CHAPTER ONE

The Economic Impact of Islamism

In 1979 PAKISTAN TOOK SOME MAJOR STEPS to give its economy an Islamic character. To satisfy the presumed Qur'anic ban on interest, banks were ordered to offer an interest-free alternative to the conventional savings account and to purge interest from all their operations within five years. Although the wider objective has not yet been met, the interest-bearing savings account is no longer an option for new depositors. Another highlight of the 1979 program was zakat, Islam's tax on wealth and income. Voluntary until then, zakat was made a legal obligation. The Pakistani government now collects zakat from several sources, notably bank deposits and farm output. Every year thousands of local committees distribute the proceeds to designated groups.[1]

Pakistan has not been alone in trying to restructure its economy according to ostensibly Islamic stipulations. Zakat is now compulsory for certain groups in Malaysia, Saudi Arabia, and the Sudan. In some other predominantly Muslim countries, the establishment of a state-run zakat system is under consideration. The impact of Islamization is especially widespread in banking. Banks claiming an Islamic identity are in operation in most countries of North Africa, the Middle East, and South Asia. In some of these they hold more than 10 percent of the commercial deposits.[2] The leading Islamic banks have also established a presence in countries where Muslims form a small minority. New Zealand now has an "Islamic Finance Corporation," and Pasadena, California, an "Al Baraka Bankcorp."

These developments are not occurring in an intellectual vacuum. A rapidly growing literature known as "Islamic economics" seeks to guide and justify the ongoing reforms.[3] The prescriptions in this literature rest partly on economic logic and partly on the Qur'an and the Sunna, the latter consisting of recollections of the words and deeds of Prophet Muhammad and his companions. Several research centers have been established to promote Islamic economics. Some of these, including the International Center for Research in Islamic Economics at King Abdulaziz University in Jeddah, the International Association for Islamic Economics in Leicester, and the Kulliyah of Economics at the International Islamic University in Kuala Lumpur, publish journals devoted to the discipline. There are also several specialized periodicals, such as the *Journal of Islamic Banking and Finance*, a quarterly published in Karachi.

The exponents of this discipline, who call themselves "Islamic economists," emphasize that it covers far more than zakat and interest-free banking. The discipline aims, they say, to provide a comprehensive blueprint for all economic activity. Accordingly, a list of suggested research topics published by the International Center for Research in Islamic Economics covers every major category of research recognized by the American Economic Association, including consumer behavior, market structure, central planning, industrial relations, international trade, and economic development.[4] Some Islamic economists are quick to admit that in most of these realms the nascent discipline has yet to make a significant contribution. But they generally agree that the fundamental sources of Islam harbor clear and definitive solutions to every conceivable economic problem. To find these, they suggest, we must turn to the Qur'an and to the wisdom of the earliest Islamic community in seventh-century Arabia, drawing wherever necessary on modern tools and concepts.

Islamic Economics as Fundamentalist Doctrine

The classical sources of Islam contain numerous prescriptions that lend themselves to the construction of economic norms, and the religion's early history offers an array of lessons concerning economic behavior and institutions. But the notion of an economics discipline that is distinctly and self-consciously Islamic is very new. The great philosophers of medieval Islam wandered freely beyond the intellectual confines of the Islamic scriptures. And none of their works, not even the celebrated *Prolegomena* of Ibn Khaldun (1332–1406 C.E.), gave rise to an independent discipline of economics.[5] The origins of Islamic economics lie in the works of Savyid Abul-Ala Mawdudi (1903–79), a Pakistani social thinker who sought to turn Islam into a "complete way of life." In his voluminous writings, Mawdudi exhorted that Islam is much more than a set of rituals. It encompasses, he argued, all domains of human existence, including education, medicine, art, law, politics, and economics. To support this assertion, he laid the foundations of several Islamic disciplines, among them Islamic economics.[6] Other seminal contributions to Islamic economies were made by Sayyid Qutb (1906–66), an Egyptian, and Muhammad Baqir al-Sadr (1931–80), an Iraqi.[7]

The teachings of these pioneers differ in major respects. Mawdudi is sympathetic to the market process, though he insists that market behavior must be constrained by behavioral norms found in the classical sources of Islam. Generally distrustful of the market, Qutb and al-Sadr favor supplementing norm-guided self-regulation by state-enforced controls. A related difference is that the latter two thinkers are relatively less tolerant

of economic inequality. These variations among the pioneers of Islamic economics are reflected in the writings of their followers, which offer a wide spectrum of views concerning government, markets, and property rights. But they have not given rise to sharply differentiated subschools. The substantive divisions within Islamic economics are more amorphous than, say, those between neoclassical economics and Marxian economics. Thus, the followers of Mawdudi tend to hold the works of Qutb and al-Sadr in high esteem. Moreover, their key positions often bear the influence of these other pioneers.

Whatever its internal divisions, Islamic economics has always presented a united front in justifying its own existence. The dominant economic systems of our time, virtually every major text asserts, are responsible for severe injustices, inefficiencies, and moral failures. In capitalism, interest promotes callousness and exploitation; in socialism, the suppression of trade breeds tyranny and monstrous disequilibria.[8] The fundamental sources of Islam prohibit interest but allow trade; hence, a properly Islamic economy would possess the virtues of these two systems without their defects. Typically, this claim is supported by references to Islam's canonical Golden Age—the period 622–61, spanning the last decade of Prophet Muhammad's life and the tenure of the "rightly guided" caliphs.[9] During this period, it is suggested, the Islamic code of economic behavior enjoyed widespread adherence, the prevailing spirit being one of brotherly cooperation. With everyone "subject to the same laws" and "burdened with the same obligations," injustices were minimized.[10] Resources were allocated very efficiently, ensuring a rapid rise in living standards. After the Golden Age, so the belief goes, the Muslim community's attachment to Islamic precepts weakened, setting the stage for a painful and protracted decline in Islam's global economic standing.

The case for restructuring economies according to Islamic principles thus rests on two claims. First, the prevailing systems have failed us. Second, the history of early Islam proves the Islamic system's unrivaled superiority over its alternatives.

To put the latter claim in perspective, we must recognize that by modern standards the seventh-century economy of the Arabian peninsula was very primitive. It produced few commodities, using uniformly simple technologies. It was essentially free of the major physical externalities that afflict modern economies, like air and water pollution. Moreover, it featured only the most rudimentary division of labor. The specific economic injunctions found in the Islamic scriptures—mostly in the Sunna—are responses to problems that arose in this ancient setting. Some of these injunctions were perceived as eternally valid. But many others were seen as changeable. Thus, rules and regulations were altered openly and unabash-

edly in response to new conditions. As a case in point, the scope and rates of zakat underwent many modifications during the Golden Age.

The historical record also calls into question certain virtues attributed to the Golden Age. The notion that the early Islamic community was a paragon of brotherly unity conflicts with evidence that it was plagued by disagreements and that force played an important role in its governance. Significantly, three of the four "rightly guided" caliphs met their ends at the hands of fellow Muslims. Nor was the Golden Age free of the corrupt practices attributed to contemporary capitalism and socialism. Officials of the Islamic state, including the caliphs themselves, were often accused of nepotism and misjudgment.[11] During part of this period the state did indeed enforce the collection of zakat, and a substantial portion of the proceeds must have accrued to various disadvantaged groups. We possess no reliable evidence, however, on whether this redistribution brought about a major reduction in inequality.

Still, the literature is replete with calls for the immediate implementation of the holy laws of Islam (*Shariʿa*) in the form they ostensibly took almost a millennium and a half ago, in one locality. In issuing such calls, Islamic economics denies that certain economic problems of the modern age had no counterparts in the past. It also denies that once-beneficial institutions might now be dysfunctional, even harmful. Some of the rhetoric of Islamic economics thus conveys the impression that it seeks to rediscover and restore the economy of a distant past.

At the same time, it draws heavily on modern concepts and methods, including many that originated outside the Islamic world. And it pursues such modern objectives as growth, employment creation, and efficiency.[12] It would be wrong, therefore, to characterize the doctrine's intense preoccupation with the economy of seventh-century Arabia merely as a scholastic search for ancient solutions to ancient problems, although this representation does fit certain writings. Islamic economics applies ancient solutions to perceived problems of the present; and where such solutions are lacking, it seeks scriptural justification for its favored reforms. Accordingly, Islamic economics shows interest in only some features of the seventh-century Arabian economic order. Having identified the prohibition of interest as the sine qua non of Islamic reform, it is engrossed in Qur'anic verses concerning lending and borrowing. It devotes comparatively little effort to exploring whether the Golden Age offers useful prescriptions against environmental pollution, having chosen, if only by default, to refrain from making the environment a major issue.

So Islamic economics is as much a response to contemporary grievances as it is a nostalgic escape into the imagined simplicity, harmony, and prosperity of an ancient social order. Notwithstanding much of its rhetoric, in its applications it seeks to revive only bits and pieces of the

seventh-century Arabian economy, not to restore it in toto. In practice it thus exhibits more willingness to accept economic realities than it does in theory.

Islamic economics is appropriately categorized as a "fundamentalist" doctrine, because it claims to be based on a set of immutable principles drawn from the traditional sources of Islam. By no means does its flexibility in practice negate this label's descriptive power. All doctrines labeled "fundamentalist" claim to rest on fundamentals set in stone, yet in application these prove remarkably malleable. Moreover, such doctrines assert a monopoly over knowledge and good judgment, even as they show receptivity to outside influences.[13]

Having billed itself as a superior alternative to all other economic traditions, Islamic economics has drawn sharp criticism from two quarters. A number of scholars, including this writer, have drawn attention to the literature's empirical and logical flaws, arguing that the proposed institutions are either unworkable or inherently inefficient.[14] Other scholars, notably Seyyed Vali Reza Nasr, have observed that Islamic economics has invited all this criticism by presenting itself not as a faith or philosophy to be understood on its own terms but as a positive science that lives up to established scientific standards. In this view, Islamic economics has been drawn into the game of utilitarian social science, and it is trying to prove its worth by beating the materialistic economic traditions of the West on Western turf. The mission of Islamic economics, maintains Nasr, should be to create a worldview that brings material goals into harmony with spiritual yearnings. It should get on with this mission without apology—without offering excuses, that is, for pursuing nonutilitarian objectives. By concentrating on its own agenda, it will eventually prove its superiority, but according to its own standards as opposed to those of the non-Muslim West.[15]

Nasr would thus have Islamic economics withdraw into its own shell in order to avoid being sidetracked by Western priorities. The logic behind this call to self-imposed isolation parallels Mawdudi's apparent motivation for founding the discipline. What propelled Mawdudi to establish Islamic economics along with other distinctly Islamic disciplines was a desire to defend Islam "against the inroads of foreign political and intellectual domination." He wanted to bolster Islam's authority in domains where Muslims had come to rely on the West's guidance, in order to restore the Islamic community's self-confidence and enable it to face the world proudly, as in the days before the economic and military rise of the West.[16] Thus, for Mawdudi Islamic economics was primarily a vehicle for reasserting the primacy of Islam and secondarily an instrument for radical economic change. Like Mawdudi, many other supporters of Islamic economics have subordinated it to wider objectives. For example, the Ayatol-

lah Khomeini made a point of denying that Iran's Islamic Revolution was motivated by economics. It was not made, he once quipped, to make watermelons more plentiful.[17] He meant that the uprising was spawned primarily by noneconomic factors—most important, the threat to Islam's role in providing cultural identity, social cohesion, and moral guidance—so it should not be judged by its economic impact. Khomeini repeatedly spoke out, of course, against poverty and exploitation, and he supported certain economic reforms, including the ostensible elimination of interest. But he always subordinated economic objectives to the general goal of restoring the centrality of Islam in private and public life, even to particular objectives such as eliminating the consumption of alcohol and ensuring feminine modesty.

Just as Khomeini's aides included activists for whom economic concerns were paramount, the expositors, practitioners, and sympathizers of Islamic economics include people drawn to the discipline's substantive goals. Many undoubtedly see it as an antidote to exploitation and expect it to bring prosperity. For some, the attraction of Islamic economics lies in its promise to solve heretofore intractable economic problems. The raison d'être of Islamic economics, they say, is its ability to improve economic performance, defined in materialistic terms. But the point remains that Islamic economics also serves, and is perceived as serving, as an instrument of legitimation and power. In proposing that an Islamic economy will promote harmony, growth, and justice simultaneously, Islamic economics enhances the appeal of an Islamic political order. It also bolsters the case for a pan-Islamic union within which Muslims can enjoy the benefits of cross-continental trade without having to compromise their religious principles.[18]

Each of the two principal institutions engendered by Islamic economics, zakat and Islamic banking, provides sources of funding for Islamic fundamentalist, or simply Islamist, causes. Islamic banks channel a portion of their profits into religious education, publishing, networking, and other activities that foster the spread of Islamism. Likewise, in countries with obligatory zakat, a significant portion of the proceeds are allocated to religious schools dedicated to the dissemination of Islamist views. Islamic institutions also constitute a channel of upward mobility for Islamists and potential Islamists. In Turkey, for example, Islamic banks provide career opportunities to relatively religious youths whose cultural backgrounds might otherwise handicap them in the corporate world.[19] Another attraction of Islamic economics, then, is the economic basis it provides for expanding the influence of Islamism.

Not everyone who voices support for Islamic economics is at heart an Islamist. Both the discipline and its applications enjoy the public support of intellectuals, politicians, and laymen who are committed neither to

Islamization in general nor to Islamic economics in particular. Their motivation for preference falsification lies in the identification of Islamic economics with core Islamic values. Because of this identification, it has become prudent in some societies to be known as sympathetic to its objectives. In Pakistan, for instance, a politician who fails to endorse Islamic banking may find his aspirations thwarted. Significantly, Islamic banking is on the platform of every major political party.[20] Yet it is known to seasoned observers of Pakistani politics that many politicians have a low opinion of Islamic economics. Indeed, politicians who lend public support to its goals are apt to do little of practical significance to promote it, once in power.[21]

All this goes to show that Islamic economics owes its support only in part to the real and imagined successes of its past and present applications. Although one would hardly know this from studying theoretical expositions, there exist diverse reasons why people find Islamic economics appealing. The merits of Islamic economics lie for some Islamists primarily in its Islamic character but for others mostly in the substance of its economics. For still others, it is an instrument for advancing the political agenda of Islamism. Finally, there are non-Islamists who lend it support simply to avoid being stigmatized as bad Muslims.

It is important to keep this diversity of motivations in mind as we turn to an analysis of the discipline's practical accomplishments. There are vast incongruities, I argue below, between the rhetoric of Islamic economics and its practice. Specifically, I demonstrate that the impact of Islamic banking has been anything but revolutionary, that obligatory zakat has nowhere become a significant vehicle for reducing inequality, and, last, that the renewed emphasis on economic morality has had no appreciable effect on economic behavior. By its own lofty yardstick, then, Islamic economics is a failure. This assessment needs to be qualified by the fact that the strictly economic impact of Islamic economics is not the only measure of its achievements. Some of its promoters may well consider the shortcomings I describe to be outstripped, from the standpoint of the wider Islamist cause, by political and cultural consequences beyond this essay's purview.

Banking and Finance

Islamic Banking

Suppose you lend $100 to an industrialist, at 5 percent interest for a period of one year. Since you stand to receive exactly $105 at the end of the year, your return is predetermined. But the industrialist's return depends on the success of his business. If his revenue exceeds $105, he will make a profit. If it falls short of $105, he will incur a loss. An interest-based

loan thus places the risk of loss entirely on the borrower. Under one interpretation of Islam, this is prohibited as unfair.

The literature is replete with additional reasons why interest is best avoided. "Interest," writes one Islamic economist, "inculcates love for money and the desire to accumulate wealth for its own sake. It makes men selfish, miserly, narrow-minded and stone-hearted."[22] Another evil attributed to interest is that it "transfers wealth from the poor to the rich, increasing the inequality in the distribution of wealth."[23] And yet another: it turns people away from productive enterprise.[24]

The purpose of Islamic banking is to prevent such inefficiencies, moral failures, and injustices by allowing people to borrow and lend without having to deal in interest. In theory, an Islamic bank accepts only two types of deposits: transaction deposits, which are risk free but yield no return, and investment deposits, which carry the risk of capital loss for the promise of a variable return. Deliberately ruled out are the insured savings deposits of conventional banks, which provide a predetermined return. An Islamic bank's lending operations are based on the same principle of risk sharing. In lending money to a firm, it agrees to share in the losses of the underwritten business activities in return for a share of any profits.

Since Islamic banks and their depositors are allowed to profit from their monetary assets only by carrying some risk of loss, Islamic economics treats the mechanics of profit and loss sharing as a topic of paramount importance. Two profit and loss sharing techniques, each utilized in early Islam and discussed in classical Islamic jurisprudence, receive the bulk of attention: *mudaraba* and *musharaka*. Under mudaraba, an investor or group of investors entrusts capital to an entrepreneur, who puts this into production or trade, and then returns to the investor(s) a prespecified share of the resulting profits, along with their principal. The remaining share accrues to the entrepreneur as a reward for his time and effort. If the business fails, the capital loss is borne entirely by the investor(s), the entrepreneur's loss being his expended labor. Under musharaka, the entrepreneur adds some of his own capital to that supplied by the investor(s), exposing himself to a risk of capital loss. The key difference between the two techniques lies in the entrepreneur's own financial commitment.

Mudaraba and musharaka have been likened to the financing techniques used by the venture capital industries of today's advanced economies.[25] Three factors differentiate a venture capitalist from a conventional bank. First, whereas the bank bases its loan decisions primarily on the creditworthiness of its applicants, the venture capitalist focuses on the potential profitability of the proposed projects. Thus, an applicant with no collateral but an economically promising project may fail to secure an ordinary bank loan yet succeed in obtaining venture capital.

Second, the conventional bank earns interest on its loans, whereas the venture capitalist receives shares of profits. Third, unlike the bank, the venture capitalist often participates in the execution of the projects he underwrites, sometimes by supplying managerial know-how. The second and third differences are obviously linked. The venture capitalist's closer involvement in project execution reflects his greater stake in the project's profitability.

In advanced economies the venture capital industry has fostered the rise of many new enterprises, most recently the high-technology sector. Islamic banking, say its proponents, can make an equally significant contribution to the Islamic world's economic development. The logic of this claim is simple. A banking system that bases its loan decisions on project profitability does not turn down projects with excellent long-term prospects but lengthy gestation periods. Nor does it deny support to entrepreneurs merely for lack of a track record. It thus allocates credit more efficiently than one that insists on demonstrated creditworthiness. The result is faster development, with everyone benefiting: entrepreneurs, who find it easier to finance their projects; owners of banks, who share in the profits of the projects they underwrite; and depositors, whose investment accounts earn greater returns.

The first Islamic bank offering a range of commercial services opened in Dubai in 1975, and Islamic banks are now in operation in more than sixty countries.[26] Many of these banks have been secretive about the composition of their assets. Knowledgeable observers generally agree, however, that neither mudaraba nor musharaka has ever absorbed a dominant share of the Islamic banks' assets. According to figures supplied by the Central Bank of Iran, in 1986 mudaraba and musharaka accounted for 38 percent of the assets of Iranian banks.[27] Two years earlier, when the Islamization of Pakistan's state-owned banking system was ostensibly nearing completion, only 14 percent of that country's bank assets were in mudaraba or musharaka, according to official reports.[28] Moreover, most of the contracts categorized as mudaraba or musharaka were actually based on thinly disguised interest. In violation of the spirit of profit and loss sharing, the bank would set a target return on its loans, agreeing in advance to reimburse the entrepreneur for any "excess profit."[29] In the Pakistani banking community it is widely believed that the share of legitimate mudaraba and musharaka never rose above a few percentage points and that it quickly fell to under 1 percent. In Turkey, where, in contrast to Pakistan and Iran, the banking sector remains heavily dominated by conventional banks, profit and loss sharing is similarly unpopular. Privately owned Islamic "finance houses" place at most 8 percent of their funds in mudaraba and musharaka.[30]

By far the most popular financing mode of the Islamic banks is *murabaha*, which works as follows.[31] A producer or trader submits to his Islamic bank a list of goods that he wishes to purchase, let us say a ton of steel. The bank buys the steel, marks up its price as compensation for this service, and then transfers ownership to the client. Along with his steel, the client receives a bill at the inflated price, to be paid at some jointly determined date in the future. What makes this transaction legitimate from an Islamic standpoint is that the bank takes ownership of the steel for some time, exposing itself to risk. Indeed, if the steel were stolen while under the bank's ownership, the loss would fall on the bank rather than the client. But the risk could be negligible, because there is no minimum to the duration of the bank's ownership; a millisecond suffices to make the transaction legitimate. From an economic standpoint, of course, an infinitesimal ownership period makes murabaha equivalent to an interest-based loan: the bank bears no risk, and the client pays for the time-value of money. There remains merely a semantic difference, which is that the client's payment is called a "service charge" or "markup" in one case and "interest" in the other.

In their applications of murabaha, the Islamic banks are keeping their ownership periods very short. Banks whose declared mission is to stamp out interest are thus making extensive use of a technique that is nothing but interest concealed in Islamic garb. In defense of Islamic banking it could be said that under murabaha there is no penalty for late payment, as there is under interest. This is true in principle, but in practice the Islamic banks have devised an ingenious method for penalizing accounts past due. They simply charge in advance for late payment, offering the client a rebate for payment on time.[32] In implementation, therefore, murabaha differs only cosmetically from the interest-based financing practices of the merchant banks and trading firms of the West. Not surprisingly, Pakistani bankers routinely tell their clients that murabaha is equivalent to interest.[33] There is actually a precedent for treating the two terms as synonymous: an Ottoman ruling of 1887 that pegged interest rates at 9 percent was named the "murabaha ordinance."[34]

The second most popular financing instrument is lease financing, known in some countries as *ijara*. Through this instrument, the bank rents some asset, let us say a truck, to an end user for a specified period of time, at a mutually agreed upon rental rate that reflects the truck's cost as well as the time-value of money. The end user may have the option of purchasing the truck. In theory, at least, lease financing satisfies the requirement of risk sharing, since the bank owns the asset for some period. If the truck suffers damage during the leasing period, the resulting loss would be borne by the bank.[35] In practice, however, the bank shifts such risk onto others by requiring the user to put up collateral and to pay for insuring

the asset.[36] From an economic standpoint, therefore, the lease-financing practices of the Islamic banks do not differ from those of the interest-laden, risk-averse leasing firms long common throughout the world, including predominantly Muslim countries.

Murabaha and lease financing are well suited to trade and commodity financing, but neither is applicable to the provision of working capital. A start-up firm that needs to finance its day-to-day operations will receive no help from an Islamic bank that has chosen to specialize in murabaha and lease financing. Nor are these financing instruments of use to a firm with a cash-flow problem: a company facing a pile of unpaid bills needs not merchandise but money. So, at least in its current form, Islamic banking does not qualify as a full-fledged substitute for conventional banking, if only because it offers a limited range of financing services.

On the whole, the sectoral composition of the Islamic banks' investments does not differ significantly from that of conventional commercial banks. Their clients tend to be established producers and merchants, as opposed to newcomers. They generally favor urbanites, as opposed to villagers, who in many parts of the Islamic world remain dependent on moneylenders charging notoriously high rates. The banks have shown no inclination to favor labor-intensive firms. Many have invested in real estate, and a few have speculated in international currency and commodity markets. With few exceptions, they have preferred trade financing to project financing. Insofar as they have engaged in project financing, they have favored safe short-term projects over long-term projects fraught with uncertainty.

Even the Islamic Development Bank, an intergovernmental organization established in 1975 to promote economic development using Islamic financial instruments, has evolved into an export-import bank. It uses funds at its disposal largely to finance international trade, in particular, oil exports to poor countries of the Islamic world. Revealingly, from 1975 to 1986 the portion of profit and loss sharing in the Islamic Development Bank's portfolio fell from 55 percent to 1 percent, while that of murabaha rose from nil to over 80 percent. Lease financing has also increased sharply, although this mode of business is not even mentioned in the bank's charter.[37] Like its commercial counterparts, the Islamic Development Bank now goes to great lengths to avoid risk. Through governmental guarantees and client-financed private insurance, it absolves itself of risk, in violation of its own principles. If a machine purchased on behalf of a Bangladeshi company is damaged in transit, the loss falls on the company, or some insurance agency, or the government of Bangladesh, but never on the bank itself.[38]

None of this implies that the financing operations of the Islamic banks are harmful to social welfare. They do no damage by refraining from carrying bona fide risk. The promotion of international trade is an eco-

nomically valuable service, especially in countries plagued by allocational distortions rooted in protectionism. Lease and commodity financing stimulate economic production. At least with respect to countries where the Islamic banks compete with conventional commercial banks, they would probably not have survived were they not meeting some previously unfulfilled need. My basic point is simply that the lending practices of the Islamic banks do not conform to the stipulations of Islamic economics.

The Resilience of Interest

Why, it behooves us to ask, does the practice of Islamic banking diverge so critically from the underlying theory? Why, specifically, are banks intended to revolutionize the world of finance sticking so closely to the techniques of conventional banks?

One reason has to do with the ongoing presence of conventional banks in all countries with Islamic banks, except Iran and Pakistan. By allowing entrepreneurs to choose between interest and profit and loss sharing, conventional banks create an "adverse selection" problem for the Islamic banks: entrepreneurs with below-average profit expectations prefer profit and loss sharing in order to minimize their losses in the likely event of failure, while those with above-average expectations prefer interest in order to maximize their gains in the likely event of success. The upshot is that the Islamic banks receive a disproportionately large share of the bad risks.[39] Implicit in this observation are the following two points. First, an entrepreneur who considers his project very risky is likely to conceal this knowledge from the Islamic banking community. Second, no bank possesses a reliable method for determining a project's riskiness.

Through training, of course, bankers can become reasonably adept at identifying bad deals. Were such skills unattainable there would be no venture capitalism in the West. But the required skills are in short supply, which is a factor in the Islamic banks' reluctance to engage in genuine profit and loss sharing. To remedy this recognized deficiency, an institute was established in 1982 in northern Cyprus for the training of personnel to screen projects. But it closed in 1984, leaving the Islamic banking system without a training center.[40] If one factor in this closing was the curriculum's shortcomings, another was a lack of enthusiasm on the part of the Islamic banks for genuine profit and loss sharing. As we saw above, even the banks of Iran and Pakistan, which are shielded by law from having to compete with conventional banks, have been reluctant to commit substantial funds to mudaraba or musharaka.

So the adverse selection problem caused by conventional banking cannot be the only reason why the Islamic banks are extremely reticent to abide by their own principles. A more fundamental factor is the wide-

spread practice of double bookkeeping. Firms habitually understate their revenues and overstate their costs to conceal their profits from the tax collector, generally getting away with it because of inadequate government audits.[41] Under the circumstances, bankers are reluctant to lend on the basis of profit and loss sharing, unless they can sit on the recipient's board. By the same token, the typical firm will let no banker monitor its operations, for fear that information about its true profitability will find its way to the government. In sum, there is a mutual distrust between the providers and users of funds. This makes interest, a compensation mechanism that requires no monitoring, mutually preferable to profit and loss sharing. Some Islamic economists are beginning to realize that profit and loss sharing is unworkable in the presence of rampant dishonesty.[42] They continue to believe, however, that it is possible to lower dishonesty to a level where all borrowers and lenders will happily substitute profit and loss sharing for interest.

An additional reason why the practice of Islamic banking conflicts with the underlying theory has to do with the profitability and relative risklessness of trade and commodity financing. In many parts of the Muslim world, certain goods are routinely in short supply due to production controls, import restrictions, and price ceilings. The firms that acquire these scarce goods for resale or production tend to profit handsomely, which makes financing their operations ordinarily quite safe. Understandably, many Islamic banks would rather finance such commercial ventures than sink funds into long-term development projects with highly uncertain outcomes. In so doing they seek, like the typical business enterprise, to avoid unnecessary risks. What needs recognition here is that the abundance of low-risk yet lucrative opportunities in trade and commodity financing reduces the appeal of long-term development financing.

A Historical Perspective

To put in perspective all these incongruities between theory and practice, it may be noted that Islamic banking is a very recent creation. Neither classical nor medieval Islamic civilization featured banks in the modern sense, let alone "Islamic" banks. Classical Islamic jurisprudence produced elaborate rules to regulate financial transactions among individuals. Yet, as Murat Çizakça notes, these rules did not give rise to a system of banking.[43] Medieval Islamic civilization produced no organizations that could pool thousands of people's funds, administer them collectively, and then survive the death of their managers. The financial rules of Islam remained frozen up to modern times, precluding the formation, except outside Islamic law, of durable partnerships involving large numbers of individuals. It was the Europeans who, possibly starting from Middle Eastern financial

practices, developed a complex financial system centered on banks.[44] So it is not surprising that the banks now operating in the name of Islam look more like other modern financial institutions than like anything in Islam's heritage.

In the 1930s there were some abortive attempts in India to establish interest-free banks. But the first successful forerunner of Islamic banking was a savings bank established in 1963 in the Egyptian town of Mit Ghamr. This bank was modeled after some of West Germany's local savings banks. It paid no interest on deposits and charged no interest on loans, borrowing and lending on the basis of profit and loss sharing. On account of these features, the bank claimed an Islamic identity, partly to distinguish itself from government banks and partly to enhance its attractiveness in the eyes of pious Egyptian peasants. The Mit Ghamr Savings Bank rapidly gained popularity and began making a substantial contribution to the local economy. Nonetheless, it was closed in 1968 by a government hostile to private initiative and suspicious of religion, under the pretext that it violated the country's banking laws.[45] Significantly, Mit Ghamr was not modeled after some Islamic enterprise of the past. Although it assumed a religious identity as a public relations ploy, its essential features were transplanted from a non-Islamic source, with no attempt to disguise this appropriation.[46] A fundamentally different claim is made on behalf of the commercial banks chartered as Islamic organizations since 1975, under the watchful eyes of clerics. They have all been billed as inherently Islamic creations. Yet, as we have seen, there is nothing distinctly Islamic about their operations. The contrast could not be more striking. Mit Ghamr shunned interest and actively promoted long-term development; today's Islamic banks pay and receive interest as a matter of course, and their primary activity is the promotion of trade.

Not that it is particularly Islamic to favor profit and loss sharing over interest. Profit and loss sharing predates Islam, and since the seventh century it has been practiced continually by diverse non-Muslim societies. Like the venture capital industry, the world's stock markets operate on the basis of profit and loss sharing. In any case, it is unclear that the Qur'anic prohibition of interest was originally understood to encompass the institution of interest as we know it today. What the Qur'an bans unambiguously is the pre-Islamic Arabian institution of *riba*, whereby a borrower saw his debt double following a default and redouble if he defaulted again. Because it tended to push defaulters into enslavement, riba had long been a source of communal friction. The purpose of the ban was undoubtedly to forestall communal disharmony by curbing, in the spirit of a modern bankruptcy law, the penalty for default. Accordingly, Qur'anic verses banning riba tend to be accompanied by calls for charity. The Qur'an enjoins lenders to show compassion toward borrowers in distress and to refrain from taking

advantage of their misfortunes. The ban on riba may be interpreted, then, as an injunction against kicking a person who is down.[47]

Many early Muslims subscribed to this interpretation, and they clashed with their contemporaries who read into the ban not an injunction against exploitation but a general prohibition of interest.[48] While the broader interpretation eventually gained dominance, this did not deter Muslims from continuing to borrow and lend at interest.[49] They went on doing so through various ruses, such as the following practice that leading jurists endowed with legitimacy: *A* wants to lend *B* $100 at 5 percent interest, but without violating the ban. So he buys a chair from *B* in return for $100 and then promptly returns it for $105, payable in one year. The chair's ownership remains unchanged; *B* receives $100 now; and *A* stands to receive $105 in a year. Although the individual transactions involve no interest, together they are equivalent to a single transaction whereby *A* lends $100 to *B* at 5 percent per annum.

Murabaha, the most popular lending mechanism of the Islamic banks, is a similarly ancient ruse. It consists of several interest-free transactions that together amount to interest. Not surprisingly, murabaha was a source of controversy in the early days of Islamic banking. In 1980 Pakistan's Council of Islamic Ideology took a cautious view on its legitimacy, stating that although it was "permissible under the Shariʿa, it would not be advisable to use it widely or indiscriminately."[50] Another common ruse takes the form of redefining as *Y* what everyone knows to be *X*. In Iran, for instance, the government has decreed that when a financial transaction between two public agencies takes place at a fixed rate of return, the charge involved is not called interest, as it would be if one party were a private citizen. So agencies freely borrow from each other at interest, liberated by the twist of a definition from having to acknowledge their violation of what passes as a sacred Islamic tenet.[51]

While a consensus exists among both theorists and practitioners of Islamic economics that interest is sinful, there is no agreement on what is meant by an "interest-free" loan. Under inflation, is it the nominal rate of return that must be zero, or the real? In other words, must loans be indexed to the rate of inflation to protect their purchasing power? A few writers argue that indexation is not only legitimate but a requirement of justice, although the dominant view is that indexation is un-Islamic.[52] Two international conferences on indexation, one held in Islamabad in 1986 and the other in Jeddah in 1987, concluded that indexation is incompatible with Islam.[53] Nonetheless, the Islamic banks index their markups, commissions, and service charges to inflation. In Turkey, where in the mid-1980s the rate of inflation was about five times higher than in Pakistan, the murabaha markup was also about five times higher.

Denunciations of the Anti-Interest Campaign and the Islamist Defense

The controversy over interest rages on. Expositors without practical experience in banking tend to insist on the necessity of eliminating interest, but they are divided as to whether Islamic banking, as it exists, is genuinely Islamic. While many are comfortable with the ruses that provide ways around the prohibition, others see these as a manifestation of the Muslim community's moral degradation.[54]

Each of these positions draws fire from Süleyman Uludağ in a 1988 treatise that employs an Islamic form of expression and draws heavily on Islamic classics. Those who insist on banning interest are ignorant, he says, of Islamic history and guilty of misinterpreting the Qur'an, which bans not interest but usury, or exorbitant interest. And those who appreciate the impossibility of doing business without interest and who, for this reason, tolerate various ruses are guilty, in addition, of promoting dishonesty and hypocrisy. This, he says, is a serious crime against Islam, a religion that stands for truthfulness. It is also a grave offense against God: even if interest were unlawful, it would be a lesser sin to deal in interest openly than to cloak it in practices aimed at deception.[55] Uludağ's suggestion that Islamic banking promotes dishonesty is highly significant in view of the argument, mentioned earlier, that the diffusion of veritable profit and loss sharing must await the improvement of business morality. If so, Islamic banking is its own worst enemy: by fostering trickery and duplicity, it hinders the task of imbuing businessmen with norms of truthfulness and trustworthiness.

Another broad attack on the prevalent opinion concerning the legitimacy of interest came in 1989 through a legal opinion (*fatwā*) of Muhammad Sayyid Tantawi, mufti of Egypt. Interest-based banking instruments are not necessarily corrupt, says Tantawi, because they may benefit everyone involved, including third parties. Generally beneficial and, hence, legitimate instruments include, he says, high-yielding government bonds and interest-bearing savings accounts.[56] But Tantawi's position is a minority position within the Islamic establishment. The dominant position remains that all interest, regardless of the benefits it confers to borrowers, lenders, and third parties, violates both the spirit and the letter of Islam.

If the proceedings of recent conferences on Islamic banking and statements by leading Islamists provide any indication, now Islamists generally accept that the Islamic banks in existence are not quite the intended interest-free enterprises. Khurshid Ahmad, a prolific writer who has held influential positions on key governmental commissions charged with steering the Islamization of Pakistan's economy, has publicly criticized his

country's Islamic banks, saying that "99 percent" of their business is still based on interest.[57] Many Islamic economists believe nonetheless that for all their identified shortcomings the Islamic banks are superior to conventional banks.

For one thing, they say, even if Islamic banks lend at interest, they generally avoid paying interest to their depositors. Indeed, the dividends paid to depositors are not predetermined, in that they fluctuate. But the same can be said of the bond funds in operation throughout the Western world. A bond fund holds interest-bearing assets, its yield on any given day being the day's average interest income, minus a managerial commission. This average may vary from one day to the next because of changes in the fund's holdings. Yet the dividends paid to the fund's depositors are financed by pure interest. Similarly, the dividends the Islamic banks pay to their depositors originate, as we saw earlier, in thinly disguised forms of interest. The variability of these dividends makes an Islamic bank no more "Islamic" than an ordinary bond fund in Korea or Switzerland.

The second line of defense against the shortcomings of Islamic banking hinges on its allegedly superior profitability. Independent observers have found, in fact, that in the late 1970s and early 1980s Islamic banks made huge profits. But their profit rates have subsequently fallen below the domestic norms. Clement Henry Moore finds that between 1984 and 1986 Islamic banks in Bahrain, Tunisia, and Turkey earned higher returns on total assets than their conventional competitors, while those in Egypt, Jordan, Kuwait, Qatar, and the Sudan achieved substantially lower returns. Outside of Bahrain, only the younger Islamic banks seem to be enjoying returns above the norm. The star performers in this period were two Islamic banks in Turkey, the Al Baraka Turkish Finance House and the Faisal Finance Institution, both established in the mid-1980s.[58]

It is not surprising that certain Islamic banks have done very well, because they enjoy some special advantages. The existence of a small but significant group of savers who feel uncomfortable with interest has furnished a ready-made source of deposits. Thus, with a handful of branches Turkey's Islamic banks managed in a few months to attract about 1 percent of the country's total bank deposits. After this initial surge, however, they found that to expand further they must open more branches. The resulting rise in their overhead will most likely reduce their profitability. Still, they could remain more profitable than their conventional rivals because, like many of their counterparts elsewhere, the Turkish Islamic banks enjoy some important legal privileges. They enjoy tax breaks. They have lower-than-usual reserve requirements, which means that, relative to their rivals, they transfer a smaller fraction of their deposits to the

Central Bank. Moreover, unlike ordinary banks, they are allowed to engage in real estate transactions and in foreign trade.[59]

In view of all this, what is surprising is that the older Islamic banks have tended to suffer a fall in profitability. A major reason is that they made careless loans during the oil boom of the 1970s, which are now taking a toll on their profits. The fact that some of these bad loans were made under profit and loss sharing helps explain why the Islamic banks are now lending almost exclusively on the basis of interest. It also supports my contention that these banks face a shortage of the skills required to make profit and loss sharing viable.[60] Interestingly, in terms of profitability Turkey's spectacular performers of the mid-1980s had by the late 1980s fallen below the Turkish norm.[61] While this slip is attributable partly to the expenses of establishing new branches, it calls for added caution in accepting the claim that Islamic banking is inherently more profitable.

Yet another defense of Islamic banking is that it enhances economic stability. In an interest-based system, macroeconomic shocks may lower bank revenues, thus aggravating the crisis by causing defaults. This source of instability allegedly disappears when returns to depositors are variable, because any decline in bank revenues is then matched by a fall in bank obligations.[62] There is a flaw in this argument, which stems from the implicit assumption that an Islamic bank whose revenues fall will not suffer a withdrawal of deposits. One would expect, on the contrary, deposits to move away from banks performing poorly and into those performing relatively well. In fact, the depositors of Islamic financial intermediaries are just as fickle as their counterparts in conventional banks. In Egypt, news in 1986 that the al-Rayan Islamic investment company lost $100 million speculating in gold provoked massive withdrawals. Depositors who were happy to hold al-Rayan's shares when high returns seemed assured were apparently unwilling to do so once the downside risk became appreciable.[63]

As Volker Nienhaus observes, Islamic banks losing funds must reduce the credit they supply to their clients.[64] So it is unclear that replacing interest by profit and loss sharing enhances macroeconomic stability. The opposite may well be true, and the Iranian and Pakistani governments take this danger seriously. Iran requires banks to share a single rate of return, while Pakistan forces rates to stay within a narrow band.[65] Consequently, there is no necessary relationship in either Iran or Pakistan between a depositor's rate of return and the actual profitability of his own bank's operations. Since a common rate of return effectively precludes profit and loss sharing, one may infer that the Iranian and Pakistani authorities consider genuinely Islamic banking destabilizing.

Responses of Conventional Banks

Attempts to establish interest-free banks or banking systems have failed, then, to replace interest by its much heralded alternative, profit and loss sharing. In no country and in no sense has the anti-interest movement revolutionized banking, let alone the entire economic system. Perhaps this is why the secular financial community shows no sign of alarm. On the contrary, secular banks see the anti-interest campaign as having created an exploitable opportunity. In Egypt and elsewhere many conventional banks, even those under non-Muslim ownership, have established interest-free branches or windows, and some investment companies have begun touting their operations as "Islamic." Even Wall Street has become a player: Citicorp and other large American banks have devised financial instruments acceptable to their customers troubled by interest. And where interest is illegal, European, American, and Far Eastern banks have had no trouble abiding formally by this ban. The Pakistani branches of Chase Manhattan and Deutsche Bank now claim to do only interest-free business, although it is widely recognized that their operations have not changed in any fundamental sense.

Redistribution

Zakat

Like other religions, Islam stands opposed to great inequalities in the distribution of resources. From the very beginning, therefore, it has featured instruments aimed at reducing, though not necessarily eliminating, social inequalities. These include an inheritance law that specifies in intricate detail how a person's estate is to be divided among his or her relatives.[66] A more celebrated instrument is zakat, an annual tax on wealth and income generally understood to incorporate certain levies that have been collected under other names, like the agricultural tax ushr. The proceeds of zakat are earmarked mostly for assistance to specific categories of impoverished and disadvantaged individuals. Mentioned explicitly in the Qur'an, zakat is viewed as one of the five pillars of Islam, along with belief in the unity of God, obligatory prayers, fasting during Ramadan, and pilgrimage to Mecca for those who can afford the trip.

The Qur'an provides only the broadest guidelines on zakat's coverage, and it leaves open the issue of rates. By tradition, it is levied on agricultural output, livestock, minerals, and precious metals—the major sources of income and wealth in seventh-century Arabia. The rate varies between 2.5 and 20 percent, depending on the source and conditions of produc-

tion, although there are various exclusions and exemptions. Wealth held in the form of precious metals is subject to a 2.5 percent levy, whereas mining income is subject to the highest rate, 20 percent. For another illustration, the rate on agricultural output is 5 percent if the land is irrigated by the owner, 10 percent if it is irrigated naturally. Again by tradition, the beneficiaries of zakat include the poor, the handicapped, travelers in difficulty, debtors, dependents of prisoners, and the zakat collectors themselves. The proceeds are also used to free slaves and to assist people serving the cause of Islam.[67]

Little is known on how zakat affected inequality in the Arabian economy of early Islam. It has been claimed that the scheme was progressive in collection, which is to say that its burden fell disproportionately on the rich.[68] This is plausible, but to determine the scheme's overall impact we would need to know not just the intended collection pattern but also the actual collection and disbursement practices. If evasion was especially prevalent with respect to certain sources of income or if the proceeds went primarily to the affluent, the overall effect might have been unequalizing. In any case, the purpose of zakat was not only to reduce inequality but also to raise revenue for the Islamic state. The state was empowered, as already noted, to channel funds to "people serving the cause of Islam," which allowed it to spend zakat revenue on public works and territorial expansion. Such objectives need not have been compatible with the goal of inequality reduction.

But whatever the impact of zakat in seventh-century Arabia, in a modern economy the effect of a traditional zakat scheme is unlikely to be equalizing. For one thing, the involved rates are generally lower than those of the prevailing secular taxation systems; even the 20 percent levy on mining income falls short of the marginal income tax in most modern economies. For another, the commodities covered by the traditional scheme play a considerably less important role today than they did more than a millennium ago. In any economy, even a highly underdeveloped economy like that of the Sudan, a substantial portion of income originates in industry and the services, sectors the traditional scheme exempts by default. And a major share of wealth assumes forms not covered by the traditional scheme, such as oil wells and corporate equity.

Yet some expositors of Islamic economics consider the forms and rates used in the seventh century to be applicable, with similarly beneficial results, to any modern economy. They believe, moreover, that a restructuring of zakat would violate Islam's spirit.[69] This attachment to ancient specifics has drawn fire from the modernist school of Islamic thought. A luminary of this school, the late Fazlur Rahman, wrote: "It is surely this kind of attitude which gives point to the communist maxim, 'religion is the opium of the poor people,' since it effectively throws dust in their

eyes."[70] The modernists want the sources of collection to include new commodities and activities, and they favor varying the rates according to society's changing needs. They also wish to redefine the categories of expenditure.

The modernist position now has the support of most Islamic economists.[71] But among the reformists there is yet no consensus on what reform should entail. There are disagreements on rates, exemption limits, and disbursements. Another source of controversy is the seventh-century principle that property is taxable if it is apparent (*zāhir*) but not if it is hidden (*bātin*). On the basis of this principle, some would exempt bank deposits, equities, and other financial assets. Others hold that because of advances in accounting and record keeping the distinction between apparent and hidden property is obsolete.[72]

Voluntary versus Obligatory Zakat

Two of the zakat systems in operation, those of Pakistan and Saudi Arabia, feature major innovations concerning coverage and rates. Whereas traditionally zakat was levied only on individuals, these countries have extended the obligation to companies, on the ground that companies are juristic persons. In addition, they have imposed a flat levy on certain types of bank deposits. Saudi Arabia levies zakat on imports, at rates varying from commodity to commodity. Pakistan allows farmers to deduct their expenses on fertilizers and insecticides, items for which classical Islamic law makes no allowance. Another Pakistani innovation is that the levy is 5 percent on all farm output, regardless of irrigation mode.[73] In contrast to Pakistan and Saudi Arabia, Malaysia has in place a collection system that departs minimally from traditional stipulations. Thus, each farmer is granted a fixed exemption, but no deductions are allowed for modern production costs. Another striking aspect of the Malaysian system is that it effectively exempts industrial workers, bureaucrats, businessmen, and shopkeepers, along with growers of rubber, coconuts, and other tropical cash crops, none of whom are mentioned explicitly in classical texts.[74]

As one might expect, these systems vary greatly in terms of yield and incidence. Pakistani figures for 1987–88 show that revenue stood at 0.35 percent of Gross Domestic Product. A mere 8 percent of the total came from agriculture, which is explained partly by the difficulty of making rich and powerful landlords pay their dues.[75] Saudi Arabian figures for the 1970s show that revenue hovered between 0.01 and 0.04 percent of Gross Domestic Product.[76] Given that per capita income in Saudi Arabia is much higher than in Pakistan, this is prima facie evidence of restrictive coverage and extensive loopholes. In fact, certain commodities of great economic importance, like housing, are exempt from zakat. There is also

evidence of widespread evasion.[77] In Malaysia, too, extremely restrictive coverage and substantial evasion constrain the yield. As of 1988, the rate of compliance was just 8 percent.[78] More interesting is the fact that the zakat burden falls almost exclusively on rice growers, most of whom lie below the country's poverty line. In the state of Perlis, for instance, rice growers accounted for 93 percent of the zakat collection in 1985.[79] If nothing else, this finding shows that zakat does not necessarily transfer resources to the poor; it may transfer resources *away* from them. It is also significant that in sharp contrast to Pakistan, the agricultural sector carries a huge share of the burden. Within the agricultural sector, zakat is progressive at the lower end of the income scale because of the traditional exemptions. But it is regressive at the upper end, apparently because wealthy farmers are particularly prone to evasion.[80] In one village in the state of Kedah, for which we have a detailed study by the political scientist James Scott, the rate of compliance between 1977 and 1979 was merely 15 percent, which means that the farmers evaded 85 percent of their obligations. Evasion took a variety of forms: disguising or underdeclaring one's cultivated acreage, underreporting one's crops, and handing over to the zakat collector spoiled or adulterated grain.[81]

Malaysia, Saudi Arabia, and Pakistan are among a handful of countries where zakat is administered by the state. In most of the Muslim world individuals have discretion over whether and how to pay zakat.[82] The Qur'an itself is mute on issues of administration and enforcement, ruling out neither the centralized, obligatory mode nor the decentralized, voluntary mode. Yet each mode has a basis in historical precedent. In the earliest years of Islam, when the Muslim community lived in Mecca, assistance to the poor was unregulated and strictly voluntary. Zakat became a formal and compulsory transfer system shortly after the community's relocation to Medina (*hijra*), at a time when it was expanding very rapidly. Thus, during Prophet Muhammad's last few years zakat came to be administered by state-appointed agents and enforced, as necessary, by military might.[83] Barely two decades after his death, however, the Islamic state's ability to administer zakat crumbled in the course of violent leadership struggles.[84] From then on, zakat was up to the individual Muslim's discretion, although in certain times and places local bodies played a role in collection and disbursement. In sum, while zakat formed a centrally administered, obligatory system during a brief but important segment of early Islamic history, for most of the religion's life it has been administered in a decentralized manner, the agents of enforcement being peer pressure, fear of God, and the individual's own conscience.

Distressingly little research has been conducted on the voluntary system in operation. But the available studies suggest that only a fraction of the nonimpoverished population pays regularly. A 1978 survey of educated

middle-class Muslims in Karachi showed that while almost all had heard of zakat, fewer than a quarter made regular payments themselves.[85] Under the present Pakistani system, Muslim citizens must assess the dues on their precious metals by themselves and deposit these voluntarily into a national zakat fund. According to an internal document of the Permanent Commission on Islamisation of Economy, such deposits have been negligible.[86] Revealingly, the zakat tables in the *Pakistan Statistical Yearbook* contain no entry for precious metals. Yet a study on the zakat potential of another country, Turkey, suggests that the dues on precious metals may be substantial. On gold and diamonds alone, the study found, this potential is around 5.5 percent of Turkey's annual savings.[87] But it would be very difficult to enforce payments on precious metals, since they are easily hidden. In any case, an enforcement campaign would most certainly cause people to shift wealth from precious metals into assets exempt from zakat, like real estate.

Another important finding is that charity is not the only impetus for making voluntary payments. Other common motives are the encouragement of worker loyalty and the promotion of social conformity. In the Kedah village studied by Scott, where payment was essentially voluntary until 1955, it was customary for landowners to make, under the rubric of zakat, a small gift to their workers, over and above wages. This gift, which the workers came to expect, helped ensure the loyalty of the landowner's work force during times of peak labor demand. Typically, the size of a worker's gift depended on his "respectability" in the eyes of the landowner. A worker whose comportment, manners, or political views gave him an unfavorable reputation received a relatively small gift. In addition to reputable workers, the major beneficiaries appear to have been the village's religious functionaries, such as the teacher of religion and the caretaker of the local mosque.[88]

Kedah's system shows that the voluntary mode does not treat the needy equitably. Apart from the religious establishment, it benefits primarily those with connections, tending to pass over the truly destitute, the unemployed, and the handicapped. This observation is bolstered by the common fact that the Islamic world has long featured, even in relatively prosperous localities, many desperately poor people who receive little, if any, charity. Against this background, the ongoing fundamentalist campaign to recentralize the administration of zakat is, if not reasonable, at least understandable. The proponents of obligatory zakat argue that this mode will augment the funds available for distribution and prevent their disbursement on the basis of personal ties. They remind us that the Prophet himself made zakat obligatory and also that the currently dominant voluntary mode took hold after the Prophet's death.

State-Administered Zakat in Operation

How, then, are the recently instituted state-administered systems performing? Relative to their decentralized counterparts, are they more successful at channeling resources to the poor? Have they overcome the role of personal connections? Although pertinent documentation and research are inadequate, clearly the high hopes of Islamists have not materialized.

In Pakistan, the Zakat Administration channels revenues into thousands of local committees that make lists of community members eligible for support. Funds are allocated among the committees roughly according to the populations they represent, which means that relatively poor communities generally receive more than their contributions to the national fund.[89] According to official records, during the 1980–88 period, 58 percent of the zakat funds went as subsistence allowances to people unable to work, including widows, orphans, and the handicapped.[90] But the grants involved were much too small to make a significant difference in the living standards of such groups. In the 1980s, when an individual needed an estimated $22 a month just to survive, most zakat payments varied between $4 and $8 per individual, and in some regions the typical payment was as low as $1.[91] The system has one million beneficiaries, which represents about 10 percent of the Pakistanis situated below the country's poverty line. An official report notes in this connection that in its eight years of operation Pakistan's state-administered zakat system has had little visible impact on inequality. There has been no noticeable decline, it says, in the number of beggars and no discernible alleviation of poverty. Under the circumstances, "people are losing faith not only in the system, but also in the belief that Islam offers a better economic order."[92]

It would be a gross error, the report goes on to say, to attribute the system's failure merely to a shortage of resources. The funds set aside for subsistence aid and rehabilitation should have been enough to provide around $8 per month to every person below the poverty line. Although the assumptions behind this assertion are open to question, the figure is suggestive, as the report itself indicates, of serious mismanagement and corruption.[93] In fact, ever since the system's inception Pakistan has been awash in rumors and newspaper reports of arbitrariness, favoritism, nepotism, and embezzlement. Zakat recipients apparently include "orphans" with two living parents, "impoverished women" wearing rows of gold bracelets, and "old people" long under the ground. Influential people have used zakat resources as a slush fund for programs benefiting primarily the rich.[94]

Ever since the beginning, Pakistan's Zakat Administration has been allocating about 20 percent of its funds to rehabilitation. Under this program, many poor women have received a sewing machine. Unfortunately,

inadequate training and materials hamper the earning ability of these women.[95] Still, in official circles there is a growing feeling that properly managed rehabilitation and public works programs would constitute more effective antidotes to poverty than subsistence allowances. Accordingly, the Zakat Administration is now building 75,000 houses for the poor, and various public works schemes are under discussion.[96] Ironically, it was a modernist, Fazlur Rahman, who launched the debate on whether zakat funds could be used on public health, housing, and education. When in the 1960s he pushed for a program-oriented expenditure pattern, Islamists denounced him for promoting a scheme alien to traditional Islam. Since then the widely recognized failures of the subsistence-oriented expenditure pattern have made many Islamists increasingly receptive to innovative alternatives.

Malaysia's federal structure assigns the administration of zakat to an office at the state level. In each state, collected funds are forwarded to the zakat office for disbursement. Here is how the zakat office in Alor Setar, the capital of Kedah, allocated its proceeds in 1970, according to its own official report: of the total, 53 percent went toward "commendable measures" (which generally means religious education), 6 percent to people making a pilgrimage to Mecca, 2 percent to converts, and 22 percent as commissions to the zakat collectors and central administration, leaving a mere 15 percent for the poor.[97] Figures from the early 1980s show that disbursements to the poor ranged between 11 and 13 percent, with zakat officials and various religious causes claiming much of the rest.[98] In Perlis, likewise, about 12 percent of the annual zakat revenue was going to the poor, the lion's share being set aside for zakat officials, the faculty and students of Islamic schools, and pilgrims.[99] The amounts given to the indigent were minuscule. Those included in the list of recipients received between U.S. $3 and $19 a year—for many, less than the cost of traveling to the zakat office to collect the money.[100]

As in Pakistan, funds collected in one locality are often spent in another. Thus, an impoverished rice-growing village that contributes to the system will not necessarily receive anything in return. In the village studied by Scott, in fact, not a single poor peasant had ever received aid through the zakat office, at least as of 1980. Apparently, the only recipient of official aid was a university student whose father was the zakat collector, among the wealthiest men in the village.[101] Many Malaysian Islamic economists now consider the established system an embarrassment to those who have touted zakat as a supremely effective measure against poverty. Some are now advocating a drastic reorientation of expenditures toward rehabilitation. One proposal is to use zakat funds for providing the very poor with resources to start their own businesses. Another is to divert some of the funds into a program to help urban prostitutes find new jobs.[102]

As we saw earlier, decentralized, voluntary zakat was criticized for its bias against poor people without proper connections and its failure to alleviate poverty. The Pakistani and Malaysian records suggest that the same flaws may also afflict obligatory zakat administered by the state. The two modes do differ, of course, in their effects, but the essential difference lies neither in fairness nor in ability to reduce poverty. It lies, rather, in the connections to which they confer value. Decentralized zakat confers value to economic connections, especially ones based on employment; state-administered zakat confers value to political connections, particularly ones touching on religion. Thus, under Malaysia's old decentralized system the surest way to obtain regular zakat payments was to work loyally for a wealthy landlord; under the current centralized system it is to enroll in a religious school or work for the zakat office.

A major difference between the current Pakistani and Malaysian systems lies in the source of compensation for officials of the zakat administration. In Malaysia officials are paid out of zakat revenues, in accordance with scripture. In Pakistan they are paid out of general government funds, apparently to foster the illusion that the system is costless, thereby enhancing its appeal.[103] Even in Pakistan, of course, the religious establishment benefits from the system. Some religious functionaries receive compensation for collection and administration; in addition, a portion of zakat revenue is channeled into religious education.[104] But the religious establishment's stake in zakat has been far greater in Malaysia, where helping the poor appears as a convenient pretext for advancing broad Islamic objectives and for lining the pockets of religious officials. To make matters worse, the official Malaysian figures underestimate the actual take of the officials. There are various irregularities in collection that benefit the collectors personally. For instance, collectors are known to underinvoice their collections, presumably embezzling the differences.[105]

Malaysia's state-administered zakat system has generated resentment among the peasantry, which tends to view it as just another tax. What may be surprising is that many ordinary Pakistanis harbor similar feelings. One cause of their resentment is the impression of widespread corruption. As in Malaysia, another factor is that the payer does not see, much less determine, how his personal contribution is spent.[106] Not only does this deny him the satisfaction of observing his contribution's impact but it facilitates disagreement over spending priorities and decisions. A zakat payer whose needy acquaintances are passed over by a fund known to support distant students may well consider the system inequitable, as apparently many contributors do. Some telling evidence on people's dislike of governmental involvement is that almost no contributions were made to a voluntary zakat fund established by the Pakistani government in the 1950s.[107] More recent evidence comes from a Malaysian survey

conducted in 1987 by Aidit bin Ghazali. About 60 percent of this survey's participants indicated that they prefer to choose the beneficiaries of their zakat payments on their own, as opposed to leaving the decision to the government.[108]

A significant source of friction in Pakistan has been the Shiite minority's unwillingness to pay zakat to a Sunni-dominated government.[109] In its original form, the zakat law obliged all Muslims to contribute to the government-administered fund, but when the Shiites took to the street in protest, the law was amended to give members of minority sects the option of exemption. To exercise this option a Shiite would simply have to submit an affidavit to his bank or the rural zakat collector.[110] Many Shiite depositors have opted to exempt themselves, and it is known that a small number of Sunni depositors are passing as Shiites simply to avoid automatic annual deductions.

Yet another cause of frustration lies in the compulsory nature of the payments. In each of these countries some individual Muslims feel that obligatory payments leave their religious obligations unmet. Consequently they make additional payments to people of their own choice.[111] In Malaysia there is even a terminological distinction between the two types of zakat. Payments to the government are designated by a pejorative term, *zakat raja*, literally "ruler's zakat," while voluntary payments made as acts of charity are called *zakat peribadi*, or "personal zakat." Because some Pakistanis and Malaysians make zakat payments over and above their obligatory payments, zakat transfers more wealth to the poor than official records show. However, while no systematic research exists on the additional transfers, they appear small. In neither Pakistan nor Malaysia can the typical indigent count on significant support from prosperous groups.

Evaluation

Underlying all the problems of the recently established zakat systems—public opposition to government involvement, widespread evasion, nepotism, and the diversion of extensive resources to the religious establishment—are two basic characteristics of human nature. People's personal experiences and circumstances color their perceptions of justice and efficiency. And they seek to influence the allocation of resources as a means of promoting their own priorities. Thus, no society is without citizens opposed to government spending patterns; charges of favoritism, fraud, and misuse are as ubiquitous as government itself. In general, moreover, government officials are more sympathetic than ordinary citizens to centralized redistribution and relatively suspicious of private decision making. In view of these observations, the recorded frictions over zakat are

merely another manifestation of the universal struggle to control resource allocation. Neither Islam nor any other religion has overcome the human impulse to control economic outcomes.

Earlier I concluded that Islamic banking has not revolutionized the way Muslims save and invest. Now I can add that zakat has not made a major dent in Muslim poverty and inequality. While it has obviously redistributed some income and wealth, it has not conferred substantial benefits on the poor as a group. One must recognize in this connection that in its Islamist interpretation zakat constitutes a rather conservative means of redistribution. Touching neither on productive assets like land and physical capital nor on consumption goods like housing and furniture, it allows limited transfers involving a restricted menu of goods and assets. Even in the best of circumstances the distributional impact of such a scheme would be modest. Poor management has compounded the disappointment.

It is worth reiterating that by extending its coverage to new forms of income and wealth zakat may be turned into a highly significant instrument of redistribution. The potential yield is indeed considerable. Islamic economists have shown that it can exceed 3 percent of Gross National Product.[112] But this estimate overlooks the huge problem of evasion. In any case, turning zakat into a major equalizer requires more than raising its yield. It is necessary also to increase the share of the proceeds channeled to the poor. The latter objective requires the development of auditing systems as well as the establishment of social and legal sanctions for diverting funds away from the poor.

The existing state-administered systems might be defended on the grounds that similar problems afflict many other official transfer programs. But remember that Islamic economics aspires to vastly superior standards. It promises not that zakat will do as well as other systems of redistribution but that it will do markedly better.

Economic Development: The Role of Islamic Morality

Islamic economics claims, as mentioned, that Islamic scripture harbors solutions to every conceivable economic problem. Many problems are to be solved by curbing selfishness through injunctions concerning consumption, production, and exchange. If these injunctions are followed, the pace of economic development will allegedly quicken, while taking on a fairer, more balanced, and less disruptive form. This assertion turns on its head the long-standing Western suspicion that Islam hinders modernization.[113] Rejecting the notion that Islam is inimical to economic development, Islamic economics affirms it to be a principal source of growth and harmony.

In their most general form, the advocated economic injunctions consist of moral guidelines common to many value systems, both religious and secular. The individual is encouraged to enjoy the bounties of civilization, but he must be willing to share his possessions with others, particularly with the less fortunate. He must refrain from abusing goods at his disposal and from keeping them unutilized. As a producer or trader, he is free to seek personal profit. But in exercising this freedom he must avoid harming others. Nor must he earn more than his efforts justify; he must pay "fair" wages to his employees and charge "just" prices to his customers. Remaining honest in his economic dealings, he must admit his mistakes and avoid false advertising. He must work hard and strive to fulfill his commitments.[114]

In the early centuries of Islam these general injunctions were applied to a panoply of situations, generating multitudes of specific injunctions. For example, the requirement to earn no more than one's fair share was taken to imply that Islam prohibits the sale or purchase of a fruit tree in blossom. The logic: since the traders cannot predict the tree's yield with certainty, the selected price could confer an unearned gain to one party while burdening the other with an undeserved loss.[115] Some Islamic economists consider such ancient interpretations to retain validity in the modern world, even though some are contradictory, and classical Islamic jurisprudence provides several different interpretations of many individual cases.[116] Feeling less constrained by classical applications, other Islamic economists call for fresh interpretations.[117]

But regardless of where they stand on the applicability of ancient interpretations, Islamic economists generally agree that if the moral guidelines of Islam are observed and enforced, the economic performance of Muslim societies will improve dramatically. People will readily sacrifice their own material pleasures for society's interests. They will find their economic activities more fulfilling. Even their jobs will become more satisfying, as they take on the character of worship. Some writers observe such changes already in countries that have committed themselves to Islamization. Here is a striking statement by a Turkish writer in a 1987 volume on economic development and Islam:

> In February 1982, I was in a bus on the way to Tehran airport, at dawn, during the time of morning prayers. We passed a middle aged, bearded street sweeper, who was cleaning the sidewalk on one of the main avenues. That one glimpse gave me the impression that in this hour of prayer he was sweeping with devotion and ecstasy. The glow on his face affected me deeply, and I conveyed my feelings to the young Iranian sitting beside me. He explained: "At various levels of our society there are Muslims for whom diligent, effective work is like worship, like a

service to religion and community. This street sweeper must know that to devote oneself to cleaning the streets of an Islamic state is a form of worship."[118]

The central point of the article to which this quote belongs is that successful development requires imbuing society with a communitarian morality of self-sacrifice, altruism, and brotherhood. This is not an isolated view. Here is a supporting statement from the literature: "[Islam] deals with all aspects of economic development but always in the framework of total human development and never in a form divorced from this perspective."[119]

In accordance with this view, a major, if not the primary, source of the Muslim world's underdevelopment is held to be its moral degeneration. The standard of morality began falling when a string of increasingly corrupt leaders succeeded the "rightly guided" caliphs of the seventh century. But this degeneration has taken a calamitous form only in recent centuries, through the influence of the West. Declining morality, say Islamic economists, has sapped productivity and reduced the effectiveness of government. Moreover, by weakening the ties of Islamic brotherhood, it has made Muslims oblivious to one another's needs. As a sad consequence, Muslims are divided on key issues, and their rivalries are keeping them from cooperating toward common objectives. Low morality is also held responsible for the practical shortcomings of zakat and Islamic banking. The misuse of zakat funds is attributed to the moral deficiencies of local officials. Likewise, the continuing prevalence of interest-based lending is ascribed, as we saw, to rampant dishonesty in business.

All these problems are taken to mean that moral education must be accorded a crucial role in economic development. Through family and school instruction, people must be molded to fit the requirements of a just, harmonious, and efficient society. They must be imbued with the notion that they belong to a community of Muslims, the umma, whose interest takes precedence over their interests as individuals. Yet one could reform, rather than individuals, the institutions that direct, shape, and constrain their choices. Many students of development would argue that the roots of underdevelopment lie primarily in institutional inefficiencies. As far as I know, no Islamic economist denies that social institutions matter; after all, they attach great importance to zakat. The distinctiveness of their position lies in the primacy it gives to the restructuring of individuals. Throughout the Muslim world, of course, massive efforts have been made since the beginnings of Islam to instill in individuals an Islamic morality. Have these efforts influenced work effort, generosity, and market behavior? If so, how? Islamic economics has undertaken no serious investigation of such matters, treating it as self-evident that Islamic education furthers growth and justice simultaneously.

Much of Islamic economics conveys the impression that a communitarian ethic is a prerequisite for economic development. But certain writers hold that such an ethic is an objective in its own right. This objective takes precedence, they say, over economic development, recognizing explicitly that in certain contexts moral imperatives conflict with growth.[120] But the two camps are united in the belief that Islamic morality is a crucial ingredient of healthy economic development. Accordingly, they agree that Muslim societies have been held back by an individualistic ethic that keeps them from working together toward common objectives.

A striking aspect of this emphasis on the inculcation of a communitarian ethic is that it draws no distinction between numerically small and large groups. The Islamic morality of self-sacrifice, altruism, and brotherhood is expected to work with equal effectiveness and beneficence in a populous modern nation as among Prophet Muhammad's first group of companions. Let us be clear about what this means. The development of a country committed to an Islamic way of life is expected to be driven substantially by Muslims' efforts to meet one another's observable needs and by their mutual cooperation toward jointly held and commonly perceived goals.

There are two serious flaws in this thinking. First, it implicitly attributes to the individual an infinite ability to receive, store, retrieve, and process information. In fact, even in a small city no individual can handle more than a minuscule fraction of the information relevant to local interests. Consequently, no member of a modern nation can be aware of the wants of more than a tiny fraction of his fellow citizens. He may understand the needs of his acquaintances and have some feel for the wants of strangers. But in general not even a pure altruist can identify the socially optimal course of action. The argument's second flaw is that it overlooks the difficulty of generating common goals. In a large society environmental heterogeneities and the division of labor make individuals experience different joys and frustrations and develop different conceptions of reality. Consequently they tend to form different judgments concerning justice and efficiency. A common Islamic education might mitigate these differences but never eliminate them.

This argument is supported by recent applications of Islamic economics. Islamic banks are supposed to commit a portion of their assets to making interest-free loans to the needy (*qard hasana*). By and large they make such loans only to their own employees, as advances on their salaries. Evidently, Islamic bankers are more sensitive to the needs of their acquaintances than to those of strangers. The same can be said about officials charged with distributing society's zakat funds. The pervasive irregularities in their operations indicate that they are inclined to differentiate among the needs of their fellow Muslims.

In an isolated group numbering at most in the low hundreds and whose members perform similar tasks, the range of experiences may be sufficiently narrow and the volume of relevant information sufficiently small to enable a veritable agreement on objectives. Moreover, the members of such a group may possess adequate knowledge of one another's needs. But it is sheer romanticism to expect such traits to characterize a population running into the millions. In a large society sustained cooperation toward jointly held and commonly understood ends is possible only in small subgroups like the family, the work team, and tightly knit partnerships.

If economics has taught us anything over the past two centuries, it is that the institution of the market allows traders pursuing *different*, rather than *similar*, ends to achieve mutually satisfying outcomes. As an unrivaled economizer of information, the market permits traders to serve the needs of others while pursuing nothing but their own selfish objectives. True, the viability of the market mechanism depends on the existence of certain constraints on people's actions, such as property rights, sanctions against dishonesty, regulations to curb harmful externalities, and contracting rules. And cooperative production in firms is a source of immense social gain. Still, a large society's economic viability is ensured not simply, or even mainly, by altruism or jointness of purpose. A crucial role is played by institutions that induce traders to serve society as a by-product of personal pursuits based on personal knowledge. Put differently, prosperity does not require the commonality of all knowledge, in the sense of each person knowing the needs of every other. Nor does it require general conformity to joint objectives. Given people's very limited informational abilities, it always requires some division of knowledge and labor.

Friedrich Hayek, the most forceful modern exponent of these insights, traces the common misperception that the economic viability of a large society depends on jointness of both knowledge and purpose to Aristotle's teachings on household management and individual enterprise. These teachings showed no comprehension of the market order in which Aristotle lived, yet they set the pattern over the following two millennia for religious and philosophical thinking on the social order. Generalizing erroneously from the household to the wider economy, later thinkers such as Thomas Aquinas held that only actions aiming at known benefits to others are morally justified and, hence, economically desirable. Not until the eighteenth century would it be recognized that the market makes it possible "to do a service to another without bearing him a real kindness," or even knowing him.[121]

But habits of thought do not die easily. Socialism, arguably the most influential social doctrine of the twentieth century, promotes the notion that a classless society is possible, even inevitable, where selfish greed has

given way to benevolence. Hayek calls this the "fatal conceit" of our time, the fundamental error that led dozens of countries to appalling inefficiency and tyranny. The supremely efficient, just, and harmonious society promised by socialism has existed nowhere but in murals of blissful workers resolutely serving socialism.

This brings us back to the Iranian street sweeper. The apparent glow on his face was taken to imply that Islam can generate widespread benevolence and, further, that this benevolence can propel a large and complex economy. Such thinking obviously betrays the Aristotelian influences on Islamic philosophy. Like other derivatives of Aristotelian thought, such as socialism, this philosophy rests on empirically untenable assumptions concerning human inclinations and capabilities.[122]

Given the preeminence of morality in Islamic thinking on economic development, one might expect a consensus on the proper domain of government and the need for central planning. In fact, there is none. The literature harbors various arguments in favor of government ownership and central planning, and many others in favor of private property and the market mechanism, all supported by revelation and tradition.[123] Significantly, the term "Islamic" has been juxtaposed both with "socialism" and with "capitalism." And however tolerant or intolerant of market processes, regimes have had no trouble finding an Islamic basis for their policies. The exponents of Islamic economics seldom appreciate this point. On the contrary, they claim routinely that their own particular positions are rooted in a well-articulated divine law admitting a single, unambiguous meaning.

The point was not lost on Hashemi Rafsanjani, who as speaker of the Iranian Parliament observed during a heated debate that some of his colleagues favored more government control over the economy, others less. Describing the disagreements as "differences among experts, not over matters of religion," he said that "Islam can accommodate all these views." It is desirable, he went on, that the rival camps reach a consensus. But if a consensus cannot be reached, then the majority view will have to prevail, and "if in practice the majority view yields no results, then the community will obviously revert to the other view."[124] As Shaul Bakhash observes, "to say that the government will try one policy and, if it fails, it will go back and try another is . . . very different from asserting that Islam requires that economic and property relations be ordered on the basis of divine law."[125]

Islamic economics features divisions on numerous other concerns of the field we call "development economics," including trade protection and industrial promotion. Many such issues have no counterparts in early Islam. In seventh-century Arabia central planning was not a possibility, industrialization not an issue. As the economy was mostly nonmonetized,

there was no monetary policy in the modern sense. It is even doubtful that the notion of economic development was present. Early Muslims had a sense of the ideal economy: one that treats its participants fairly and minimizes inequality. Clearly, they felt that the attainment of this ideal depends on curbing selfishness and dishonesty. There is no evidence, however, that they conceived of self-sustaining economic growth, let alone that they reflected and agreed on how best to attain it. In view of all this, it is unsurprising that Islamic economics is as divided on the institutional context of development as it is united on the primacy of morality.

Prognosis

It is time to pull together the threads of a long argument. In practice, not to mention doctrine, Islamic economics is hardly as comprehensive as its proponents apparently believe. Its concrete applications have been limited essentially to redistribution and banking. Not even in Pakistan, which has undertaken the most carefully planned attempt to reorder an economy according to Islamic precepts, and which has a population exceptionally committed to the concept of an "Islamic way of life," has the scope of reform gone much beyond these two areas. Like the underlying theory, the implemented modifications lack coherence. Islamic redistribution and banking have involved two separate agendas, and neither has been reconciled with other institutions and practices serving related or similar goals. As a case in point, the Pakistani zakat scheme coexists with a plethora of price controls and indirect taxes that counteract, if not offset, the intended redistribution. Nor have the specific reforms been revolutionary in their consequences. The advent of Islamic banking has altered only the cosmetics of banking and finance, and zakat has nowhere led to a perceptible reduction in poverty or inequality. Finally, the Islamic economic agenda remains poorly defined. It remains unclear, for instance, whether the ban on interest precludes the indexation of monetary transactions. And although there is agreement on the desirability of imbuing Muslims with an Islamic morality, no consensus has emerged on the implications for governance.

In trying to explain why Islamic economics has had no major impact, one identifies several classes of causes. First, its many ambiguities allow the prevailing political forces to give it whatever meaning seems least threatening to the status quo. Second, certain elements of the Islamic economic agenda conflict with human nature. Thus, Muslims are required to accept financial risk, whereas they prefer security. And they are supposed to pay zakat on their precious metals, but they resist. Third, the Islamic reforms have been impeded by social realities that their promoters

have expected religious sentiment to overcome. We saw, for instance, how the continuing prevalence of tax evasion has made it imprudent for bankers to engage in profit and loss sharing. Finally, Islamic reforms have suffered from poor organization and a shortage of skills. While there is some demand in every society for profit and loss sharing, the Islamic banks do not yet possess the skills necessary to make this financing method viable. Likewise, the established zakat systems lack effective monitoring.

What does the future hold for Islamic economics, and what of its continuing impact? The myth that reforms undertaken in the name of Islam represent radical departures from preexisting practices is unlikely to be sustained much longer. Yet they can be recognized as ineffective without causing the abandonment of basic objectives such as the elimination of interest. People do not modify their ideologies at the first sign of conflict with reality. As Albert Hirschman suggests, mental resistance is especially pronounced where the fit between ideology and reality was poor to begin with. Given the initial disparity, new facts that contradict the ideology do not worsen the fit appreciably and are therefore disregarded or else easily rationalized.[126] In any case, even when an individual becomes disillusioned with the prevailing ideology, real or imagined social pressures might make him refrain from publicizing his doubts.

Yet, as long as some individuals have the will to voice misgivings, there is reason to expect the eventual mobilization of an organized opposition, even in countries where the wisdom of Islamization is now seldom questioned in public. How long, then, will it take for the emergence of widespread dissent? And what will be the response of committed Islamists? Forecasting is a difficult task, especially, it has been said, when it is about the future. A social scientist can detect instabilities but not predict when these will give way to order, recognize sources of conflict but not specify how these will be resolved, and identify ranges of future possibilities but not provide a definitive account of impending evolution. While historical circumstances delimit the possible evolutionary paths, historical accidents determine the paths actually followed.

One possible scenario is for the ongoing quest for a moral order to become an obsession that makes power holders try earnestly to perfect the individual Muslim. Since there is vast room for disagreement on the nature of moral perfection, a consensus that the human impulses of Muslims need no further organizing would prove elusive. But if the history of socialism is any indication, it could take decades for a broad segment of society to wonder why the desired benevolence is so difficult to elicit. Failures along the way could easily be taken to mean that educational efforts need to be redoubled and non-Islamic influences curbed further. In this vain search for the Islamic utopia the political establishment would become increasingly repressive, making it treacherous to suggest that

Islam does not offer clear and definitive answers to economic problems. Meanwhile, the discipline of Islamic economics could feed on itself for decades, mistaking apologetics for serious reflection and cosmetics for genuine reform. The twenty-first century could thus become for Islam what the twentieth was for socialism: a period of infinite hope and promise, followed by disappointment, repression, disillusionment, and despair. Identified with failed policies, Islam would lose its authority as a wellspring of sound economic policy. The sequence could end with a flight from Islam into other sources of spiritual and moral inspiration.

An alternative scenario is for Islamic economics, which emerged as a movement to restore idealized economic relationships of the past, to turn into a major innovative force. After all, the Protestant Reformation started as a backward-looking movement, only gradually assuming a forward-looking character. As R. H. Tawney has documented, Luther and other leaders of the Reformation fought for the restoration of virtues they thought had been abandoned; yet, paradoxically, their attacks on ecclesiastical corruption weakened Church authority, thereby accelerating the developments they tried to reverse. The Reformation thus set the stage for the Industrial Revolution.[127] Such a scenario could be replayed within the Islamic world. Here is a possible sequence of events. The current preoccupation with economic morality turns the spotlight on incumbent political establishments, discrediting them further. Progressively delegitimized and weakened, existing regimes are replaced by Islamist regimes. The new regimes promise to rid society of its major social and economic problems by restoring properly Islamic values and practices. Alas, problems do not just yield to fresh policies. Disillusionment sets in, the Islamist regimes split into discordant factions, and the ensuing power struggles force the traditionally interventionist governments of the Islamic world to loosen their controls on private economic activity. By the time central governments regain their lost authority, market institutions are firmly entrenched and private enterprise very influential. These developments leave the promoters of an Aristotelian morality with no significant base of support.

Just as the rise of European capitalism coincided with the emergence of new social philosophies, so, too, political and economic liberalization in the Islamic world could be accompanied by a complete transformation of Islamic economics. The Islamic banks become genuine venture capital organizations, and zakat evolves into a bona fide social security system. Meanwhile, it becomes commonplace that feelings of altruism and solidarity carry less significance in a large, complex economy than in a small, simple one. And the notion that the Qur'an offers limited help in the realm of economic policy gains increasing recognition. There are, in fact, Islamic precedents for accepting the limitations of the traditional sources.

As a case in point, clerics eventually released army commanders from the requirement to abide by Islam's rules of warfare, permitting Muslim armies to act as their commanders saw fit.

In a less tumultuous and less circuitous variant of the second scenario, the key players are the practitioners of Islamic economics. Endeavoring to implement Islamic economics, they recognize its unrealism. As we have seen, this stage has already been reached in Islamic banking, where bankers instructed to lend on the basis of profit and loss sharing have discovered that under current circumstances this lending instrument yields more loss than profit. Sensing that it may never be practical to eliminate interest, that zakat requires new thinking to become an effective instrument of redistribution, and that the envisaged moral transformation is a mirage, onetime believers in Islamic economics begin chipping away at its edifice. At first they transform only the practice, resorting to many ruses. Then they begin altering the theory openly—for example, by redefining interest and reformulating the mechanics of zakat. Their endeavors gain the approval of individuals with a stake in common practices, including Islamists who have prospered doing "interest-laden" business. In this scenario the practitioners of Islamic economics serve as hidden agents of secularization, arbiters between the doctrine's goals and the secular practices it still condemns.