforce contracts, thus promoting property rights; (ii) fostering good governance and providing a conducive environment for private initiative; and (iii) structuring a financial infrastructure that promotes growth, as endorsed by Al' Alwani (1991a). Our final recommendation is consistent with the institutional perspective of Acemoglu et al. (2005).

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## Appendix

### Understanding the Flagrant Errors of the Jurists

When the Qur'ānic imperative outlawing the charging of loan interest and usury (both encompassed by the term *ribā*) was first revealed in the final years of the Prophet Muhammad's mission, it was nothing short of a command to the believing Muslim to act with loving kindness towards his brother. The Qur'ān (2:276) in particular issued a command to adhere to the virtues of cooperation and mutual support via charitable lending (Zuhayli, 2006). Should a Muslim ever be in a position of creditor, he was entreated to lend without interest even though he would be vulnerable to actual and potential financial deprivation. The Qur'ānic imperative conflicted with the rules of natural law, which find no objection to an agreement freely entered into by two parties. Even in that instance where complete freedom falls into doubt, such as in the case of an impoverished borrower in dire need of a loan and who, from his desperation, accepts unfair contractual terms, natural law considers it fair for a creditor to impose a moderate rate of interest upon his loan. He is, after all, risking the total loss of his money if the borrower defaults or absconds with the funds. Moreover, even if the debt is repaid, the creditor is deprived of the use of his own money for the duration of the loan period.

It seems that the demands of the market constituted an irrepressible force that precluded an *in toto* ban on loan interest by Muslim authorities; this fact is abundantly clear from the Muslim legal literature, as jurists of all legal schools from at least the 9<sup>th</sup> century on were keen to limit the meaning of *ribā* and, by extension, its application in the real world of financial transactions. Overwhelmingly, Muslim jurists decided that the remit of *ribā* was specific to fungibles measured in volume or weight, adding a further condition of oneness of kind (*ittihad al-jins*). Those commodities measured by any other criteria, such as length or number, were not deemed *ribawī*. Neither were non-fungibles considered *ribawī*, such as animals, carpets, lands, houses and trees (Zuhayli, 2008). For these, exchange in unequal amounts was considered lawful, irrespective of the fact that the very rationale for the prohibition of *ribā*, which the jurists themselves had pointed out, was being undermined.

The question may arise, why had the error of the jurists not come to light sooner? One possible reason, as stated above, is that financial economics as a separate field only evolved in approximately the last fifty years. In contrast, the rudiments of Islamic financial



terminology, which developed around 1200 years ago, have remained static, as its formulators did not keep pace with the changing intellectual environment. Whereas the classical jurists may have had no alternative but to allow plain-vanilla interest, modern jurists who have ostensibly experimented in the field of financial economics (contrary to the Qur'ānic injunction in verse 17:36, imploring Muslims not to engage in matters which they are not qualified in) can have no such absolution. They should have rather sought counsel from those (i.e., Muslim economists) who are endowed with the same (see Qur'ān 16:43). This issue is reinforced in the *Sunnah*, which is against religious scholars going beyond their mandate into temporal ones which are technical in nature (see Sahih Muslim, translated by Siddiqui, 1986, Chapter 986, *Hadīth* No. 5831). This suggests that the jurists have misconstrued the Qur'ānic verses (8:29; 57: 28), which promise to endow God fearing people the criterion (*furqān*) between truth and falsehood. This has ultimately resulted in a monopoly of the religious establishment, as illustrated in Abbas (2004).

*“The madrasah institution produced a number of scholars of the highest intellectual caliber, including Al-Ghazali, Ibn Khaldun, ...*

*Over time, however, the institution suffered from a consistent pattern of degradation and degeneration. As a result, many of today's madrasah 'products' are known for anything but scholarship and learning....*

*The ulama's influence over society, however, continued to increase – or, at the very least, sustain – its position of significance. In most cases, the modern Muslim state accepted this role because the ruling elites in both monarchic and non-democratic states needed the ulama's authority in order to sanctify policies and bolster the regime's legitimacy. It turned out to be a mutually beneficial relationship. Even today, authoritarian regimes often use the clerical fatāwā for political purposes. Simultaneously, the ulama's hold on the religious spectrum had a negative impact on the psyche of Muslims in the sense that ordinary Muslims gave up, or were forced to give up, their individual right to interpret and understand religion.....*

*Islamic theology consequently became the reserve of a group that was increasingly out of touch with the realities of everyday life, while its standards of scholarship were negatively affected by a closed-door environment. A judgmental opinion on a legal issue, for instance, given by an 'ālim or a group, even if several hundred years old is still part of Shari'ah law and thus considered a legal precedent. As only ulama are supposed to be qualified and educated in this specific field of interpreting religious law, no ordinary Muslim is allowed to delve into this sphere. In essence, this isolating impact retarded the growth of Shari'ah law. The ulama, hence, became increasingly dogmatic, while ordinary Muslims became increasingly unaware of the essence of their religion...”*

[Hassan Abbas, 2004, p.2]

The monopoly that the jurists have enjoyed on formulating, interpreting and articulating the religion has had a detrimental effect in the recent history of Muslim communities, especially in the field of economics. It also provides ammunition to those critics who allege that Islam has held back progress of the Muslim world. A further twist of the knife is the fact that some jurists extricate economic surplus from the ‘Islamic’ financial industry, as contended by Khan (2010, p. 818). This issue is also corroborated by Kahf (2004) as follows:

*“The ulama in the 1950s had weather-affected, dried skin hands and humble clothing, sitting in the cold, teaching on the ground of mosques in Cairo, Damascus, Aleppo and Baghdad, are now replaced with soft-living ulama who are used to luxurious garments and services of five-star hotels and expensive restaurants. This new life style of Islamic banks’ ulama has resulted in certain changes in viewpoint as well. Many of them are now accused of being bankers’ window-dressers and of over-stretching the rules of the Sharī’ah to provide easy fatāwā for the new breed of bankers.”*

[Monzer Kahf, 2004, p.27]

A second reason is the institutionalization of the various sects (schools - *madhāhib*) in Islam. This rise of sects has stifled to some extent the possibilities of critical thinking, as Muslims were exhorted to think strictly in line with their school of thought. This is depicted in Al’ Alwani (1993).

*“Deviation, distortion and confusion affected all sciences and disciplines. Sufism, for example, deviated from its original objective of education and spiritual refinement in order to delve into metaphysics, philosophy of the abstract and mysticism, resulting in complete denial of human will and the value of any action. The issue of cause-effect relationship, as taught to and understood by the Muslim mind at the beginning of the Revelation, was lost in a metaphysical maze. Fiqh lost most of its comprehensive approach, endeavor and quality and became more and more concerned with trivial and secondary issues. Muslim thought became disoriented and Muslim intellect lost its enthusiasm for innovation or new thinking and tended to find solace in turning back to following the already established schools.”*

[Tāha Jābir Al’ Alwani, 1993, p. 17]

A third reason advanced by the late M. Amir Ali of Chicago, IL, attributed the decline in scientific leadership of the Muslim world to the narrow interpretation of religious scholars (see Ali, 2002, pp. 1-2). He termed it the “*development of the dichotomy of sciences,*” where the scholars narrowly perceive religious knowledge from the Qur’ān, *’Hadīth, Seerah* (life of Prophet Muhammad) and perhaps the history of Islam as the only true knowledge (*’ilm*). They do not regard Mathematics, Physics, Chemistry, Astronomy, Medicine etc. as real

sciences and derogatively labelled them as *funoon* (arts). He stated that “*this dichotomy has developed, perhaps, because the Muslims see natural and social sciences coming from Europe, a land of kuffār (rejecters of Islam). Therefore, any of their contributions are mundane, not divine in origin. In general, Muslims consider that the only thing divine in origin is what is revealed to prophets and messengers. Since revelations to ancient prophets are not preserved except for whatever was revealed to Prophet Muhammad, nothing qualifies as ‘ilm except the Qur’ān and Sunnah and whatever is derived from them....I consider this as ignorance...The consequence of such thinking is that the most honourable learning in the eyes of Muslims is to become an ‘ālim (scholar) of the Qur’ān, ‘Hadīth and fiqh (Islamic Jurisprudence) – labelled collectively as ‘Uloom al-Islamiyah’ or Islamic sciences. The learning of natural and social sciences is considered a mundane activity propelled by greed to make money or gain prominent positions. Such thinking is against the teaching of the Qur’ān, and has reduced Muslims from a Super Power to the world’s most disgraced people due to their backwardness, illiteracy, poverty and weakness in every indicator of modern progress within the Islamic context.*”

A fourth reason is that the ruses concocted by the *Sharī’ah* scholars (and what Timur Kuran, 2005, describes as Westernization) represent an intellectual dead end, compelled by an agglomeration of errors in what is a static *ijtihād*.<sup>39</sup> This is described in Al’ Alwani (1991b) as a ‘crisis in fiqh’ as follows:

*“The state of fiqh in those days being what it was, it should have come to no surprise that the Muslims felt uncomfortable and not a little confused. Often-times, something pronounced ‘harām by one faqīh would, at the same time, in the same place, and under the same circumstances, be pronounced ‘halāl by another faqīh. In order to have a sense of what really occurred in those times...a new and extensive chapter in jurisprudence was being written then, the chapter known as al ‘hiyal wa al makhārij, or legal stratagems and dodges. Indeed, the mastery of the particular subject became a sign of the faqīh’s erudition and academic preeminence...*

*It was from this time onward that people began neglecting the Holy Qur’ān and its sciences, and likewise the Sunnah and the disciplines associated with it. Instead, they satisfied themselves with quoting teachings from different madhāhib, and then arguing in favor of those and, under what might be considered the best of conditions insofar as the exercise of legal acumen was concerned, using them as the basis from branching into details.*

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39 This is in contrast to the dynamic *ijtihād* espoused by Ibn Qayyim Al-Jawziyya (2004).

*The decline then continued, and the differences of opinion on legal issues increased and became more profound. Indeed, generations of scholars grew up under taqlīd, with the result that all independent legal thought was stifled and the tree of ijtihād withered.*

*Practically speaking, the result of all these attempts was to prepare the ummah, mentally and intellectually, for tacit acceptance of the doctrine that the door of ijtihād had been closed...*

*Fiqh scholars became engrossed in the business of inventing legal loopholes and stratagems that would allow people to avoid the rulings of the Sharī'ah. Indeed, stratagems were worked out for nearly every subject covered in fiqh. Unlike the early imams of fiqh who worked out legal stratagems solely for the purpose of sidestepping damage, or loss, scholars set themselves to the task of inventing ways to dodge legal responsibilities.*

*[Tāha Jābir Al'Alwani, 1991b, pp. 319-321, 323, and 327]*

**Table 1: Classical *Sharī'ah* scholars' perspective on the *ribā* prohibition**

<u>Category</u>	
<i>Ribā al-fadl</i> - the hidden <i>ribā</i>	<i>Ribā an-nasī'ah</i> - the evident <i>ribā</i>
<u>Application</u>	
Relates to spot exchanges	Relates to deferred exchanges
<u>Legal Cause</u>	
Excess in exchange without an equivalent counter value	Delay in payments with an increase above the original amount at the settlement date; or vice-versa (i.e., lowering the debt in return for an accelerated payment)
<p>Specifically prohibited in transactions involving the six commodities in the <i>Sunnah</i> (see Sahih Bukhari Vol. 3, 34:344; Sahih Muslim Book 10, 20:3853). Impermissibility of other commodities is generally based on the nomenclature developed by the <i>Sharī'ah</i> scholars from the major <i>Sunnī</i> schools of thought, namely: (i) intrinsic or monetary value; and (ii) volume or weight.</p> <p>However, there are additional conditions that are not shared amongst the major <i>Sunnī</i> schools, that is: (i) the commodity being edible, nutritious or storable; (ii) the threshold for which the condition on weight or volume becomes applicable; and (iii) the interpretation on 'oneness in kind' or genus of the exchanged commodities.</p> <p>Following this nomenclature, commodities that do not have these characteristics are precluded from the <i>ribā</i> prohibition: (i) non-fungibles or (ii) fungibles that are measured by length or counted; which may in effect be significant. For example, in the exchange of animals or cloth.</p>	
<u>Rationalisation</u>	
<p>The <i>ribā</i> inhibition is aimed at avoiding exploitation and fraud for the protection of one's property, fairness and justice. The injunction of <i>ribā al-fadl</i> arises as a blocking means to the evident <i>ribā</i>, that is preventing access to a greater evil. The restriction on the exchange of the six commodities in the <i>Sunnah</i> extends from them, representing food staples and currencies, which during the period of the Prophet Muhammad and Caliphs (successors) were essential for survival and measure of price, respectively.</p>	

Source: Salleh et al. (2012).

**Table 2: Economic perspective of the *ribā* prohibition**

<i>Category</i>	
<i>Ribā al-fadl</i> - the hidden <i>ribā</i>	<i>Ribā an-nasī'ah</i> - the evident <i>ribā</i>
<i>Application</i>	
Barter transactions	Plain vanilla interest bearing contracts
<i>Rationalisation</i>	
Exchange is inefficient, as it has the potential to expropriate assets of either party in the exchange of goods	The contract is (i) inefficient; and has the potential to (ii) expropriate assets of either lender or borrower; (iii) exacerbate financial fragility; and (iv) induce financial exclusion
<p>In general, the <i>ribā</i> prohibition delineates protection of rights of both contracting parties. This is retrospective of the <i>Sharī'ah</i> that accords <i>protection of property rights</i> as one of the five essential elements of the objectives of the law.</p>	

Source: Salleh et al. (2012).

## Glossary of Arabic terms

Number	Arabic term	Nearest English meaning
1	<i>Ahl al-hadīth</i>	Traditionists
2	' <i>ālim</i> [singular] ' <i>ulamā</i> [plural]	Religious scholar(s)
3	<i>Ash arīs</i>	Dominant theological school in Islam named after Ab- al- Hasan al-Ash'ar» (d. 324/935).
4	<i>bai' al-Salam</i>	Islamic forward sale
5	banking <i>murāba'hah</i>	A sham 'credit sale' imitating an interest bearing loan
6	<i>fan</i> [singular] <i>funoon</i> [plural]	Art(s)
7	<i>fatwā</i> [singular] <i>fatāwā</i> [plural]	Religious ruling(s)
8	<i>faqīh</i> [singular] <i>fuqahā'</i> [plural]	Jurist(s)
9	<i>fiqh</i>	Islamic jurisprudence
10	<i>furqān</i>	Criterion between truth and falsehood
11	<i>gharar</i>	"Deception based on the absence of knowledge on the likelihood of delivery with the prospect to do harm"
12	' <i>hadīth</i> [singular] <i>a'hadīth</i> [plural]	Saying(s) of Prophet Muhammad
13	' <i>halāl</i>	Lawful
14	<i>Hanafīs</i>	Followers of Sunni school of law named after Nu'«m«n ibn Th«bit, better known by his teknonym, Ab- Han»fa (d. 148/767)
15	<i>Hanbalīs</i>	Followers of Sunni school of law named after Ahmad ibn Hanbal (d. 241/855)
16	' <i>harām</i>	Unlawful
17	' <i>hikmah</i>	Wisdom
18	' <i>hīlah</i> [singular] ' <i>hiyal</i> [plural]	Ruse, legal stratagem [also termed as <i>sharī'ah</i> arbitrage]
19	' <i>husn</i>	Seemliness or conformity
20	<i>ijtihād</i>	Literally 'exertion.' It implies independent deduction of laws not self-evident from the primary sources, namely the <i>Qur'ān</i> and <i>Sunnah</i> .
21	' <i>illah</i>	Effective cause
22	' <i>ilm</i>	True knowledge
23	<i>imām</i>	Religious leader
24	' <i>inah sale</i>	Double sale
25	<i>isti'hsān</i>	Equity
26	<i>istiqrā'</i>	Inductive reasoning
27	<i>ittihad al-jins</i>	Condition of oneness of kind
28	<i>kuffār</i>	Non-muslims

## Glossary of Arabic terms (Continued)

Number	Arabic term	Nearest English meaning
29	<i>madrashah</i> [singular] <i>madāris</i> [plural]	Educational institution(s)
30	<i>madh-hab</i> [singular] <i>madhāhib</i> [plural]	School(s) of thought [sect(s)]
31	<i>Mālikis</i>	Followers of Sunni school of law established in Madinah, named after Mālik ibn Anas (d. 179/795)
32	<i>māl-ghair-ribawī</i>	Asset devoid of characteristic of <i>ribā</i>
33	<i>māl-ribawī</i>	Asset with characteristic of <i>ribā</i>
34	<i>maqsad</i> [singular] <i>maqāsid</i> [plural]	Objective(s)
35	<i>masla'hah</i>	Public interest
36	<i>maysir</i>	Gambling
37	<i>mudārabah</i>	This is a limited liability contract between a principal ( <i>rabb-ul-maal</i> ) and an agent ( <i>mudārib</i> ), constituting a partnership in an enterprise.
38	<i>munāsib</i>	Suitable
39	<i>murāba'hah</i>	Credit sale
40	<i>mushārahah</i>	This refers to a joint enterprise where the partners share its profit and loss.
41	<i>mutakallimin</i>	Theologians
42	<i>mu'tazila</i>	This is an Islamic school of speculative theology that flourished in Iraq during the 8th–10th centuries.
43	<i>qādī</i>	Judge
44	<i>qiyās</i>	Analogical reasoning
45	<i>qardh-'hasan</i>	Interest free loan
46	<i>qubh</i>	Unseemliness or deformity
47	<i>Qur'ān</i>	The holy book of Islam
48	<i>ra'y</i>	Opinion
49	<i>ribā</i>	An injunction protecting property rights. This is generally misinterpreted as usury <i>or</i> interest.
50	<i>ribā al-fadl</i>	This is termed as hidden <i>ribā</i> . It is an injunction to deter expropriation of assets on spot exchanges.
51	<i>ribā an-nasī'ah</i>	This is termed as evident <i>ribā</i> . It is generally an injunction to deter expropriation of assets on deferred exchanges. It also mitigates financial fragility and the exclusion of underprivileged from financial services.
52	<i>ribawī</i>	Interest bearing contract
53	<i>Salaf sāli'heen</i>	First three generations of Muslims
54	<i>seerah</i>	Life of Prophet Muhammad
55	<i>sharī'ah</i>	Divine law
56	<i>Shāfi'īs</i>	Followers of Sunni law school named after Muhammad ibn Idrīs al-Shāfi' (d. 188/820)



## Glossary of Arabic terms (Continued)

Number	Arabic term	Nearest English meaning
57	<i>Shī'ah</i>	This comprises the second largest sect in Islam, which is also based on the teachings of the Qur'ān and the message of Prophet Muhammad. <i>Shī'ahs</i> revere the family of Prophet Muhammad and consider his cousin Ali to be his successor.
58	<i>shuf'a</i>	Pre-emption
59	<i>sunnah</i>	Literally 'a clear and well trodden path.' It implies the practice of Prophet Muhammad. Along with the <i>Qur'an</i> and <i>Hadith</i> (recorded sayings of the Prophet Muhammad), it is a major source of <i>Sharī'ah</i> , or Islamic law.
60	<i>Sunnī</i>	This comprises the largest sect in Islam, whose laws are derived from the <i>Qur'ān</i> and the <i>Sunnah</i> , in addition to using methods of juristic reasoning and consensus.
61	<i>tahl'l</i>	A process in which a person is instructed, usually for payment, to marry a woman who has been three times divorced and cannot therefore remarry her original husband until a fourth, dummy marriage has been gone through and duly consummated. After this she can legally remarry her old husband.
62	<i>taqlīd</i>	Imitating the rulings of religious authority without examining their scriptural basis.
63	<i>ta'awun</i>	Co-operation
64	<i>tawarruq</i>	A ruse replicating a non-collateralized interest bearing loan
65	<i>'uloom al-Islamiyah</i>	Islamic sciences
66	<i>ummah</i>	Global Muslim community
67	<i>waqf</i> [singular] <i>awqāf</i> [plural]	Charitable foundation(s)
68	<i>Zāhirī</i>	This is a school of thought in Islam, which insists on sticking to the manifest ( <i>zāhir</i> ) or literal meaning of expressions in the Qur'ān and the <i>Sunnah</i> .