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**Towards an Interest-Free Islamic Economic System**

**A Theoretical Analysis of Prohibiting Debt Financing**

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Foreword

There have been a number of significant contributions in the last ten years which have shown that an interest-free Islamic system is not only viable but is, potentially, far superior to the traditional interest-based system. The present study, Towards an Interest-Free Islamic Economic System, by a young and brilliant economist, Dr. Waqar Masood Khan, is perhaps the most rigorous and the most convincing in establishing this proposition. While most of the other studies have relied heavily on equity considerations, this study has shown quite convincingly that even on grounds of pure efficiency an interest-free financial system performs better than the one based on interest.

The author has developed a model which allows a comparison of two schemes, i.e. a fixed return scheme (FRS) and a variable return scheme (VRS). While the first scheme is the backbone of the Western financial system, the pacesetter of financial operations all over the world, including the Muslim countries, it is prohibited under the Islamic system for moral as well as economic reasons. Islam permits variable return on financial contracts. In view of this categorized and unequivocal prohibition of interest in all its forms, a Muslim society that is committed to establishing its socio-economic relations on Islamic values is bound to search for an alternative to the fixed return scheme. The near-consensus amongst Islamic economists suggests that while Islam wants to discard all fixed

1. Report on the Elimination of Interest from the Economy, Islamic Ideology Council, Pakistan, Islamabad, 1979; Money and Banking in Islam, ed. Ziauddin Ahmad, Munawar Iqbal and Fahim Khan, Institute of Policy Studies, Islamabad, 1982; Banking Without Interest, by Dr. Nejatullah Siddiqi, Islamic Foundation, Leicester, 1983; Issues in Islamic Banking, by Dr. Nejatullah Siddiqi, Islanic Foun- dation, Leicester, 1983; Monetary and Fiscal Economics of Islam, ed. M. Arif, Centre for Research in Islamic Economics, King Abdul Aziz University, Jeddah; Towards a Just Monetary System, by Dr. M. Umer Chapra, Islamic Foundation, Leicester, 1985.

Return schemes in respect of loan/investment operations it aims at establishing an economy where equity participation becomes the chief mode for financial operations. Dr. Waqar Masood Khan has shown, with academic rigor, that under a set of plausible conditions, even within the parameters of an otherwise secular economy, a variable return scheme per- forms better than a fixed return scheme, thus establishing the superiority of the Islamic system over the traditional one. This constitutes a seminal contribution from a young bud- ding Islamic economist.

However, Dr. Khan is not dogmatic in his approach. He points out that the traditional banking system though un- Islamic, is not entirely without merit. Similarly, an interest- free system should not be taken as a panacea for all economic ills, nor should the changeover be considered a costless, painless transition. He has pointed out the benefits as well as the costs of the two schemes in an entirely objective manner.

The strength of the interest less system lies in its ability to distribute risk more widely. The author has shown that this leads to an all-equity situation which is pare to optimal. He has demonstrated that debt financing is inferior to equity financing. If this is so, why then does one find that in the real world the scene is dominated by debt financing while on moral and social counts the answer has never been difficult to find? The author has also offered a convincing and economic answer to this important question.

The variable return system has some stringent requirements which place it in a disadvantageous position in the real world. The most crucial requirement turns out to be the ability of the

Financier to monitor the real performance of the project. The information requirements of a variable return system are much more than those of the fixed return system. Since in practice the investor can observe the performance of the project causelessly, while the financier has to incur some extra costs on monitoring, this asymmetrical information in the credit markets provides an incentive to the investor for under- reporting the results of the project. Since debt has the characteristic of minimizing the informational requirements of a financial contract, it becomes a more attractive instrument of financing. Therefore, the practical dominance of the interest-ridden system is a result of the 'moral hazard' in the variable return system.

At the same time, since information costs are a deadweight loss to society, the variable return system may lead to a loss in society's output. This loss has to be weighed against some other benefits of the new system, some of which have been mentioned by the author, such as greater stability of the system, possible increase in investment due to non- requirement of collateral, increase in expected return due to higher risk-taking, saving of resources required for deposit insurance in an interest-based system, etc. This brings into sharp focus only certain aspects of the benefits of the new system. The reader would have to refer to other literature on the subject to evaluate every economic, social and moral benefit of the interest-free system.2

Towards an Interest-Free Islamic Economic System, based as it is on the doctoral research undertaken by Dr. Khan in the University of Boston, constitutes an important contribution in the theory of finance as well as in the theory of Islamic economics. His analysis is as applicable to a secular economy as it is to an Islamic economy. His contribution to the theory of finance lies in developing a model which is capable of explaining the capital structure of a firm, finding a pare to optimal solution under varying conditions of financial con- tracts and devising an optimal monitoring strategy for the lender under different situations. He has also offered a new and convincing explanation of the paradoxical results of the Miller-Modigliani theorem. His contribution in the field of Islamic economics lies in developing a rigorous model for analyzing the implications of the Islamic injunctions prohibiting interest and establishing the superiority of an equity- based Islamic system of financing.

Some Islamic economists may have certain reservations about the technique employed by the author. They may feel that the framework and the parameters used in the study remain almost exclusively secular. While the usefulness of this approach cannot be denied, the richness of the Islamic approach which integrates the moral and the economic remains

2. See Chapra, Siddiqi and Ziauddin, et al., given in footnote No. 1.

Far greater than what could be captured in the study because of the limitations of the technique. Islamic economics considers values as an essential component of economic analysis and as such the exclusion of the moral aspects of the contractual liabilities is bound to miss some of the features of the Islamic system. A model which has to formally incorporate cheating and dishonesty as essential elements of the system and had, as a matter of fact, to settle with the 'optimal' level of cheating, even though positive, is bound to remain 'sub-optimal' in the Islamic framework of analysis. It deserves to be appreciated that the author had to take note of the practical situation prevailing in present-day Muslim countries where unfortunately dishonesty is widespread. It most probably was this realization which influenced him to incorporate the element of cheating and dishonesty in the system without which he might have thought the analysis would remain unrealistic. Despite all the sympathy for this realism, as well as its usefulness in the present-day situation, it must not be ignored that Islam aims to establish a society where cheating and dishonesty are minimized and finally eliminated. When one allows for an honest world, the moral hazard problem which introduces the deadweight loss in the variable return system may be eliminated. The reader should keep in mind the distinction between prevalent conditions in the so-called Muslim countries and the characteristics of the Islamic system, a distinction which has to be kept in view, whatever the weaknesses of the present-day world.

His analysis of the practical experience in Pakistan, although partial and somewhat premature, is illuminating. His prescription for the requirements of the new system are extremely useful and enlightening. They are most timely and deserve serious consideration from all policy-makers, not only in Pakistan, but in every part of the world where experiments in Islamic banking are being made in the public or the private sector.

I take this opportunity to extend my very warm congratulations to him on producing such a valuable and path-breaking work. I hope and pray that Brother Masood Khan and other colleagues will carry forward this important line of analysis.

Towards an Interest-Free Islamic Economic System is being sponsored by the International Association for Islamic Economics as its first publication. The Association was formed in 1984 as a result of the sustained efforts of Islamic economists during the last decade to promote Islamic economics in teaching, research and application. The Association was formally launched at a conference held in the Turkish republic of Northern Cyprus in July, 1984 and is presently enlisting the support and co-operation of all those economists who are interested in further developing the nascent discipline of Islamic economics. As President of the Association, I take genuine pride in offering Dr. Waqar Khan's research on an interest-free financing system as this addresses itself to one of the major problems with which Muslim economic policy-makers as well as practitioners of Islamic banking are confronted.

I take this opportunity to thank Brother Umar Zubeir, Dr. Anas Zarqa, Dr. Nejatullah Siddiqi, Dr. M. Umer Chapra and Dr. Munawar Iqbal for their sustained support and co- operation in promoting the activities of the Association in general and in enabling the Association to publish the present study. May Allah bless their efforts?

I am also grateful to the Islamic Foundation for joining hands with the International Association for Islamic Economics to publish this work.

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