

**SUPREME COURT VERDICT: A
RESPONES TO ISSUES & CHALLENGES**

ISLAMIZATION OF ECONOMY

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While there may be scores of issues facing Pakistan economy, their solution lies not in piecemeal treatment or in trying to solve an individual problem in isolation. We have to address the entire gamut of issues in either of the two ways, apply remedy in the given set-up that has ceased to function properly due to perusal of wrong policies as well as running the economy on secular lines; or go for the alternative by implementing Islamic financial system. It is clear that the way the country's economic affairs are being managed is not in conformity with the ideology, values, and social norms of the nation.

Supreme Court's judgment declaring Riba un-Islamic is the culminating point of debate on the alternative Islamic financial system as it also provides a guideline for the purpose. Now all efforts should be aimed at enforcing an Islamic financial system in the country.

An effort to understand the Supreme Court's recent judgment against *riba* and its implications, plus adopting a well-founded strategy for implementing this verdict in letter and spirit, are the two areas that need urgent attention.

Background of the Judgment

The Council of Islamic Ideology (CII) report of 1980 was the first landmark in Pakistan's efforts to at least conceptually comprehend the question of *riba*-elimination and to develop a strategy to achieve that. This report was largely based upon the homework done by two committees of experts on the panel of Bankers and Economists, under the leadership of Dr. Ehsan Rashid, then vice chancellor, Karachi University, and Dr. Ziauddin Ahmad, then deputy governor, State Bank of Pakistan, and another report prepared by the State Bank of Pakistan by a group of bankers under the chairmanship of AGN Qazi, the then governor State Bank of Pakistan. The CII Report has been acknowledged the world over as a contribution to literature on Islamic economics and has won the IDB prize on Islamic banking.

The report tells what *riba* without going into big controversy. The issue was clarified in clear terms and then it was suggested that *riba* should be eliminated not merely from the banking and finance but from the economy as such, which covers the public sector, government policy, as well as the financial and business sectors of economy. The idea was that while Islamization of banking institutions at the micro level is neither ruled out nor disregarded, the strategy focused upon starting with the government sector and leading to elimination of *riba* from the whole economy. The first priority that the report gave was to government and inter-government sectors; the financial system in the country, the economy taken together and then down to micro level of institutions, of instruments, of products, of individual arrangements.

Somehow, when the government tried to implement this report, they reversed the order. Instead of following the strategy the report had laid down, the government chose to reform three financial institutions NIT, ICP and HBFC followed by introduction of an interest free counter, PLS counter, within the banking system. This was followed by an 'alleged' switch over in 1985. The proposed PLS system did not conform to the CII Report. It was a caricature, in fact a departure that ultimately sabotaged and destroyed the whole process. The CII, individual scholars and economists took serious note of that reverse movement and suggested that mere change in nomenclature cannot usher in a new system. It represented a change in name and not a change in the substance. And that is how the beginning and the end of the so-called Islamization of financial sector in the 80s took place. It was in this background that a number of appeals were made to the Federal Shariat Court, once the 10 year embargo on consideration of fiscal and monetary matters had ended.

In December 1991, the Federal Shariat Court came out with a judgment on this issue. In that judgment, it was made clear that interest in all its forms is *riba* and as such clearly against Islam: the nation must not be confused by differentiating between interest or usury or bank interest and non bank interest, simple or compound, individual or institutional, public or private. *Riba* covers all these dimensions of interest. The Shariat Court also disapproved of indexation, but more importantly it came out strongly on the mark-up system; and how it has metamorphosed the whole effort towards a genuine Islamization of the financial sector; and how because of that the whole process has aborted!

The Federal Shariat Court came up with a clear position on the issues involved. It found some 28 laws or parts of them repugnant to the Qur'an and Sunnah and declared them to be void, giving the government and the Parliament seven months to bring in the alternate legislation. Instead of legislating, the then government and some of the banks went to the Supreme Court with an appeal against the decision. This took another 8 years for the Appellate Bench to come out with its judgment. Meanwhile, under public pressure, the government tried to go for a Shariat Enforcement Act (1993) and an Islamization Commission, which did, present its interim report within the first year, but that report was never presented to the parliament, never discussed no any effort was made towards its implementation.

The Commission was reconstituted in 1997 with Raja Zafar ul Haq as its Chairman. He came out with a good report that drew largely upon the Report of the Self-Reliance Committee. Both these reports, though good and serious efforts to show the way towards elimination of *riba*, were never officially presented, accepted or implemented.

The Judgment

The 600-page judgment against these appeals announced on Dec. 23, 1999 by the Supreme Court Shariat Appellate Bench consists of four parts. First part is the joint operational judgment which defines the nature and concept of *riba*, endorses its total prohibition and after examining some 28

specific laws come to the conclusion that all of them do have interest which is repugnant to Qur'an and Sunnah and as such these laws have to be replaced within the next one and a half year. Then the court lays down guidelines as to how the country can move towards a *riba*-free system, which is a very valuable part and contribution of the court. The Federal Shariat Court had decided against *riba* but had not delineated the path for change. On government's insistence the Supreme Court Appellate Bench has done that. It was apprehended by some quarters that the country might face a crisis if a path to transition is not spelled out. The Appellate Bench has given very concrete and realistic suggestions for legal, institutional and policy changes, and has also suggested a time frame in which different steps may be taken serving as building blocks towards freeing the economy of *riba* within a time span of 18 months.

Constitutionally, the court was only obliged to say that in its view these laws should become void within a specified time horizon. And that time horizon should suffice the legislature to legislate on those issues so that a new set of laws replaces the old laws and also should suffice the government to take necessary executive and policy steps to move towards the new system. Their constitutional obligation was only to give a period for those laws to cease to exist; nothing more and nothing less. This, the court have done by suggesting that 8 of the laws should cease to exist after March 31, 2000 and the remaining 20 laws by June 30, 2001.

This part of the judgment, according to the constitution, is mandatory i.e. whether anything is done or not if we continue to operate according to this constitution and the court does not review its decision, then there is no other appellate authority and these laws would cease to exist at the time limits given by the court. As such, it is no longer a game of pick and chooses as the successive governments have been engaged during the last 52 years. This has now attained importance and something has to be done as far as these laws are concerned. However, the rest of the timetable is declaratory and not mandatory and to that extent there is some flexibility within the judgment and the way statutes are interpreted.

The verdict consists of three detailed judgments; one by Justice Khalilur Rehman, the other by Justice Wajihuddin and the third by Justice Taqi Usmani. All three are well written, worth reading documents. They have a scholarly flavor and they have recorded all major viewpoints that had been presented before them. The honorable judges have also discussed some of these viewpoints and then have in the light of all the discussion come to their own conclusions. Academic debates had been there in the past and would continue in the future; there is no bar on that and I am one of those who feel that freedom of discussion and freedom of re-thinking should always remain. Yet, as far as the definition of *riba* and its place in the financial system of the country is concerned, this judgment is definitive. There is no question of keeping the debate open. And now it would be unfair and unnecessary to spend time and energies on efforts to defining what *riba* is and what is not. Rather the effort should now concentrate on implementing the verdict. This is not a legal imperative; it is also a moral obligation. It is unfortunate that a certain lobby has tried to reopen

some of the settled issues. This is waste of time and creating confusion by dragging the nation into a futile war of words.

Implications of Review Petition

Before proceeding further, a word about the review petition filed by United Bank Limited. This shabbily drafted petition that has been lodged with the Supreme Court would not affect the present status. It should be kept in view that review petition and appeal are not the same things. Review is discretion of the Bench and as a matter of fact, the petition has not been admitted by the bench since the bench does not exist. While in the case of an appeal, the judgment becomes immediately suspended till the appeal is disposed of; in the case of review no such development takes place. So, instead of relaxing and loosening belts, we should further tighten them and realize that the judgment is very much there.

Review can take its own course, it cannot and must not halt the process. Moreover, if review is based on some sound academic or empirical grounds, it should not be discouraged. Rather, one should hope this may further help in improving the earlier and the present efforts. Nevertheless, the way the review petition has come has nothing new, nothing rational. In contrast, the position has been reversed; the appellants say that the Supreme Court has gone beyond its jurisdiction by suggesting a strategy and steps to make the required transition and that it was not their job. Then they have come up with old and oft-repeated arguments; that savings would shrink and what would happen to government borrowings, and other nonsensical objections. None of these objections merits review of judgment. Interestingly, the petition itself confesses it has been drafted under a hurry. Thus the petition is based on a wrong premise; if the drafting of review petition was done in haste, how could the petitioners have sufficient time for full examination of the judgment while running for a review?

Issues in the Judgment

Definition of Riba: The judgment is based upon some assumptions or concepts at the conceptual level. *Riba* have been defined in clear terms. While doing this, the Court has taken into account the controversy that has been taking place about *riba* in different circles, giving due consideration that all viewpoints being presented were not insincere, many think honestly about the differences. Yet, the court has rightly come to the conclusion that *riba* covers all forms of interest, usury, bank interest, public utilities and government schemes if they are based on a pre-determined fixed return related to time. It is also very clear that there could be other forms of exploitation and Islam is as much against those forms of exploitation as the exploitation in the form of *riba*. This should not in any way make the *riba* concept flexible, yet extension to new situation is not ruled out.

Indexation: Secondly, the verdict has clarified that indexation is not the answer; serious problems and injustices arise from inflation and the menace must be fought. May I submit that there can be two possibilities one, which is most preferable and pragmatic is that Inflation has to be controlled at its source and that is possible only if we have a monetary policy in which stabilization of prices is the primary objective. The government should live within its means. It is a question of living beyond its means that creates a situation because of which excessive borrowings take place, and inflationary pressures are generated. Today in Pakistan, we do not have just M1, M2 and M3, there are dozens of categories of virtual money. And this explosion of money and credit and the erosion of their real value is not particular with Muslims only, economists the world over are seized of this issue. European Common Market has laid down as one of its fundamental principles that member countries must contain inflation below 3%. Japan has been able to contain inflation to around 1%. So, it is through monetary policy addressing at the source that the problem has to be checked. But for argument sake, if it is not possible then we can develop certain programs and packages in the interest of justice because inflation in its real terms is a tax upon the poor and the under-privileged. This is the way to face it and not by going for indexation of return on credit.

Search for Alternative: The judgment is based on the belief that there is an alternative to interest; both at the theoretical level and at the operational level. Not that at the practical level things are perfect or all problems have been solved. Economist and bankers who appeared before the court had also been conscious of these problems, in fact they emphasized those problems. Hail to the verdict it has recorded these concerns. As said earlier, elimination of *riba* is not just an act or an event it is a process through which all the problems would be addressed. Every effort may not necessarily succeed even failures would also be met in the way. Islam is guidance in the perfect form but human efforts to approximate towards that ideal would remain human and as such subject to error. There can be errors in human judgment, of competence, of not cognizant of ground realities. We have to learn from the mistakes and rectify the wrongs. This process is within the framework of Islam which has taken place in the past and which will take place in the future as well. The Supreme Court judgment is clear that alternatives are available and one must not be obsessed by the apprehension of the unknown. The realization that there are issues and challenges, which would have to be faced, only suggests that we should be realistic, innovative and creative. There is no cause for despondency.

Dishonesty and Moral Laxity: The court has also addressed one of the issues which are often but not justifiably presented as an obstacle. That is the issue of dishonesty, moral laxity, and information asymmetry. All these are genuine problems, but not insolvable. These are problems not merely for a *riba* free Islamic economy; they are problems for any economy. Moreover, the question of dishonesty is not merely a Muslim society syndrome; it is universal and a menace to banking anywhere in the world. Transparency, accountability, enforceability of contracts, credible ratings both of borrowers as well as of lenders are ingredients of a good economic order. There is no reason when we are talking of elimination of *riba* we must not address these issues and

develop policies, institutions legal framework and viable business practices that are needed for that. So none of these can be an excuse for not moving in the direction of *riba* elimination. Judgment has discussed all these issues.

The Macro-dimension: Now let us come to the future. Islamic Banking and elimination of *riba* are essential pillars of an Islamic economy. However, mere elimination of *riba* in an otherwise capitalistic system is not going either to achieve the objectives or even produce a just system. So, the target should not be merely elimination of *riba*; it should be to see that elimination of *riba* takes place in the context of movement towards a different model of economy which has clear socio-moral objectives and where different parts of economy help and support each other to create a welfare and just society and network of relationship ensuring fair-play for all. With that as objective, it is more important particularly for the bankers and economists to be clear as to what is Islamic Banking?

The key issue in this context is the role of money in the economy. Discovery of money was a revolutionary development, even more important than discovery of the wheel that led to the whole technological revolution in history of humankind. No doubt, money can be a facilitator and a helper for exchange, production and economic development. Yet, it has the potential to become an instrument of exploitation if it abdicates its original role and is used to beget more money without real value creation. If money becomes the objective and money attracts money without developing economic activity, asset creation, flow of goods and services, it will create nothing but trouble. So in Islamic framework money is the means of exchange, not a commodity and an instrument for mere amassment of wealth.

In this regard, it may be useful to point out that in the classical formulation, the formula was CMC i.e. Commodities via Money leading to production of Commodities. The capitalistic system changed this into MCM. Focus moved from commodity to money, yet commodity and asset creation was there at the centerpiece and money was used to produce commodities and services. And this circle continued. But now the grossly exploitative capitalism has created a situation where the formula has been reduced to MMM. Now it is a process where money is generating money without creating assets. The make-believe world of derivatives, options and claims on assets has created a fiduciary world unrelated to the real assets and productive efforts in the economy. Daily transactions in foreign exchange derivatives are to the tune of \$1.3 trillion, fifty times more than the physical trade in funds and services. It is only the big players who are milking billions without contributing to the physical growth of the economy. Thus, this is the most exploitative phase and interest is the kingpin in this process. In the Islamic context, there is no objection to have money, but money as an intermediary, not money as an objective and an instrument of exploitation.

On that basis, the question of investment can be at two levels. One, direct investment where anybody who has money and resources, can make them available to anybody who has expertise, projects, and can run the business. And historically, this has been a very important process for

promoting economic activity and development. The second step is that of financial intermediation. In more sophisticated arrangement, investment is through financial intermediation and that is where the contemporary banking system comes into foreplay; where mutual funds, pension funds and all similar schemes lie. Since this is a natural transition, there is no harm in it. In the Islamic system, there are institutions of financial intermediation but with a difference. The Islamic banking is banking proper. It has clear economic, commercial, profit-oriented objectives. It is not charity or simple social service. It has to operate professionally with clear objectives in view; not following in the footsteps of the capitalistic model of banking. Along with that it has some distinct characteristic; while it is banking proper, professional and geared to productive, commercial and economic objectives, it operates in an ethical framework. This is the distinct characteristic of all Islamic institutions. Along with that, the most important characteristic in Islamic banking is that it is equity-based. While there is some scope for credit and near-fixed return based financial instruments, the real thrust of Islamic banking has to be towards promoting an equity-based investment culture. It has to move towards a more equity-sharing, stake-taking, risk-sharing arrangement.

Movement Towards Investment and Equity-based Instruments: One genuine concern also shown in the judgment and needs to be addressed is that though experiments in Islamic banking so far have made a remarkable beginning in the direction of elimination of *riba*, by and large bulk of the operations are still close to debt-based instruments. Movement towards investment-based equity-sharing and stake-taking instruments is slow. A recent report of International Islamic Banks reveals that the role of *Musharaka* and *Mudaraba* has increased from 5-6% to around 18-19% over the last 10 years. This is a slow movement particularly while the main operations of the Islamic banks remain debt-based. In this context, the Islamic banker has to realize that he will have to take a bold step to move towards an equity-based financial system. There is no denying that some need for debt and credit would stay and as such some kind of debt-based instruments may remain. This, however should not be the main business of the banking. Instead, we should move towards the new model not only in the banking but subsequently whole of the economy, because that has to be a more equitable and stake-taking society, a participatory society and not merely a debt-based economy.

The Islamic vision of economy is not one of predominantly debt-based one or is an equity-based economy. And as such the role of the bank is not merely of a lender but also rather more of an investor and a partner in the enterprise it is financing. Bank is a participator in the process and let's just as a foot-note add that one must not be allergic or too apprehensive about it, because even in the Western banking tradition there are very profound historical traditions of commercial banks involved in investment banking. In this respect, the German Banking System of the 19th century and the Service Banking System of France are two important examples where commercial lending and investment banking have gone side by side. Definitely, the expertise that is needed by the bankers would change. Attitudes and stakes would also change, but that is the kind of transition

Islamic banking has to make. So while trade-based and debt-based instruments would remain, investment-based and equity-based instruments must gradually become the backbone of the system.

Collateral and Inflation: That the Islamic system is more entrepreneur-friendly is not mere heresy. The focus shifts from collateral to the project, to the entrepreneur, i.e. the viability of the project and credibility of the entrepreneur. As such, it becomes more just. Operating it in this spirit will essentially result in asset-creation and increase of production and providing resources to those who have ideas, who have skills, who have projects, but who may not have the sole merit of collateral. It does not mean that collateral is ruled out. Collateral would be there, but as one of the many not as the only or the most important factor. After all, *rehn* (mortgage) is one of the islamically accepted modes of security. But the attitude has to change. Let it be entrepreneur-friendly. Profit-sharing has another merit. It would be production-oriented and as such non-inflationary. Return based on profits would capture the wagers of price change. Elimination of *riba* and production of profit-sharing has the potential to keep the inflationary pressures in check, particularly when easy borrowing would be curtailed and discouraged at all levels. It is submitted for the economists and bankers to reflect on this idea that profit would essentially capture inflation in the society. Interest has to capture it artificially, arbitrarily, but profit would capture it automatically. And as such a system in which the main stream is profit-sharing and equity-sharing, then the inflationary pressures, right from their generation can be contained.

That Islamic banking system along with the monetary system of the government has to be non-inflationary. It has to have a human face characterized by deep human concerns; it cannot be merely profit-oriented.

These are some of the important considerations because of which Islamic economic system is destined to be more just system. It should have a policy objective to see that the resources of many are utilized for the well being of all. Its investment and lending policies as well should have this dimension. That is why it is hoped if this system is operated with the moral and social objectives in view and the banking system runs professionally it would lead to the creation of a welfare-based society with equitable system of wealth and income.

Future Challenges

Political Will: As regards to the future challenges, political will is the foremost challenge. It is the key to change and its absence has been responsible for all the dilly-dally witnessed during the last 52 years. As citizens, every member of the society has a right to influence the policy-makers to do the needful. The Supreme Court judgment has created certain legal pressures that the government cannot ignore. Yet, they are not enough to bring about the real change. The first essential is political will and every effort must be made to see that this is there. The problem with the Muslim Ummah is that its rulers and peoples' aspirations are not at the same wave length, with the result

that the alienated rulers misuse the energies and resources of the state and society. They do not use them for fulfilling aspirations of the people but for suppressing them. And that has led to the political and cultural crises in the society. The answer lies in greater public awakening and mobilization of public opinion to pressure the government to fulfill its responsibility towards bringing about the needed change.

Public Awareness: Second and equally important is public awareness. It would not be right putting everything in the lap of the government. Public awareness is equally important. There is need to have a very active campaign in making people realize what the Islamic system is. People do not know what Shariah consistent modes of investment and savings are. These modes are there, but people lack in their knowledge. A number of studies have shown that in Middle East and even in the Muslim community in the UK lots of funds are available which have not gone into the banking system because of the ethical and moral reservations of the people. And if opportunities with the Shariah consistent modes are available, the total stock of savings in the system is bound to increase. But for that, awareness, credibility and confidence are much needed. It is unfortunate that many of our mosques have become centers of sectarian rivalry or emotional outbursts, and not of education and sharing information. There are morally acceptable Shariah consistent instruments and products available but awareness is not there. So public awareness is very important. Education, information, media, government policies and agencies, scholars both religious and professionals – all of them have to play their part in that.

Institutional Preparedness: Third is professional institutions and personal expertise; their level of preparedness is also conspicuous by their absence or being very low. Appeal should be made to those who are representing financial institutions to seriously reflect upon how institutions and professionals can prepare themselves for the new role. It is a matter of pride that Islamic economics is no longer the preserve of a few scholars, *ulema* and *Fuqaha*. Still we have to realize that we have to make up for the deficiencies. Shariah boards are important for this transition. For preparedness, the education system has to be changed and training programs have to be developed. This 1½ year period allowed by the Supreme Court is a very important opportunity to prepare for that by developing task forces, training programs, certificate and diploma courses, seminars, discussion groups and other similar activities. It should not be taken for granted that answers to all the problems are available, but with the right kind of efforts and the institutional preparedness, we should be capable of discovering answers for all problems.

Legal Framework: There are a number of laws that will require changes. The Supreme Court has also said that and the review petition that followed the verdict has also pointed out that there are certain laws which have not been discussed by the court. However, one should not ignore the fact that the Supreme Court was not *suo motto* discussing all the laws. The court has made a very clear observation that while it has discussed certain laws, the government should take necessary steps to review all the laws from this viewpoint. Legal framework should essentially be strengthened for

enforcement of contracts and for effective and quick disposal of disputes and punishments for those who are in default. This is essential for any system and it should be confessed that in the Western world the legal and judicial system is effective enough to ensure that contracts are enforced, that defaulters are penalized, that in case of default, assets are acquired by financial institutions and within a specified time, that is not more than six months. There are special fraud-detection squads and agencies which try to see that corruption and misuse of funds do not take place. Definitely all these are needed, and for that making necessary reform in the legal and judicial system is the prime need. Greater transparency, better regulatory and supervisory mechanism, effective accountability are indispensable for the success of the system.

Review of Priorities: Review of priorities at the state level and the level of business and commerce is a must. Such an exercise can show the level of implementation of *riba* free-economy. The whole fiscal and legal system in this country is presently geared to discourage profit, penalizing dividend while protecting *riba* and giving incentive for *riba*.

The present situation is that interest is an item in the cost of production, so if a person pays interest it is tax free, if he pays dividend it is subject to tax. This unfair system has to be changed. There is no level playing in relation to interest and profit in the system. This has to change. We have to evolve a tax system which encourages dividend payment to a certain level. Tax should be there but after a certain level of dividend or reward on investment. A new system can be easily devised which has built-in incentives for genuine dividend and profit based investment and also meets the needs of the state. I favor those systems of taxation, particularly in the case of indirect taxes, which are incentive-oriented towards higher production. Fiscal reforms are needed with the objective of giving incentive to equity-based investments and discourage and penalize fixed returns.

Documentation: The economy also needs documentation. Documentation with change of attitudes, policies and fiscal system will help in promoting transparency and honesty. There is a vast informal sector. Part of it is no doubt composed of black economy i.e. smuggling, corruption, debt-evasion etc, but there are also a variety of other economic activities that may be undocumented but are sustaining Pakistan's economy. These should not be made subject to the mischief of the tax system. Documentation is important and banks also have to play a very important role in it. The court has also made it very clear that within six months, the Pakistani banks and financial institutions should try to develop an elaborate system of Islamic instruments properly documented and publicized so that a real movement to the new system could start. This again emphasizes the need of education of the whole system at various levels. These levels include as earlier indicated government, professional bankers and at the user level chambers of trade, commerce and industry. And then finally comes the common man.

Research: There is a need for further research and developing new products. One feels sorry that whatever work has been done, unfortunately, is lying idle and government agencies and

professionals have not benefited from that. There should be a serious effort to do that, but along with that research is needed and all should pool resources and join hands to develop new products and new instruments. There are about 30 issues that are hindering the development of Islamic banking and have been mentioned by the IDB in one of its study. It was a big survey that was conducted and all of the problems deserve reflection, analysis, prescription and experimentation. None of them is un-resolvable. All of these are challenges but they have to be met by developing both; the equity-based final instruments, even along with some near-credit-based instruments for the transitional period. This will lead us towards a higher level of development and stability.

Transition at all Levels: The process of major transition at all levels is very important. The court has emphasized about two dozen suggestions particularly about rating, transparency and credibility. Modern banks are also facing all these problems. Banks are no longer closed-door shops as used to be in the 19th and early 20th century. They are now coming up with new ideas and initiatives that would enable them, and us, to face the challenge of moral hazards more comfortably. All these problems have solutions, only we have to work them out, perfect them, improve and modify them with experience. Effort and struggle is the only way to live and achieve worthwhile results. There is no substitute for effort as Allah has laid down in the Qur'an that for humans is what they strive for.

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