PALGRAVE STUDIES IN
ISLAMIC BANKING,
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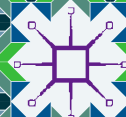
ETHICAL DIMENSIONS OF ISLAMIC FINANCE

Theory and Practice

Zamir Iqbal &
Abbas Mirakhor



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Foreword

This timely book reminds us all that in Islamic civilization finance was never divorced from religious ethics going back to the Noble Quran itself in which discussion of what is now known as finance and economics is almost always combined with ethics. In fact, economics as a separate "science" did not even appear in the numerous works in classical Arabic and Persian dealing with the enumeration and classification of the sciences from the works of al-Kindī in the third/ninth century to those of Mullā Ṣadrā composed over seven centuries later. The Greek word from which the English term economics derives was translated as *tadbīr al-manzil*, meaning management of the household, and the word for economics in Arabic and Persian used today, that is, *iqtiṣād,* had a completely different meaning in classical texts. The most famous classical Islamic work with this term in its title, that is, *al-Iqtisād fi'l-i'tiqād* by al-Ghazzālī, deals with faith and theology and not with what we call economics today. From the point of view of traditional Islamic thought, economics as an independent science is not even considered as a legitimate intellectual discipline. Rather, what is now called economics is part of the sciences of the Divine Law (*al-Sharī'ah*) and is inseparable from ethics.

In this context, it is important to recall that Khadījah, the wife of the Prophet, was a major businesswoman and that the Prophet himself was a merchant in her employment before he was chosen by God as His messenger. Consequently, in the Islamic world, the bazaar was always the part of the city associated with religious devotion and *bāzārīs* were seen to be especially imbued with piety. To this day, the Khānkhalīlī bazaar in Cairo is associated with the locus of religious fervor, and it is not accidental that

the bazaar itself is located next to Ra's al-Husayn, the religious heart of Cairo. In this context, it is also worthwhile to remember the central role of the Tehran and Qom bazaars in the Islamic Revolution in Iran led by Ayatollah Khomeini and the close rapport between the *ulamā* with the bazaar in that country.

In traditional Islamic society, financial and economic activities were based on ethics derived from the *Sharī'ah*, particularly the virtues of honesty and trust with full attention paid to the *Sharī'ah* categories of *ḥalāl* and *ḥarām*. These realities persisted into modern times and, although weakened, have not disappeared completely even now. I remember that when I was a child the Tehran bazaar had people called "trusted ones" (*amīns*). Each evening, the *amīns* would go from shop to shop in the bazaar collecting big sacks full of money, which they would not even count. The next morning, they would return each sack to its owner. There was complete trust on behalf of everyone. To recreate Islamic finance in its authentic sense, these virtues of trust and honesty have to be revived parallel with the creation of contemporary financial norms and institutions which, however, should not simply emulate secular Western economic and financial structures and practices.

During the past few decades, "Islamic economics" has been one of the central issues with which many Muslim scholars have been concerned and on which numerous works have been written. Most of these works, however, have been concerned mostly with the question of *ribā'* and how to create a *ribā'*-free economy and even banking. Moreover, this concern has been combined with the practical task of creating Islamic banks, a movement that is spreading in many countries. But unfortunately only a few scholars have addressed the deeper issues involved, such as the blind acceptance of the secularized view of modern science that considers nature as pure quantity devoid of any other value and the vision of man as a purely earthly being whose only real needs are material. The Islamic view of man and his real "needs" stands at the very antipode of the view of man upon which modern economics is based. We need to develop a contemporary Islamic economics and finance based on the Islamic understanding of who man is, what the purpose of his life on earth is, and where he is going.

Dr. Zamir Iqbal and Dr. Abbas Mirakhor are eminently suited for taking steps in this direction and the present book is in fact an important step on this path. Both men know Western economics well not only theoretically but also practically through their long association with such major modern institutions as the World Bank and the International Monetary

Fund. They also know well Islamic teachings concerning economics and finance. Moreover, they are not only nominally Muslim, but men of great faith deeply rooted in the Islamic tradition both intellectually and in their personal lives. And they are very aware of the current discussions about Islamic economics as well as practices such as Islamic banking. Their work thus marks an important addition to the field of Islamic economics and finance. In this current atmosphere of chaos and confusion in so many domains in the Islamic world, this work is a clarion call to clear, and at the same time authentic, thinking and practice in a domain that is so important to the life of Muslims today and will be so tomorrow.

I pray for their continued successful efforts in this important domain and hope that this short but valuable book will be read widely in both the West and the Islamic world especially by those who are seeking to recreate an authentic Islamic economic order imbued with Islamic ethics and spirituality and harmonious with the natural environment.

Wa'Llāh^{u} a'lam^{u} bi'l- ṣawāb Seyyed Hossein Nasr

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CHAPTER 1

Ethics and Finance

Discussing the role of morals and ethics in economics and finance is not new but several developments can be attributed to a renewed interest in discussing the relevance of ethics to economics and finance.[1] (See Box 1.1). The financial crisis of 2007–2008 and its aftermath have led to a debate about the need to consider the role of ethics and morality in the economic and financial workings of contemporary capitalism.[2] Financial scandals, crimes, and unethical practices by financial institutions leading to financial repression are being noticed. For example, research into the growth of economic and financial crimes was focused on the impact of globalization and the resulting economic changes, but gradually attention is being paid to the most fundamental change—the erosion of morality. In addition, repeated failure of governance, regulations, and accountability are considered a sign of deteriorating ethics in financial markets. Finally, new evidence is emerging on a widening gap in income and wealth, and reduced opportunities for poor to share growth and prosperity, which raises serious ethical questions. All these developments call for a deeper understanding of

[1] Hoepner and Wilson (2010) show that the annual number of publications indexed by Factiva for the search words 'Bank' and 'Ethics' increased by 357.9 percent from 4164 in the year 2000 to 19,069 in the year 2009. This indicates a sudden increase in the topic in the post-financial crisis era.

[2] See for example, the initiative "Citizen Ethics in a Time of Crisis" by Citizens Ethics Network (2010).

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the strong roots of ethics in finance, which has been mostly ignored or underplayed by mainstream research.

Box 1.1: Key Factors for Renewed Interest in Ethics and Finance

First, repeated financial crises and especially the financial crisis of 2007–2008 have raised the question if such crises could have been avoided if there were strong ethics embedded in financial transactions, public policy, regulations, governance, and business leadership. In addition, erosion of economic value and the social cost to the society and especially to the poor is getting serious.

Second, widening income and wealth disparity and diminishing opportunities for sharing growth and prosperity is viewed as an inherent outcome of capitalism when ethics are compromised.

Third, financial scandals (e.g., Enron, Worldcom, LIBOR), financial failures (e.g., Lehman Brothers), financial crises, and financial crimes have forced academia to question the very fundamental assumptions, such as self-interest and rational expectations, underlying modern economic thinking.

Fourth, while the issues relating to deficiencies in effective governance and regulations that govern financial intermediation and its links to the financial crises have been the focus of a global policy and academic debate, little has been done on the actual moral and ethical aspects of the problems and how to deal with challenges of unethical and immoral financial transactions that might be the seed of future global financial turbulences and meltdowns.

Fifth, increased complexity of financial transactions and financial markets, especially with the development of complex derivatives, has also raised ethical issues. The complexity has blurred the issue of ethics and has made it difficult to establish clear accountability for individual or corporate actions.

Sixth, ethics and morals are becoming part of investment decision-making for some groups of investors who are concerned about the negative impact of ignoring ethical practices. As a result, ethical investments or Socially Responsible Investments (SRIs) are growing. Preference for ethical investments could have an impact on corporate behavior and on corporate stock prices, depending on actual or perceived ethical or nonethical behavior.

(*continued*)

Box 1.1: (continued)

Finally, after the financial crisis of 2007–2008, leading business schools in the USA came under attack for producing top business executives whose academic training and thus business practices were void of ethical behavior. This has prompted these schools to embed discussion on ethics as a part of their curriculum. In addition, academic resources devoted to the study of ethics have also increased in the last two decades.

Source: Maghrebi et al. (2015)

Whereas mainstream economics have strong views on keeping the discipline of economics value-neutral, there are a number of schools of thought that challenge this approach to ethics and economics. Four main opposing schools of thought are especially prominent: Grants Economics, Humanistic Economics, Social Economics, and Institutional Economics.[3] These schools are closely related and mostly differ in terms of degree rather than substance. Grants and Humanistic Economics argue that altruistic behavior is not an aberration from rationality but rather a legitimate expression of rational choice. Grants Economics asserts that altruistic transfers or "grants" are an important part of the economy along with the formally recognized "exchange" or trade transfers.[4] Parents transfer to children expecting nothing back, as do friends to friends and even strangers to strangers. No economic model can be complete without taking into account altruistic as well as self-interested behavior, and incentives for both should be taken into account in formulating economic theories. Similarly, Humanistic Economics states that economic theory should promote human welfare by recognizing and integrating the full range of basic human values.

Social Economics takes things a bit further by stating that economic policy should be reformulated according to ethical considerations. One proponent, Amartya Sen, argues that the distancing of economics from ethics has impoverished Welfare Economics and also weakened the basis of a good deal of descriptive and predictive economics, and that economics can be made more productive by paying greater and more explicit attention to ethical considerations that shaped human behavior and judgment. In other words, greater morality can lead to greater efficiency and productivity.[5]

[3] Chapra (2008).
[4] See Boulding et al. (1972).
[5] Chapra (2008).

Finally, Institutional Economics takes things yet another step farther by arguing that not only can morality increase productivity but that change in institutions can actually be used to promote productivity enhancing morals. Organizations act as agents of change by making individuals behave in the desired manner through changes in benefits and costs. This School carries great promise because it can help explain how changes in institutions over time influence the present and the future and why some economies perform better than others do. It can also help explain cooperation and coordination and a number of other behavioral patterns in human society that neoclassical economics is unable to do by concentrating primarily on self-interest and competition. These possibilities have gradually raised the conceptual and practical importance of studying the role of institutions in human society.[6]

It is worth noting that Adam Smith, considered the father of Western economics, wrote his book *The Theory of Moral Sentiments* some decade and half before his other treatise *The Wealth of Nations*. An argument has been made that the proposition discernible from *The Wealth of Nations* regarding the workings of market capitalism must be placed within the institutional framework of *The Theory of Moral Sentiments*, which provides the mooring for them. The decoupling of the two books, in effect, cuts off economics and finance from the ethics of the system envisioned by Smith. This purging process to purify economics and finance in order to make them "value-free" began in earnest in the second half of the twentieth century, leaving market capitalism with only one ethics: "quid pro quo."[7]

1.1 Ethics and Economics and Finance

For a long while, financial economists have resisted linking economic theories to ethics, but as financial markets advance and the complexity of financial transactions increases, it is becoming necessary to incorporate ethical concepts such as honesty, fairness, integrity, trust, and cooperation into mainstream financial economics in more explicit form. Aragon (2014, p. 17) calls this phenomenon of ignoring the ethical dimension "moral muteness" and observes that some ethical issues "are transmuted into less morally charged terminology, for example, by referring to financial manipulation as 'income smoothing,' lying as 'cheap talk,' or theft as 'rent seeking.'"

[6] Chapra (2008).
[7] See Mirakhor and Alaabed (2013).

Most economists who discuss the relationship between ethics and finance do so indirectly. For example, they might discuss issues such as monitoring, signaling, collateral, bonding, and corporate governance structures as ways to reduce the negative consequences of particular moral failures without addressing the root causes of those failures. In other words, most economists emphasize treating the symptoms rather than the causes of market failures such as window dressing, misleading valuation, insider trading, and kickbacks.

Aragon (2014) argues that vast research in financial economics on the economic consequences of imperfect information is actually dealing with ethical issues underneath expected behavior and, therefore, has an ethical dimension embedded in the relevant theories. Two major concepts, moral hazard and adverse selection, are the foundation of several advance economic and financial theories such as agency costs theory and signaling theory. Furthermore, the development of means and mechanisms to reduce or mitigate costs associated with moral hazard and adverse selection has led to the development of a theoretical framework of institutional economics that focuses on the importance of formal and informal institutions.

The classic example of unethical behavior such as dishonesty and information asymmetries in economics is that of Akerlof's (1970) "lemons" model, in which information asymmetries would lead to market failure when agents are expected to be dishonest. The dual conditions for market failure (that is, information asymmetries and dishonesty) suggested by Akerlof's model reflect the key link between economic value and ethics. This necessitates that assumptions about the moral character of economic agents could provide deeper analysis of their economic behavior.

Similarly, the actions of financial intermediaries and creditors can involve moral hazard if they involve excessive risk taking without providing full information to savers and lenders. Moral hazard arises when savers are not able to observe the risk-taking behavior of financial intermediaries while in fact the savers are at risk of losing their savings, should the worst case be realized. This was common in the recent 2008 crisis known as the subprime crisis. If looked at in light of fiduciary responsibilities, excessive risk taking would be considered an ethics issue.

In the last two decades, many financial scandals have encouraged financial economists to reexamine even well-accepted assumptions and theories. For example, the assumptions that "rational expectations" and "market-discipline" would police the market and protect investors against

informational asymmetries are flawed, as witnessed by financial crisis. Thus financial ethics may involve, from an ethical perspective, the examination of such diverse issues as the fiduciary duties of managers to shareholders and society at large; to considerations of whether insider trading is moral; and whether economic agents should, if given the chance, expropriate value from others. Alternatively, from a financial perspective, financial ethics involves an objective examination of the effects of, for example, honesty on valuation, trust on efficiency, and self-interest on altruism (Aragon 2014).

This section discusses select examples of ethics and ethical behavior in the practice of finance. These cases demonstrate that it is not possible to keep ethics and finance separated and that there is mounting evidence of ethical issues arising in today's financial practices that cannot be brushed aside.

1.1.1 Frequent Financial Crises and Crimes

Contrary to common understanding, the subprime financial crisis of 2007–2008 was not only the result of excessive risk taking and inadequate capital and liquidity; it had been brewing for some time as a result of a gradual deterioration of ethical business leadership, of lapses in governance and in the regulatory framework (particularly in derivatives markets), and of an ineffective risk management framework. The subprime crisis evolved in mortgage markets as financial intermediaries provided mortgage loans to high-risk individuals (subprime borrowers) without adequate screening. These intermediaries started spreading this class of toxic loans to other institutions at tempting returns compared to alternative investment opportunities in capital markets, with inadequate information regarding the inherent risk of holding such assets, as borrowers (subprime homeowners) could not systematically meet their debt obligations. Therefore, the holders of these toxic assets were effectively holding increasingly worthless paper given the rising default frequency and correlation of defaults.[8]

There is a view that considers discipline of finance as "a profoundly moral issue, as it involves the creation of relationships of trust, often with very high stakes indeed" (Davies 2012). This is perhaps the reason why

[8] Dowd (2009) provides a detailed exposition of the involvement of moral hazard in the recent financial crises.

the revelation of the extent of fraud and other financial and economic crimes committed by financial institutions created intense moral outrage, reverberating in the Occupy protest movement.[9] Observers, such as Stiglitz (2010a) and Zuboff (2009), have commented that reasons usually given for the crisis such as deregulation, lack of oversight, and flawed incentive structure that established a link between executive compensation, share prices, and shareholders value have merit.[10] However, the most important cause at the heart of the crisis was the terrifying moral breakdown. The apparent absence of moral compunction in finance and business communities has been blamed on the dominant business model that celebrates what is good for organization insiders while dehumanizing and distancing everyone else.

It is the "narcissistic business model" that paved the way for thousands of men and women entrusted with people's economic well- being to systematically fail to meet minimum standard of moral behavior. Thus, in an expression of moral outrage, Zuboff (2009) argued at its heart, what drove the crisis was a sense of "remoteness and thoughtlessness compounded by a widespread abrogation of individual moral judgment." This is promoted by the predominating "business model" that is characterized by self-centeredness of its practitioners, who operate at an "emotional distance" from their victims and from the "poisonous consequences" of their actions. It was this "narcissistic model" that "paved the way for a full-scale administrative economic massacre…to the world's dismay, thousands of men and women entrusted with our economic well-being systematically failed to meet…[a] minimum standard of civil behavior" that "says: you can't just blame the system for the bad things you've done."[11]

[9] Such as Occupy Wall Street movement after the financial crisis of 2007–2008.

[10] See also Mirakhor and Alaabed (2013).

[11] Zuboff (2009) found appropriate the philosopher Hanna Arendt's formulation of "the banality of evil" in her observation of Eichmann in his trial in Jerusalem. Arendt observed that Eichman did not appear "perverted and sadistic," but "terribly and terrifyingly normal" (Arendt 2006). Accordingly, Eichmann was motivated by nothing except "an extraordinary diligence in looking out for his personal advancement." The same motivation animated the practitioners of the "narcissistic business model" operative in the run-up to the crisis. Zuboff argues that "the crisis has demonstrated that the banality of evil concealed within a widely accepted business model can put the entire world and its people at risk." She concludes that "in the crisis of 2009 the mounting evidence of fraud, conflict of interest, indifference to suffering, repudiation of responsibility and systemic absence of individual moral judgment produced an administrative massacre of such proportion that it constitutes economic crime against humanity."

There is evidence that business community has paid high costs for this behavior. In an article in Harvard Business Review in 2011, Porter and Kramer argued that in recent years "companies have been considered to an increasingly large degree the cause of social, environmental and economic problems.[12] And a large proportion of the population believes that companies have prospered at the expense of the community." They emphasized that "the legitimacy of business has fallen to levels never seen in history."

1.1.2 Expropriation of Value and Fair Valuation

The integrity of a financial institution and its managers is a valuable asset. One example of integrity is that the institutions do not expropriate value from one class of capital providers to another (i.e., bond-holders versus shareholders or current shareholders versus future shareholders). Expropriation refers to the unwilling or unwitting transfer of value from one party to another, which is a fancy name for theft or, since in many cases it is legal, "theft-like." Other synonyms used by financial economists for this type of activity include *predation*, *free-riding*, *market power*, *rent seeking*, *implicit compensation*, *tunneling*, *shirking*, *externalities*, and *sharking* (Aragon 2014). Jensen (2011) calls a system without integrity an incomplete system. Although the law does attempt to curb expropriation by imposing some explicit obligations to current and future bondholders and shareholders through disclosure rules and regulations, due to lack of integrity, the managers can still act improperly and make decisions to expropriate value.

Expectations play a critical role in economic valuation under uncertainty. Valuation models for pricing assets, equity in particular, are a function of expected cash flows, respective timing, and expected magnitude. Releasing of a signal or any information that would influence the expectations in one's favor or create erroneous expectations about the future could be considered unethical. In this respect, ethics have a subtle impact on the valuation of any security traded in the market. For example, knowingly overselling of future projects or creating marketing hype to raise expectations to increase the firm value to mislead investors, stakeholders, bondholders, and credit agencies would be considered unethical practices.

[12] Porter and Kramer (2011).

In a recent article, Professor Pablo Fernandez questions his fellow academia colleagues regarding the most common pricing model used for equities, i.e., Capital Assets Pricing Model (CAPM). Given the well-known and established shortcomings of CAPM, he makes the assertion that to continue to teach a model that does not truly represent the reality and is subject to serious criticism would amount to unethical.[13] Although, CAPM has been under rigorous scrutiny in the last couple of decades but making an argument that continuing teaching such a model knowing that it does not explain much about risks and return of an asset should be considered an ethical issue. Such an argument could have serious consequences on the way finance is taught or practiced today.

1.1.3 Corporate Governance

Corporate governance caught the attention of policymakers after the Asian crisis of 1997–1998, and the issues were highlighted to strengthen the governance and risk management framework. However, the current financial crisis showed that although governance and risk management frameworks were in place, they failed to deliver the promise of preventing a crisis before it erupted. Managers focused on short-term profit generation, and the boards neglected their task of asking probing, tough questions.

Although the role of the boards of financial institutions has increased dramatically over the last decade, they have been criticized for being too complacent and unable to prevent collapses. Weaknesses in safeguarding against excessive risk-taking behavior in a number of financial services companies were exposed during the subprime financial crisis. Again, the shareholders' trust in governance mechanisms and the role of the boards suffered, and this had a negative impact on the value of equity.

Corporate governance brings in the ethical dimension of responsibility and accountability of each stakeholder in the governance framework. This is more critical in the financial industry, due to the trust placed on the managers, the board, and other stakeholders by individual investors in particular. A classic case of massive breach of trust is the case of Bernie Madoff, who cheated his investors by operating a Ponzi scheme and was able to hide the crime despite stronger controls imposed on the asset management business.

[13] Fernandez (2017).

1.1.4 *Business Leadership*

As mentioned earlier, the financial crisis highlighted the issue of a decline in moral and ethical values in senior management, who seemed to care more about circumventing regulatory constraints and finding loopholes in the law than about morally correct behavior. Increasing greed and personal empire-building became the norm on Wall Street, with little emphasis being placed on producing moral and ethical business leaders.

Evidence from a survey of 401 chief financial officers (CFOs) reveals that 78 percent of surveyed executives were willing to knowingly sacrifice value to smooth earnings (Graham et al. 2005). Although several financial scandals have made CFOs less willing to use accounting manipulations to manage earnings, there is no check on their willingness to change the operating decisions of the firm to destroy long-run value and support short-run earnings targets, which raises serious concern about the intentions and actions of business leaders.

One common trait observed in several of today's business leaders of financial institutions is arrogance, which can take several forms. For example, the financial sector and its lobbyists are often accused of resisting any substantial regulation that attempts to restrict their risky behavior. If one believes the accusation of Nobel Laureate and professor Joseph Stiglitz that the financial sector in the USA prefers to return to the golden (unregulated) days before the crisis, the world is in for another financial and humanitarian catastrophe (Graafland and van de Ven 2011). Business leaders are also accused of acting recklessly and with imprudence. Taking excessive risks is a reflection of acting without prudence and probably for self-interest rather than the larger interest of all stakeholders.

1.1.5 *Due Care, Honesty, and Transparency*

The financial sector is expected to develop a culture of transparency, and financial institutions are expected to provide full disclosure of the fair state of their financial affairs. If the financial institutions are not honest or transparent in their dealings, it will lead to serious information asymmetries within the system making it vulnerable, crisis prone, and instable. Analyzing the banks' actual behavior against three core desired traits of honesty, due care, and accuracy, Graafland and van de Ven (2011) found that in some cases, banks did not behave according to the very moral standards they set themselves, despite a well-developed ethics framework, ethical values, and

ethics training. This raises several serious issues. For example, have the institutions developed these ethical policy statements and frameworks only on paper, with no strict enforcement mechanism in place? Furthermore, despite good intentions of the institutions, how does one develop the moral character of the managers and employees so that they will comply with the desirable ethical behavior of the institutions?

1.2 Moral Failure of Capitalism

While the recent rise in the intensity of debate on the morality of capitalism is due to the financial crisis, a series of corporate scandals and collapses had preceded the crisis in the two preceding decades (e.g., Enron, Tyco, and WorldCom). Nearly all of these events were considered to have been driven by "internal corporate greed, callous executive deception and failures in accounting (and accountability) system and in corporate boardrooms". These expressions were not unique or limited to a few commentators. Joseph Stiglitz[14] argued that the crisis exposed the "moral depravity" of the exploitation of the poor and middle-class and asked if those who knowingly cause financial and economic harm to others "have any moral compunction?"

It is important to note that empirical observations by sociologists and economists had noted widespread "moral erosion" in the very core of society among "respectable citizens" even before the crisis. In 2006, for example, Karstedt and Farrall in *The British Journal of Criminology*[15] reported the result of their study in the UK and Germany pointing out that moral failure in human behavior reaches " the kitchen table, on the settee and from desks and call centers, at cash points, in the supermarkets, restaurants, and in interaction with builders and trade people…by people who think themselves as respectable citizens." They showed that 54 percent of the population of their sample reported as being both victims and offenders of such behavior. And, 64 percent had themselves engaged in "illegal" or "shady" practices.

What is clear is that the present form of capitalism and the overall society in which it is embedded need to regain a "moral sense." The challenge is to awaken individual and collective consciousness to the moral compass inherent in "being human." Unfortunately, it is not only the willingness

[14] Stiglitz (2010a, b).
[15] Karstedt and Farrall (2006).

to ignore unethical finance and business practices that do enormous harm, it is also the fact that the present moral state of societies encourages distrust, fear, and a cynical attitude, leading to widespread willingness to engage in unfair, harmful, and even illegal behavior in the marketplace.

Recently, advocates of capitalism have mounted a moral defense of the system arguing that it has freed the mass of people from lives of poverty. It is the government policies that sap the moral energy of capitalism by infringing on individual liberty. And they appeal to the idea of "self-interest," which they consider as the essential ingredient of the system envisioned by "the father of capitalism" Adam Smith, who was, according to Noam Chomsky "a figure of Enlightenment. What we would call capitalism he despised." Doubts about the present form of capitalism are widespread. Joseph A. Schumpeter in his *Capitalism, Socialism and Democracy*[16] expected circumstances wherein capitalism leads to the creation of an "atmosphere of almost universal hostility to its own social order." Perhaps, no other result of the operations of capitalism has been as damaging to its moral standing as the strident inequality in income and wealth observed in all societies dominated by this system.

How did capitalism and its business model evolve to its present "despised" form with such extremely skewed income and wealth distribution? Is "moral capitalism" an oxymoron? If not, how can the present forms of capitalism be anchored on some universal moral foundation in a world of plurality of moral perceptions? And, can the present form of capitalism change its functionality to become acceptable to the majority of the world's population?

Briefly, the following discussion argues that capitalism as it was originally envisioned by its acknowledged "father," Adam Smith, was to be embedded within a moral/ethical framework that ensured convergence of individual and public interests. In this sense, the operations of capitalism or "commercial society" as termed by Adam Smith, need not contradict moral principles. That framework was to have been internalized by market participants for the economic model of the Wealth of Nations to lead to its expected results. It is argued here that given the rapid pace of globalization and the plurality of moral views, the ethical framework envisioned by Adam Smith may not find universal applicability. Hence, there is need for a simple and universally acceptable moral principle that can lead to a model of moral capitalism without explicit commitment to a particular moral framework.

[16] Schumpeter (1943).

Capitalism was unrestrained up until the emergence of the Great Depression in the wake of which it was "leashed" with regulations such as Glass-Steagall Act, antitrust laws, anti-collusion, anti-price fixing, high income and inheritance taxes. These measures were implemented first in the epicenter of the Great Depression, i.e., the USA, and then replicated elsewhere. This phase lasted until the emergence of conservative politics in most of industrial countries beginning with the administration of Reagan in the USA and Thatcher in the UK. Hence, the decade of 1980–1990 was the phase of "unleashed" capitalism with the dismantling of regulatory structure, reduction of income, wealth and inheritance taxes, and creation of incentive structure for business to feel unprecedented freedom of action.

As mentioned earlier, the most serious evidence of moral weakness of capitalism is the emergence of highly skewed income and wealth inequality where "1% of the population accounts for almost half of global wealth and where the poorest 50% owes as much as the 85 richest individuals." (Credit Suisse Global Wealth Report.) Thomas Piketty in his *Le Capital au XXle Sièle* provides massive data going back two centuries to demonstrate that the creation of inequality is an inherent characteristic of capitalism.[17] He shows that, with the exception of few decades in which inequality's growth slowed, the general trend of inequality in the long run has been upward. Aside from regulatory actions imposed during the period in which inequality slowed, high income, wealth, and inheritance taxes were the contributing factors. His data show that inequality will grow even faster for the rest of this century unless corrective action is taken.

Piketty's extraordinary empirical effort demonstrates the thesis of John Maynard Keynes published in *Economic Journal* in 1931 that capitalism produces two "evils": unemployment and skewed income and wealth distribution in favor of the "rentier" class. The "villain of the piece," Keynes asserted, is the interest rate mechanism. Similarly, Piketty argues that there is a race between the rate of growth of the economy "g" and the rate of return to capital "r." It is when r grows faster than g that inequality accelerates. Coincidentally with the growth of inequality, debt also grows along with credit and leverage.

As Reinhart and Rogoff argued,[18] all financial crises have been debt crises, no matter what labels they were given at the time such as "foreign

[17] Piketty (2013).
[18] Reinhart and Rogoff (2009).

exchange crisis" or "banking crisis." The incentive structure in place during periods of the run up to crises always encourages buildup of credit, debt, and leverage. What made the 2008 crisis so much more damaging was the growth of the "paper economy" where financial innovation and growth of information technology provided the means by which trade and speculation in debt securities created a decoupling of finance from the real economy. In 1984, Nobel laureate in economics James Tobin had warned that such a paper economy with its own ethics and morality was emerging where the object of finance was no longer intermediating funds for production of real output but creating a speculative environment of making money off paper trading; a "casino" capitalism. In such an economy, Stiglitz says, the players had learned "there was money to be made at the bottom of the pyramid and did everything possible to move it toward the top." The paper economy "converted the businessman into a profiteer." To do this, Keynes said, "is to strike a blow at capitalism" because a businessman is valued "so long as his gains can be held to bear some relations to what, roughly and in some sense, his activities have contributed to society."

The widening inequality, stagnant incomes, large unemployment, string of crippling crises, huge growth of government and consumer debts, and a host of other ills consequent to the operation of the present form of capitalism have seriously challenged faith in the system. The widely held perception of selfish, greedy, and harmful business has created a "regime uncertainty" where, as many ague, there is doubt if the system can be saved from itself or is even worth saving. There can be little doubt that the crisis and its aftermath demonstrated a fundamentally "massive moral failure" that has, in turn, caused a "moral panic" that there is a systemic assault upon human dignity, trust, contracts, and property, all of which constitute fundamental elements of the institutional structure of societies. The question pertinent to the debate is whether it is the system that has morally failed or the people who operate in the system who have lost their moral and ethical moorings. Compelling arguments have been made that it is the system's moral failure when it creates incentive structures that unleash greed, selfishness, and self-centeredness by removing legal and regulatory restraints on the behavior of finance and business. In these circumstances conditions are created for the Gresham effect to allow bad ethics to drive good ethics out of the market.[19]

[19] Gresham's law is a monetary principle stating that "bad money drives out good".

1.3 Financial Repression

Financial practices leading to exploitation and repression of the borrowing class certainly raise the ethical issues on the ground of fairness and justice.

The cluster of ideas advanced by Reinhart-Rogoff and their associates contend that: (a) all financial crises are, at root, debt crises regardless of labels, (b) high level of debt is a drag on growth, and (c) to avoid outright default when public debt is very large, governments resort to "financial repression" to "liquidate" their debt. Here too, an argument can be made that the theoretical root of these pronouncements date at least to Keynes-Tobin-Shaw and McKinnon that laid the foundation of the financial liberalization, the "get the prices right" movement of 1970–1990s and, ultimately, the "Washington consensus." Getting the prices right meant allowing market forces to operate freely to induce all prices to reflect opportunity costs. All prices, that is, except the price of financial resources whose opportunity cost was the "market rate of interest." Never mind that there was no such a thing as a "market rate of interest" in an environment in which policy drove the "market rate of interest." Tobin (1969), and before him Keynes, had already pointed out the policy induced deviation of interest rates from the true opportunity cost of financial resources. Monetary policy had the ability, Tobin argued, to force a deviation between market valuation of capital and its replacement cost. His "fundamental-valuation efficiency" concept, interpreted as "allocative efficiency," would establish the opportunity cost of financial resources requiring that they be directed to their best uses. According to the "get the prices right" doctrine, in a market where prices were not allowed to reflect their opportunity cost repression ruled. This was the McKinnon-Shaw argument for liberalization of the financial sector of developing countries. Financial repression, the deviation of the "administered" interest rate from the "market" interest rate, led to market distortions, thus discouraging saving, investment, and economic growth. In the succeeding decades of the fierce application of financial liberalization, a basic question never asked was how and in what sense did the "market" rate of interest reflect the true opportunity cost of financial resources and whether indeed deviation between it and prevailing rates of interest truly measured the magnitude of financial repression.

Currently, the issue of financial repression seems more important than its relation to public debt restructuring. It is potentially at the heart of a corollary of Richard Koo's balance sheet issues and transcends the

problem of temporary disequilibrium. The central problem of major economies is the uncoordinated and mismatched balance sheets of the real, financial, household, and government sectors. Presumably it is the market that is to coordinate the balance sheets for equilibrium to emerge. Given a runaway financial sector, decoupled from the real sector, that allocates only a very small fraction of trading in markets to capital formation in the real sector (about 0.8 percent of $33 trillion according to John C. Bogle: *Clash of Cultures* 2012), a real sector with corporations awash in cash, but not investing, Small and Medium Enterprises (SMEs) starving for financial resources, and a government sector with huge debt, the market's coordination capacity is seriously impaired. Clearly, James Tobin's prophetic warning in 1984 regarding the emergence of a "paper economy" without much connection to the real sector has become a reality with vengeance. Low or negative interest rates have not only created serious debt problems; they have also led to significant incentive for credit-financed consumption everywhere at the expense of savings. Such an environment begs the question whether to get the balance sheets right does not require that one must first get the prices right, meaning a realignment of prices with opportunity costs. In that sense, one then asks whether 4–5 percent differences between the prevailing rates of interest and the "market" rate indeed measures the true magnitude of financial repression when rates of return to investment in the real sector anywhere in the world, measured by any accepted concept, is a sizable multiple of the "market" rate of interest. Governments are repressing but they are not the only ones. Those in the financial sector who have mastered the art of risk shifting through leverage and debt are benefitting immensely from the "paper economy" they helped create.

1.4 Case of Economic Crimes

No matter what definition or measure is used, economic and financial crimes have been increasing at a pace that closely resembles an epidemic.[20] No country, society, culture, or community is immune from their devastations.[21] Such crimes had been labeled as "victimless crimes."[22] However, consideration of these crimes has evolved over the last four decades, intensified in the aftermath of 9/11 and accelerated in the wake of the

[20] Abdullah et al. (2015).

[21] United Nations (2006), McAuley (2011).

[22] Beloof et al. (2010).

2007–2008 financial crisis. Criminal economic activities that used to be thought of as developing country crimes, such as bribery, corruption, and fraud, are now also becoming concerns in rich and developed economies. While the financial crisis focused attention on elite white collar crimes, empirical research was pointing to another alarming development: "the everyday crimes of the middle class," crimes being committed by those "at the very core of contemporary society."[23]

Much of the research into the growth of economic and financial crimes has focused on the impact of globalization and the resulting economic changes including the accelerated pace of global expansion in information technology.[24] Very little attention has been paid to what a number of observers consider as the most fundamental change: the erosion of morality.[25] To be sure, there are theoretical and empirical classes of sociological, political, and psychological studies that focus on "market anomie," meaning the weakening "market morality" or "normlessness." To our knowledge, however, there have been very few studies that examine the relationship between economic and financial crimes and the erosion of morality at the global level, even in societies where the "market" does not have a dominant role in the economy.[26]

Some have focused their sights on the rapid weakening of general moral standards and admit that humanity is facing a "particularly acute" moral confusion. The cause of this "confusion," however, is thought to be the rapid changes that have undermined "many of the institutions or traditions that previously formed and policed our values." Furthermore, the Bishop of Edinburgh Richard Holloway says: "There can be little argument about the agent that has caused this change; it is the dominance of the global market economy and the social and cultural movements that have accompanied its ascendance."[27] Accordingly, globalization led to the emergence of conservative administrations in the 1980s and 1990s that radically restructured and removed traditional restraints on markets and on capital, in turn unleashing greed and self-centered and self-interested behavior.

Analytic thinking about economic and financial crimes has evolved over the four decades beginning in 1980. The most important dimension of

[23] Karstedt and Farrall (2007).
[24] Serio (1998), United Nations (2006).
[25] Holloway (1999), Porpora (2001), Kateb (2011).
[26] Akinbo (2009).
[27] Holloway (1999, p. 188).

this evolution has been the changing focus from economic crime as "victimless" to the recognition of its far reaching and adverse impact on a broad spectrum of victims. In 1982, a leading American political scientist, James Q. Wilson, advanced an idea that became known as the "broken windows theory." The metaphor argued that if a broken window in a vacant building were left unrepaired, soon most of the windows of that building would also be broken. The first unrepaired broken window signals that no one really cared about the building itself and its integrity. Generalized, the idea suggests that tolerating crimes leads to epidemics and, eventually, to social disintegration. Recently, William Black, the author of *The Best Way to Rob a Bank is to Own One*, has contextualized "the broken windows theory" to "elite white collar crime." He suggests that Wilson's idea that "tolerating widespread smaller crimes would lead to epidemic levels of larger crimes because it undermined community and social restraint" has been proven by the "epidemics of elite white collar crime that have driven our recurrent, intensifying financial crises." He predicts: "Corruption that is excused and tolerated by elites is…likely to spread in incidents and severity because it undermines community and the rule of law. It is likely to grow more pervasive and harmful the more we tolerate it." Low tolerance for activities that would not appear very serious, such as consumer fraud, would soon create a Gresham's effect "in which businesses or CEO's that cheat gain a competitive advantage and bad ethics drives good ethics out of the market. These offenses degrade ethics and erode peer restraints on misconduct."

In the same year that Wilson advanced his theory of broken windows, Tomlin suggested five basic typologies of victims of white collar crime: the individual, corporate or business enterprise, governments, society, and the "international order." The consequences of the inability to deal with white collar crimes, Tomlin (1982) suggested, were "…distrust of government and other institutions, a damaging effect on the moral fabric of society, and in the propensity of the populace to rationalize the existence of other types of traditional crimes." More than two decades later, these words were echoed by the Governor of the Bank of Thailand (Deva Kula 2005) when he asserted that the consequence of economic crime "go well beyond the financial loss and the economic well-being of society and the country." The Governor argued: "What is more important than the economic well-being is the feeling of living in a fair and just society. If drug lords continue to live well on their ill-gotten wealth, corrupt politicians continue to exert influence in the political arena, fraudulent bank executives continue to go

unpunished with no loss of status, and stock price manipulators continue to get wealthier at the expense of other shareholders, people would ultimately feel that the society in which they live is unfair and unjust." And, it was not only the domestic economic crime that needed prevention and prosecution, there "were more subtle forms of economic crime…where bigger nations exploit the natural resources of smaller nations…where businessmen from large countries move into smaller countries…to exploit the latter's natural resources" and exploit the consumers in these countries, and "when products which are hazardous to health in bigger nations, have been relocated for production and sale in less developed nations."

These are the harms done to individual victims. Other crimes such as corruption victimize whole societies. They harm the legitimacy of government and societal trust in government and public service. The World Bank has conducted extensive research over decades on the harm and damage caused by corruption and other economic crimes,[28] and has concluded, in part, that these crimes "have devastating impact on the capacity of government to function properly; on the private sector to grow and create employment; on the talents and energies of people to add value in productive ways and ultimately on societies to lift themselves out of poverty."[29] Recently, Krishan asserted: "Corruption and poor governance undermine both democracy and development. The poor are disproportionally hurt—the mother who cannot afford to pay a huge bribe to get medical attention for her dying child; the family who will be able to have safe drinking water if it pays a bribe; and the unemployed who remain jobless because public work projects are not implemented since corrupt officials have pocketed the funds that were allocated for them."[30] Akinbo expressed similar sentiments, arguing that economic and financial crimes "are among major challenges facing all countries of the world." They "have damaging effect on the economic and political system of a country." These crimes "undermine development by distorting the rule of law and weakening the institutional foundation on which economic growth depends…In a nutshell, they are the primary threat to good governance, sustainable economic development, and fair business practices in the country."[31]

[28] McCarthy (2011), Banuri and Eckel (2012).
[29] Folsom (2007).
[30] Krishnan (2011).
[31] Akinbo (2009).

Not long ago, it was assumed by social scientists and politicians that some economic and financial crimes, such as corruption, were "developing country" phenomena. Researchers often considered corruption as a deterrent to economic development of poor and middle-income countries in that it was thought that corruption conditioned development and good governance. As a result, indices of corruption were designed within this axiomatic framework. As Ades and DiTella note, no society is immune to corruption: "Governments of all political colors in countries of all levels of wealth are affected by corruption scandals with a frequency and intensity that seems to be always on the increase."[32] Specifically, they argue, Western democracies can no longer have pretentions of immunity to corruption they viewed as "aberrant" deviation from Western norms.[33] Corruption, in its broadest sense of abuse of public office, is an economic crime and as such afflicts all societies.

1.5 Summary

Some scholars attribute the observed, widespread "moral anomie," "moral confusion," and "moral failure" to massive changes resulting from globalization and rapid progress in information technology over the last few decades. For some, these changes are not dissimilar to those that occurred in Europe in the late seventeenth and eighteenth centuries. An important consequence of these changes was the decoupling of morality from its theological moorings. Subsequently, a new morality, a new "moral sense" emerged anchored on the authority of society, self-love, moral sentiments, and natural sympathy as its sources.[34]

At present, there is a growing general perception of a nexus between the accelerating pace, and widening spectrum, of economic and financial crimes—as well as Zuboff's moral panic regarding the growing banality of these crimes—and moral failure. This perception points to a need for the emergence of a new global moral sense that would motivate strong international cooperation and coordination to lead to collective action that would motivate development of unified legislative, judicial, legal, and other ways and means of preventing economic and financial crimes. The new moral sense would have to satisfy, at least, the two requirements

[32] Ades and DiTella (1997).
[33] Ades and DiTella (1997, pp. 496–497).
[34] Turco (2003).

proposed by Holloway: it would have to be based on the "consent" of all parts of humanity and it would have to be based on the principle of "harm" prevention.

It would seem doubtful whether the two approaches discussed are sufficient to address moral deficits in business relations. Rather, there is a need for an overriding moral principle to make clear that individuals must consider the impact of their actions on others, regardless of the belief held or their ultimate purpose. Such a moral principle could then lead to ethical rules to promote a sense of responsibility that prevents the "narcissistic business model," focused on short-run gains, to lead personal and business life to a race to the bottom.

There is a strong case to bring ethics back into economics and finance, as it has been demonstrated that decoupling morality and ethics from economics and finance could lead to catastrophic damage to society through repeating financial crises, increased financial crimes, and prolonged financial repression. There is a need for re-examination of core economic and financial theories and assumptions in light of morals and ethics, which could make finance more responsible and could lead to the betterment of society.

Whatever the causes in the erosion of morality across cultures, structuring a universal moral principle, acceptable to all members of the human community, will have to form the foundation of effective mobilization of international cooperation in collective action against economic and financial crimes. Abdullah et al. (2015) argue that the "demand" for international cooperation to combat these crimes has not succeeded to elicit the desired results because of the absence of a well-articulated, globally shared moral basis for collective action against economic crimes and therefore such a moral foundation is urgently needed. Given the deep pluralism that characterizes contemporary humanity, this is a daunting challenge.

Although on moral grounds there are many issues and subjects of disagreement, there should be very little doubt about the moral clarity of the harm, pain, and suffering caused by economic and financial crimes and on the need to prevent them. It should not be beyond the realms of possibility to expect the emergence of a universal moral principle, which would serve as the moral foundation of global collective action against these crimes. Simply stated, these crimes are harmful on so many levels that they pose a threat to societies and to humanity. To motivate concerted, coordinated collective action on national and global levels aimed at their prevention and their successful prosecution (when they occur), as well as taking

remedial, restorative action to assist the victims, there is a need for a universal principle that would attract the consent of moral plurality.

The result of post-crisis analyses of the causes of the crisis has led to the emergence of the view that what is now needed is a new framework for ethical business that integrates corporate governance, social responsibility, and sustainability. While it appears that corporate social and environmental responsibility is moving from the margins to the mainstream, there are important challenges. These include:

(a) a bewildering array of international initiatives without an anchor that explains how they relate to one another;
(b) the main driving force of these initiatives seems to be getting businesses to sign onto an initiative without ensuring effective implementation;
(c) lack of credible monitoring and verification mechanism in these initiatives; and
(d) lack of a compensation mechanism for communities harmed by businesses that violate the norms established by these initiatives. Existence of these initiatives seems to validate the claim of the distinction between business and ethics.

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CHAPTER 2

Moral Sense and Ethics in Economics and Finance

The discussion in the previous chapter suggests two major explanations of unethical behavior in the business community. The first focuses on massive changes in social, political, and philosophical thinking of the last few decades that have led to moral disorientation. This view would argue that humans are innately moral and that the present is a period of moral adjustment to shocks originating in rapid technical changes and globalization. However, all the changes held responsible for the present "moral confusion" are expected to continue at their rapid pace and there is no guarantee that their progress will slow in the future. The second view suggests the increase in unethical behavior has resulted from the reorientation of education and practices of the business away from morality and ethics. Countering these trends would require morally and ethically based business curricula, on the one hand, and ethically based business practices on the other. Accordingly, ethics are being taught in business schools as the systematic study of moral principles to determine rules which ought to govern business behavior. The objective being to emphasize that ethics and responsibility are at least as important as profits and that business decision making is an exercise in morality. Whether supplementing regular business schools' curricula with moral and ethical education will correct the perception generally held that corporations and their managers lack a moral compass remains an empirical question that will be answered by the behavior of future business leaders who are now enrolled in such curricula.

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Morals, values, and ethics are related and are interlocking concepts. Whereas morals refer to specific, articulated rules, values refer to the underlying aesthetic valuation or determination of those rules, and ethics refer to the practice of determining which rules should or should not be adopted. For example, the moral "you should feed the hungry" could be accompanied by the value "relieving suffering is good" and underpinned by an ethics that suggests that "those who have more than enough should share with those that do not have enough." The three have something of a symbiotic relationship, which can lead to confusing results if the purpose of one is obfuscated.

Ethics seek to develop moral conduct based on a set of values which determines what is intrinsically right or wrong for a given society. How these ethics are derived from the values is subject to diverse sources and theories. Ethical behavior is also subject to factors such as stage of moral development, personal morals and values, family influences, peer influences, and life experiences of individuals or societies.[1] The study of ethics can be sub-divided into three sub-domains—meta-ethics, normative ethics, and applied ethics. Meta-ethics attempts to understand the metaphysical, epistemological, semantic, and psychological presuppositions and pledges of moral thoughts and practices. Meta-ethics undertakes the study of the linkages between beliefs, causes for action, and human motivation to act right or wrong. Normative ethics generally exemplifies standard, or rule, or principle, in opposition with what is "normal" for people to do, in contrast with what they really do.[2] Normative ethics is in relation with the moral norms and a moral norm is a norm in the sense of being a regulator with which moral agents should comply.[3] Finally, applied ethics is used to apply philosophical techniques to recognize the ethically correct course of action in numerous domains of human life.

Before a theory of business ethics can be developed, it is critical to form a perspective of a moral sense which can provide a philosophical basis for ethical behavior. What values determine the moral sense and how it affects the economic and business behavior is essential to understand. Following section provides such a perspective from the history of economics and raises the question if a universal moral principle can be derived to formulate a theory of business ethics.

[1] Rizk (2008).
[2] Abbas et al. (2012).
[3] Rawls (1971).

2.1 Perspectives on Moral Sense[4]

The eighteenth century may be seen as similar to the latter decades of the twentieth century and at least the 16 years of the twenty-first century because of the rapid changes that took place over 200 years ago, which called for a "synthesis between a number of developing oppositions that were increasingly being felt in social life."[5] As Seligman has observed, the developing oppositions in the eighteenth century that were between "the individual and the social, the private and the public, egoism and altruism, as well as between a life governed by reason and one governed by passion, have in fact become constitutive of our existence in the modern world."[6] The major social change from a feudal society to a market society and the "emergence of capitalist market relations, with its distinction between public and private, posed a new set of problems for the conception of the social order" in need of articulation of new moral vision. "The freeing of labor and capital developed together with a new awareness of individuals acting out their private interests in the public realm."[7] Social action and motivation were being based on self-interest. A new moral order was required that was founded on rational self-interest rather than on "a shared vision of cosmic order."[8]

Accordingly, the new "moral sense," a term first coined by Francis Hutcheson, "the first Scottish philosopher to approach the problem of the foundation of morals in an original way,"[9] was based on moral sentiments, self-love, and natural sympathy. Moral sentiments were an axiomatic property of the human mind that united humans "by instinct, that they act in society from affections of kindness and friendship."[10] Self-love "is the natural inclination to pursue the pleasures provided by external objects, or the means that is used to satisfy it."[11] Sympathy is a feeling through which "we participate in others' feelings."[12] Fundamental to this moral sense is the idea of benevolence which according to Hutcheson was the object of moral sense, and is what drives individual to "seek the natural good or

[4] Mirakhor (2016) and Abdullah et al. (2015).
[5] Seligman (1992, p. 25).
[6] Seligman (1992, p. 25).
[7] Seligman (1992, p. 25).
[8] Seligman (1992, pp. 25–26).
[9] Turco (2003, p. 138).
[10] Adam Ferguson, cited in Seligman (1992, p. 27).
[11] Turco (2003, p. 138).
[12] Turco (2003, p. 145).

happiness of others."[13] Indeed, Hutcheson argued that human nature itself "included a moral sense which recognized benevolence as the core of moral action; further that when the moral sense is enlightened and not distorted by selfish passion, a person's judgment and behavior will tend to contribute to the overall happiness of society and humanity. In other words, harmony between the moral life of the individual and perfection of moral community is a possibility and, hence, a moral, ultimately a religious, duty for humanity."[14]

In *The Theory of Moral Sentiments*, Adam Smith argued that "recognition" and "appreciation" by others were the primary motivator of "all toil and bustle of the world" and that it was man's interest in "being the object of attention and appreciation" that motivated all economic activity. This innate need for mutual sympathy and recognition constituted the foundation of morals for individuals and motivated their economic activity.[15] It bears keeping in mind that, as Seligman points out, while the fathers of the Scottish Enlightenment decoupled morality from theology, they did not dispose of the Deistic or transcendent source of all things: "The Author of Nature" in Adam Smith's terminology.[16] Anthony Ashley Cooper, the Third Earl of Shaftesbury, who greatly influenced Hutcheson and Adam Smith, argued—in response to Hobbes's theory that human nature is fundamentally selfish—that God provided human nature with a number of generous forms of affections that predisposed humans to live together. Humans are also provided with natural capacity to be attracted to positive affections and repelled by negative affections.[17] In his book, *Inquiry into the Original of our Ideas of Beauty and Virtue*, Hutcheson argues that God is the source of "moral sense" to direct human action. Moral sense, he asserts, is common to mankind and is independent of an individual's will, "It is immediate, that is to say, its deliverances are not mediated by consideration of personal advantages or harm…As every man has a capacity to make moral distinctions, so the weight of moral virtue is within the competence of every man." Hutcheson concludes: "Moral excellence can be attained by any person, independently of his learning, power or riches."[18]

[13] Turco (2003, p. 141).

[14] Haakoson in Bradic, ed., (2003, p. 209).

[15] Adam Smith (1982, p. 50), Seligman (1992, pp. 27–28), Evensky (2005), Weinstein (2007), Beisner (2012).

[16] Adam Smith (1982).

[17] Robertson (1964). Earl of Shaftesbury. Cited in Turco (2003, p. 136).

[18] Hutcheson (1725), cited in Turco (2003).

In spite of (or perhaps because of) the evolution of the conception of morality over the past two centuries, Scottish Enlightenment has found resonance in contemporary thought. One of the most famous American contemporary thinkers, James Q. Wilson, whose theory of broken windows makes a compelling, spirited, and articulate case in his book *The Moral Sense*: humans do indeed have an innate capacity to make moral judgments. This is a counter-position to that of moral relativists' conviction that not only morality but also human nature itself is a product of culture. As Geertz asserted in 1973, "There is no such thing as a human nature independent of culture."[19] Three years later, Foucault went even further suggesting that even man "is an innovation of recent date and one perhaps nearing its end."[20] Another philosopher, Richard Rorty, has asserted that humans do not even possess anything like a "core self" and that there are no such things as "moral facts." He posited further that there is no "neutral ground on which to stand and argue that either torture or kindness is preferable to the other." Rorty argued: "Human beings must stop looking for some non-human or extra-human reality, such as God, nature, spirit, matter or even human nature; for something-in-itself that, though entirely independent of human knowing, would nonetheless provide us with universal laws for governing our actions and our thinking."[21]

To all this, Wilson replies: "Humans do have a core self, not wholly the product of culture"[22] that has "a capacity to judge disinterestedly" how its "interests ought to be advanced." He further argues that even in the face of moral confusion, most humans have no difficulty experiencing the

[19] Geertz (1973).

[20] Foucault (1973, p. 387). See also Robinow (1984).

[21] Metcalf (2007).

[22] Decades earlier Noam Chomsky (1974), had reached the same conclusion. He argued that there must be a "mass of schematics, innate governing principles, which guide our social and intellectual behavior…there is something biologically given, unchangeable, a foundation for whatever it is that we do with our mental capacity." Therefore, there must be a human nature (Chomsky 1974, pp. 136–140). For Chomsky, "Unless there is some form of relatively fixed human nature, true scientific understanding is impossible." Robinow (1984, p. 1). Some scholars go further to argue that humans have a moral conscious that "draws its existence rather from that ethical totality which derives from the inner law of our being permitting us to fulfill our entelechy, to become what we are, and what we dare not betray. The moral conscious is that ontological truth of man's nature, the microcosmic reflection of the cosmic principle, the inner law of universe, which is the ethical demand we must have the courage to face, naked and unafraid." Anshen (1952, p. 3).

world as an arena of moral choices where human moral sense asserts itself in daily life. Reflecting Adam Smith and Francis Hutcheson, Wilson contends that "people have a natural moral sense" composed of sympathy, fairness, self-control, and duty. These, he argues, make the moral sense universal because they exist in various degrees in every culture. He notes however that humanity "has a moral sense, but much of the time its reach is short and its effect uncertain." He warns that humans take centuries to create a new culture of commitment to morality, but once created, such a culture can be destroyed in "a few generations. And once destroyed, those who suddenly realize what they have lost will also realize that political action cannot, except at a very great price, restore it."[23]

George Kateb, another contemporary scholar, echoes Wilson in his book *Human Dignity*. He argues that morality needs no justification, particularly "against relativists." He considers relativism as meaning "that there is no such a thing as morality; there are only different codes... There are no principles of morality that are universally accepted or nearly so, and there is no way of proving that one set of principles is correct and other sets are mistaken." In a counter-position, Kateb argues: "There is sufficient continuity throughout recorded history in what counts as fundamentally right or moral, despite differences in interpretation and application." Given the fact of wide acceptance of morality, no proof is needed as "there can be no other proof of the validity of a moral precept than the quite common and fairly steady acceptance of it by people all over the world, for as long as there has been moral reflections…No transcendent instruction is needed: it is not even a question of human discovery, but a sensitive awareness of the obvious that gradually accumulates adherence."

Holloway suggests two conditions for such a moral principle. First it should focus on preventing harm and second it must attract universal consent. What is most relevant to this discussion is Kateb's position: "Pain and suffering are the central moral concern, and that efforts to prevent or reduce it preoccupy moral agents. Yes, the center of morality is remedy, where possible, for humanly caused suffering that seems needless and dispossesses human beings of what is their desire or that neglects to preserve them in it."[24] As we indicated earlier, enormous pain and suffering are perpetrated upon victims of economic and financial crimes. The moral

[23] Kimbal (1993), Raksin (1993).
[24] Kateb (2011, p. 43).

principle advocated by Kateb, Holloway, and others is to prevent harm, pain, and suffering as much as possible and to remedy their effects whenever necessary.

2.2 Search for a Universal Moral Principle

Searching for a simple and universal moral principle would seem challenging, given the enormous changes brought about by ongoing globalization, the technological revolution proceeding in different fields—such as biotechnology, molecular biology, computer science, artificial intelligence, communications, material science, nanotechnology, robotics, finance, and many more—and the plurality of moral perspectives characterizing contemporary humanity.

Concurrent with the dream of one world government, there was another dream: the dream that humans could think of themselves as members of single community "on the basis of a *single ethical system*, while retaining cultural pluralism and individuality."[25] As witnessed, both dreams of establishing a world government and a single ethical system have failed to materialize as the memory of war receded and urgency gave way to business and politics as usual. However, as part of the search for a "single ethical system," one idea that has proved its enduring historical appeal to mankind resurfaced and has stayed on the moral radar for most of humanity. In an essay published in 1952 and titled: "the Deep Beauty of the Golden Rule,"[26] Robert M. MacIver, then Professor of Political Philosophy and Sociology in Columbia University, raised the question: given the plurality, diversity, and relativity of ethical, moral values, is a universal moral, ethical principle based on reason alone, and applicable to all "in this world of irreconcilable valuation," possible? He responded: "There is no rule that can describe both my values and yours or decide between them. There is one universal rule, and only one, that can be laid down, on ethical grounds—that is, apart from the creeds of particular religions and apart from the ways of the tribe that falsely and arrogantly universalize themselves. *Do to others as you would have others do to you.* This is the only rule that stands by itself in the light of its own reason, the only rule that can stand by itself in the naked, warring universe, in the face of the contending values of men and groups."[27]

[25] Anshen (1952, p. xi).
[26] MacIver (1952, p. 41).
[27] MacIver (1952, pp. 41–42).

MacIver argued that the word “universal,” as he used it, “is one of procedure. It describes a mode of behaving, not a goal of action. On the level of goals, of final values, there is irreconcilable conflict.” Humans hold different principles, which they wish to become universal and try to “convert” others. “Others will certainly resist and some will seek to persuade us in turn—why shouldn’t they? Then we go no further except by resort to force and fraud. We can, if we are strong, dominate some and we can bribe others. We compromise our own values in doing so and we do not in the end succeed; even if we were masters of the whole world we could never succeed in making our principle universal. We could only make it falsely tyrannous.”[28] How prophetic indeed when one considers the history of imposition of standards, codes, and conventions designed unilaterally by the rich and powerful and then “encouraged” on the rest of humanity to sign on through sheer power, “bribes,” threats and intimidation. MacIver appeals for adoption of a different strategy: “So if we look for a principle in the name of which we can appeal to all men, one to which their reason can respond in spite of their differences, we must follow another road. When we try to make our values prevail over those cherished by others, we attack their values, their dynamic of behavior, and their living will. If we go far enough we assault their very being. For the will is simply valuation in action.”

Now the deep beauty of the golden rule is that instead of attacking the will that is in other men, it offers their will a new dimension. “Do as you *would* have others…,” as you would will others do. It bids you to expand your vision, see yourself in new relationships. It bids you to transcend your insulation, see yourself in the place of others, see others in your place. It bids you to test your values or at least your way of pursuing them. If you would disapprove that another should treat you as you treat him, the situations being reversed, is not that a sign that, by the standard of your own values, you are mistreating him? This principle makes for a vastly greater harmony in the social scheme. At the same time, it is the only universal of ethics that does not take sides with or contend with contending values. It contains no dogma. “It bids everyone follow his own rule, as it would apply apart from the accident of his particular fortune.” Our sole concern is to show that the golden rule is the *only* ethical principle, as already defined, that can have clear right of way everywhere in the kind of world we have inherited. It is the only principle that allows every

[28] MacIver (1952, p. 41).

man to follow his own intrinsic values while nevertheless it transforms the chaos of warring codes into a reasonably well-ordered universe.[29] MacIver ends his essay citing Jesus: "All things therefore whatsoever ye would that men should do unto you, even so ye also unto them; for this is the law and the prophets."[30]

2.2.1 Golden Rule in Historical Context

There has been considerable research on the history of the golden rule dating back to Babylonians, Confucius, ancient Egypt, Greece, Rome, Persia, European Middle Ages to the writings of contemporary philosophers, scholars of law, and social scientists. Research has also shown evidence that the golden rule is considered sacred in nearly all religious traditions including Hinduism, Zoroastrian, Buddhism, Judaism, Christianity, and Islam. All traditions consider avoidance of harm a duty.

The golden rule is found in both positive and negative forms. Historically, the negative form of the rule is traced to Confucius who is reported to have been asked: "Is there a single word that can serve as the guiding principle for conduct throughout one's life?" Confucius replied: "Perhaps it is *Shu,* 'Consideration.' Do not impose on others what you do not desire others to impose upon you."[31] The rule appears in its negative and positive forms in all systems of thought throughout history.[32] One of the most powerful appearances of the negative form of the golden rule is reported in the following incident involving Rabbi Hillel, a contemporary of Jesus: "On another occasion it happened that a certain heathen came before Shammai and said to him, 'Make me a proselyte, on condition that you teach the whole Torah while I stand on one foot.' Thereupon he [Shammai] repulsed him with the builder's square which was in his hand. When he went before Hillel, he [Hillel] said to him, 'what is hateful to you, do not do to your neighbor:' that is the whole Torah, while the rest is commentary thereon; go and learn it."[33]

Not only did the rule resonate clearly and loudly among the followers of Jesus, in his words, especially in his Sermon on the Mount, it was raised

[29] MacIver (1952, p. 42).
[30] MacIver (1952, p. 42).
[31] Allinson (1985), King (1928), Hummel (1952), Confucius; Csikszentmihalyi (2008).
[32] Abdullah et al. (2015).
[33] Wattles (1996, p. 48), Muilenburg (1952), Allinson (2003), Levine (2008), Samuels (2011).

to a much higher and more substantive pitch. In the words of Jesus, the rule transcended the reciprocity of a mutual relation with one's neighbor to extending love to that neighbor.[34] Accordingly, Paul Ricoeur argues that the golden rule implies, or establishes, reciprocity between the doer of an action and the person acted upon. This reciprocity "implies equality between the parties concerned: If I treat others as I would wish them to treat me, then that presupposes that they will treat me as I would treat them, creating a social contract between equal parties."[35] Furthermore, in contrasting the golden rule with the principle of "love your neighbor," Ricoeur suggests that the former is ethical and the latter is "hypothetical." The former, he argues, can be interpreted as being limited to a mutual reciprocal arrangement: "I will only do this for you if you do something for me." The latter, however, has the logic of generosity, benevolence, and altruism where one gives more than another deserves.[36]

Gensler (2013) provides an in-depth historical chronology of the golden rule throughout the human civilizations, some of which are re-produced in "Annex I" of this chapter to demonstrate the long history of acceptance and application of this universal rule. Select variations of the golden rule from a number of world religions and traditions as listed and compiled by well-known management guru John C. Maxwell (2003) are summarized in Table 2.1.

2.2.2 The Golden Rule as Universal Moral Principle

Certainly much has been written on the golden rule both before and after MacIver's essay, but few have been so succinct, clear, and forceful defense of the rule as a universal moral principle. There have been a number of credible theses on the history of the golden rule dating back to the Babylonians. Others have investigated the philosophical, psychological, sociological, theological, and political implications of the rule across cultures throughout history. Intense debates have taken place between opponents and proponents of the rule as a moral principle applied to issues such as abortion, euthanasia, sexual orientation, and a host of other issues with moral implications. There has also been a growing literature on the application of the rule in legal and judicial proceedings. Nevertheless,

[34] Wattles (1996, pp. 52–66), Kirk (2003), Chiton (2008).
[35] Ricouer (1992, 1995), Simms (2004 p. 117).
[36] Simms (2004, p. 117).

Table 2.1 Select variation on the golden rule

Tradition	*Golden rule quote*
Bahai	And if thine eyes be turned towards justice, choose thou for thy neighbor that which thou choosest for thyself
Buddhism	Hurt not others with that which pains yourself
Christianity	Whatever you want men to do to you, do also to them
Confucianism	What you do not want done to yourself, do not do to others
Hinduism	This is the sum of duty; do naught unto others what you would not have them do unto you
Islam	No one of you is a believer until he loves for his neighbor what he loves for himself (Sahih Muslim, 45)
Jainism	A man should wander about treating all creatures as he himself would be treated
Judaism	What is hateful to you, do not do to your fellow man. This is the entire law; all the rest is commentary
Yaruba proverb (Nigeria)	One going to take a pointed stick to pinch a baby bird should first try it on himself to feel how it hurts
Zoroastrianism	Whatever is disagreeable to yourself, do not do unto others

Source: Maxwell (2003)

the adequacy of the knowledge of and understanding of the golden rule by the general public is questionable. In the preface to his book *The Golden Rule,* Jeffrey Wattles asks:

> How is one to move beyond shock and cynicism as one confronts the evidence of moral decline in society? What reaction comes more easily than to blame *them*? We may be driven to act on the tendency to separate humankind into two camps—those who are the problem and those of us with higher standards—but such is not the ultimate solution. I believe that we can learn to relate more humanely and reach out more effectively by discovering the golden rule. The need even for morally active people to discover the rule is greater than I realized over a decade ago when I began my research. I used to assume that nearly everyone was raised so that when they heard the phrase "the golden rule" they could supply a principle worded, approximately, "do to others as you want others to do to you." I also assumed that nearly everyone who heard that principle spelled out had a roughly accurate initial grasp of its meaning. And I assumed that those who thought highly of the principle would occasionally spend time thinking about how to apply it. I have not made a scientific survey and would not hazard an estimate in percentage term, but my experiences talking about the rule with individuals and groups during the past years incline me to doubt

> these assumptions. A volunteer soliciting contributions for an environmental group guessed that the golden rule was "An eye for an eye and a tooth for a tooth." A reporter misquoted the rule: "Do to others as will be done to you." Given the correct formulation, two students debated at length with their professor that the rule meant the same as the motto "Get even." A pastor's wife doubted that the rule was biblical. Philosophers often distort the rule and dismiss it, while others who prefer a charitable interpretation find no reply.[37]

Wattles argues that the rule is intuitively easy to grasp, has immediate intelligibility, and is obvious and self-evident. "I know how I like to be treated; and that is how I am to treat others. The rule asks me to be considerate of others rather than indulging in self-centeredness."[38] Wattles reviews the historical development of the golden rule from Confucius, ancient Greece and Rome, the Jewish Tradition, New Testament, European Middle Ages through to the writings of twentieth century scholars. He concludes: "The golden rule is, from the first, intuitively accessible, easy to understand; its simplicity communicates confidence that the agent can find the right way…the rule is a principle in a full sense. Even before it is formulated, its logic operates in the human mind. Once formulated, it shows itself to be contagious and quickly rises to prominence. It functions as a distillation of the wisdom of human experience and of scriptural tradition… Much of the meaning of the rule can be put into practice without any religious commitment, since it is a non-theological principle that neither mentions God nor is necessarily identified with the scriptures or doctrines of any religion. The rule is an expression of human kinship, the most fundamental truth underlying morality… 'Do to others as you want others to do to you:' is part of our planet's common language, shared by persons with differing but overlapping conception of morality. Only a principle so flexible can serve as a moral ladder for all humankind."[39]

A number of scholars have developed dimensions of behavior that could be subjected to the golden rule. For example, the rule could be applied to specify the "rights of personhood." Alan Gewirth suggests that the golden rule could be interpreted as: "Do unto others as you have a right that they do unto you." He defines a set of rights he refers to as

[37] Wattles (1996, pp. v–vi).
[38] Wattles (1996, p. 3).
[39] Wattles (1996, pp. 188–189).

"generic rights." They include "life and physical integrity" and prohibition against "lying, stealing, and promise-breaking."[40] In the context of generic rights, Gewirth's formulation of the golden rule becomes: "Act in accord with the generic rights of your recipient as well as of yourself."[41] John Finnis goes further in specifying rights in terms of what he calls "basic human goods" that are "irreducible" aspects "of the fulfillment of human person." These are "substantive" basic goods which "correspond to the inherent complexities of human nature, as is manifested both in individual and in various forms of community." The important function of moral norms is to identify these basic goods. Moral norms being "prohibitions on killing, theft, acts of dishonesty, and other similar negative and positive precepts the capricious contravention of which anyone would consider immoral."[42]

One category of such basic goods is human "life in itself, in its maintenance and transmission, health and safety." There are other basic goods Finnis calls "reflexive basic goods." These goods allow humans to become "active persons, acting through deliberation and choice." They include goods that are various forms of harmony and peace. In turn, these include "peace of conscious," which allows one to create consistency between "one's self and its expression," inner peace, peace with others and "peace with whatever more-than-human source of reality, meaning, and values one can discover." These two types of basic goods constitute the "integral human fulfillment."[43] Finnis formulates a version of the golden rule which he calls "the first and most abstract principle of morality" as follows: "In voluntarily acting for human goods and avoiding what is opposed to them, one ought to choose and otherwise will those and only those possibilities whose willing is compatible with integral human fulfillment."[44] He argues that to "do evil" is "to destroy, damage, or impede a basic human good."[45] To intentionally harm a basic human good is "never acceptable for God or man."[46]

The same degree of universality inherent in the golden rules exists for these "basic human goods" and "generic rights" defined by Gewirth and

[40] Gewirth (1978).
[41] Gewirth (1978, p. 135).
[42] Finnis (1991, p. 42).
[43] Finnis (1991, p. 45).
[44] Finnis (1991, p. 45).
[45] Finnis (1991, pp. 54–55; 71).
[46] Finnis (1991, pp. 74–75).

Finnis. Every system of thought ancient or contemporary, religious or secular, contains moral norms prohibiting their violation. In one form or another, in one degree or another, their sanctity is affirmed by all cultures and societies constituting humanity. As referenced earlier, Confucius advised to avoid "harm." Rabbi Hillel defined the essence of the teaching of Torah as avoiding "harm" to others. A study of prophecy in ancient Israel reveals the intense concern of the prophets with harm to human dignity, trust, contract, and property.[47] Teachings by rabbis reinforced and further explained the concerns of the prophets. The teachings of Jesus transcended "not doing harm" to one's neighbor to extending "love" to that neighbor.[48] Just as in other Abrahamic traditions, Islam, clearly and unambiguously, considers violations of these four "basic goods" as transgressions against moral norms, laws, and prohibitions ordained by the Creator.[49] Similar positions on the non-violability of these rights are discernible in Hinduism,[50] Buddhism,[51] Zoroastrian,[52] and in ancient Greek, Roman,[53] and Egyptian[54] thought. Earlier, references were made to non-religious, secular thought where "harm," and its avoidance, was the crucial pivot of the universalization of moral principles.[55]

Given the universality of the golden rule, the condition of universal consent seems to be met by the rule. Moreover, the Oxford philosopher R.M. Hare argued that the rule possesses two logical features: universalizability and prescriptivity.[56] The former suggests that by making a moral judgment, one gives another person the right to the same in a similar situation. Prescriptivity means that one's action is consistent with one's moral

[47] Lindblom (1967), Unterman (1959), Tamari (1987), Sachs (2012).

[48] Dodd (1952), Neibuhr (1952), Ricoeur (1990), Finnis (1991), Ricoeur (1995, 2000), Kirk (2003), Donders (2005), Chilton (2008).

[49] Khan (1952), Hakim (1952), Rahman (1985), Engineer (1990), Fakhry (1991), Al-Attas (1992), Zaroug (1999), Naqvi (2003), Oh (2007), Abuarqub (2009), Mirakhor and Hamid (2009).

[50] Nikhilananda (1952).

[51] Suzuki (1952), Hummel (1952), Hallisey (2008), Scheible (2008).

[52] Moazami (2008), Rost (1986).

[53] Rosemont (1999), Dewald (2008), Berchman (2008).

[54] Rosemont (1999), Dewald (2008), Berchman (2008).

[55] Northrop (1952), Sacks (1952), Linton (1952), Von Fritz (1952), Maritian (1952), Baier (1958), Brandt (1961), Gellner (1992), Gensler (1996), Holloway (1999), Blackburn (2001), Epstein (2010), Kateb (2011).

[56] Hare (1981) R.M. Hare, Moral Thinking: Its Levels, Method, and Point, Oxford: Oxford University Press, 1981.

judgment. This means that by prescribing to themselves, individuals commit themselves to doing what their judgment requires. In absence of obstacles, individuals must act in conformity with their prescription. The rule contains characteristics of being able to be universalized and consistent. It is not an exaggeration then to suggest that there is no other moral principle that comes even close to being as simple, universal, fair, consistent, reciprocal, and prescriptive yet non-dogmatic, while having roots in all world religions, as the golden rule. It seems self-evident that the rule meets the conditions of universal consent.

2.3 Applying Golden Rule to Economics and Finance

Either in its positive or negative form, the golden rule can serve the purpose of forming the moral foundation of ethical business. A number of contemporary scholars have developed dimensions of behavior subject to the application of the golden rule.

Every system of thought, ancient or contemporary, religious or secular, contains moral norms prohibiting their violation. In one form or another, in one degree or another, their sanctity is affirmed by all cultures and societies constituting humanity. A study of prophecy and ancient Hebrew law reveals the intense concern of the prophets with harm to human dignity, trust, contract and property. Teachings by rabbis reinforced and further explained the concerns of the prophets. The teachings of Jesus transcended “not doing harm” to one’s neighbor to extending “love” to that neighbor. Just as in other Abrahamic traditions, Islam, clearly and unambiguously, considers violations of these “basic goods” as transgressions against moral norms, laws, prohibitions ordained by The Creator. Similar positions on the non-violability of these rights are discernible in Hinduism, Buddhism, Zoroastrian, and in ancient Greek, Roman and Egyptian thought (Abdullah et al. 2015).

The golden rule is not the same as the typical economic view, in which the agent is less concerned with how the other should be treated but rather assumes that the other party is driven by self-interest and therefore is protecting him- or herself. In some sense, the difference in economic and ethical perspectives on life is the difference between expecting to be treated the worst and expecting to be treated kindly. “Do as you would have others…” As you would will others do. It bids you expand your

vision, see yourself in new relationships. It bids you transcend your insulation, see yourself in the place of others, see others in your place. It bids you test your values or at least your way of pursuing them. If you would disapprove of another person treating you as you treated him or her, the situations being reversed, is not that a sign that, by the standard of your own values, you are mistreating that other person? This principle makes for a vastly greater harmony in the social scheme. MacIver ends by citing Jesus: "All things therefore whatsoever ye would that men should do unto you, even so ye also unto them; for this is the law and the prophets." MacIver (1952, #47).[57]

Clearly, the "narcissistic business model" that led to the damage to life, property and the overall well-being of so many violated the rights of the human person defined by Gewirth and Finnis. Premeditated actions stemming from the breakdown of morality represented assault upon human dignity, trust, contract and property which define basic human goods. The same degree of universality inherent in the golden rule exists for these basic human goods. As argued earlier, every system of thought, ancient or contemporary, religious or secular, contains moral norms prohibiting their violation. In one form or another, in one degree or another, their sanctity is affirmed by all cultures and societies. The golden rule prohibits harm to these basic goods. Kenneth Costa argued that "the debt crisis simply would not have happened had The Golden Rule been universally followed." One may add that had the golden rule been followed universally, wealth and income inequality and poverty would not have been as glaring as observed today across the world mainly due to the fact that a corollary of the rule requires that one sees oneself in place of "the other." This is the notion of empathy and "sympathy" as the cornerstone of Adam Smith's idea of how public and private interests could converge in a "commercial" or capitalistic society.

Universal adherence to the golden rule could have a significant impact on inequality and poverty. The need to find ways and means of slowing the intensity of the present inequality and alleviate poverty has become a major concern of policy makers. Various solutions have been proposed. One was offered by His Royal Highness (HRH) Sultan Nazrin Shah in a presentation to the 2014 session of Khazanah's *Megatrends Forum*.[58] In this presentation, HRH argued that inequality and exclusion are threats to social solidarity. Inequality squeezes out the middle class which is the backbone

[57] The quote is from Matthew 7:12. (see Abdullah et al. 2015).
[58] Shah (2014).

of the sustainability of the economic system as it is the source of innovation and entrepreneurship, the most important elements of the dynamism of capitalism. It also allows social mobility that gives hope and aspiration to lower income groups in the society. Without innovation, entrepreneurship, and social mobility the economic system becomes sclerotic and unstable. He suggested that solutions to inequality, poverty, and environmental degradation require reorientation of business and economic activities through three paradigm shifts:

(a) from production to preservation;
(b) from maximization to optimization; and
(c) from ownership to stewardship.

It should not be difficult to envision how each of these paradigm shifts would serve the requirement of the golden rule applied to present and future generations since each of them would require treating others as one would will it to become a universal law. This would mean treating others as ends in themselves and never as means to an end, as Immanuel Kant's version of the golden rule would have it.

In the context of economic and financial crimes, the selection of the golden rule as the universal principle of morality would mean that since these crimes do harm to everyone, each member of the global community has a reciprocal duty to ensure that no other member of the community is harmed as a result of these crimes. Some of the important characteristics of the golden rule are its simplicity, impartiality, consistency, reciprocity, and fairness. As Wattles suggests, the golden rule "interpreted by moral reason requires an even-handed consistency" and this "consistency blocks hypocrisy and promotes harmony of thought, word and deed. In modern rational ethics, the special point of consistency is to be impartial in application of principles." He argues that impartiality can only be important and matter if the "equal basic" worth of each person has been a priori affirmed and that is what the golden rule does "as it equates the value of the self and other."[59] Contrast this to the present state of the international combat against economic crime. Nearly all the standards, codes, and conventions deal with the prevention of crimes that in the perception of powerful members of the international community primarily harm them. As evidenced by decades of ignoring the pleas of poorer and less powerful

[59] Wattles (1996, p. 180; p. 80, pp. 122–140, p. 7).

members for international cooperation in combating economic and financial crimes that harm them, it appears that the rich and powerful are saying: "I demand that you cooperate with me to prevent what harms me but I do not care about what harms you."

In the context of economic and financial crimes, the above arguments would suggest a moral principle on which international cooperation for collective action against economic crimes could be based. The reasoning of the golden rule could be formulated as: "A nation would not want that other nations are harmed by economic and financial crimes." Just as one nation would be pleased that it is not a victim of a particular economic crime, it should want to participate in international efforts to prevent other nations from being harmed by that same crime. Given this moral foundation, domestic and international legislation, law, standards, codes, and conventions can be created that stipulate how specific crimes are to be treated, prevented, and prosecuted.

In the present context, "generic rights" and "basic goods" defined by Gewirth and Finnis, respectively, to specify the rights of the human person would be violated by economic crimes. These ideas can be further tailored specifically to reflect what the victims of economic and financial crimes have described as their rights that have been violated. As mentioned earlier, the long list of harms that victims suffer can be classified into four categories: assault upon human dignity; assault upon trust; assault upon contract; and assault upon property. These four categories would then define the "generic rights" and the "basic goods" that constitute "the integral human fulfillment."

2.4 Theories of Business Ethics

Whereas vast literature is available on the morality and ethics as a discipline of philosophy, application of such to business is relatively new. As modern business becomes more complex, it raises several ethical issues which are then subject to debate. Each theory of business ethics is driven by certain underlying philosophical foundation justifying the moral principles and values to determine the applicable ethics to resolve business issues. There are at least three major theories of business ethics which have emerged in the last couple of decades.[60] The philosophical perspectives underlying

[60] Ali (2014).

each business ethics theory are (a) teleological; (b) deontological; and (c) virtue ethics.

The term teleological is derived from the Greek work *telos* meaning goal or purpose. This perspective is considered a "consequences-oriented" approach primarily focusing on the significance of consequences or results in determining if a certain act is acceptable or not. Therefore, the ethical test of a business decision to be ethical depends primarily on the outcome of that particular action. Two sub-theories derived from this perspective are egoism and utilitarianism.[61]

In contrast to the teleological perspective, deontological ethics (derived from the Greek word *deon* or duty) places emphasis not on the outcome but on certain duties and responsibilities. Deontologists base their judgments on a set of "moral rights" people are believed to possess; in other words, any individual has a right to be treated in ways that ensure his dignity, respect, and autonomy. The rights driven or Kantian Model, named for Immanuel Kant, rests on the assumption that every person has basic rights in a moral universe, and accordingly, an action is morally correct if it minimizes the violation of the rights of all stakeholders. Intentions are central to the deontological approach, as they determine whether or not business decisions are ethical or unethical. Only when members of the business community act from duty do their actions have moral worth.[62] An action is not considered worthy of moral right if it is taken out of self-interest as compared to one which is taken from a deep sense of duty.

Unlike deontological and teleological approaches, virtue ethics is embedded in the values and beliefs that one subscribes to. It seeks to highlight the virtues that lead to a meaningful and rewarding life. How these are acquired, developed, and evolved is part of the domain of –ethics. Since virtue ethics do not exist independently of the society and the environment where a person lives, virtue ethics tend to be numerous and may differ, in priorities, among societies. Virtues are good habits that must be practiced. Virtue ethics, therefore, differs from previous theories as it primarily revolves around individual character, attitudes, and other dispositions and preferences, including values and guiding norms. These qualities can be taught and acquired, which can induce the business community in general to behave in an ethical way.[63] Merely having an understanding and

[61] Ali (2014).
[62] Ali (2014).
[63] Ali (2014).

knowledge of virtues is not sufficient, but the key to good ethics is determined by the degree by which such virtues are internalized by individuals and organizations.

Virtue ethics emphasizes the virtues, or moral character, in determining the morality of actions. While teleology is concerned with the result of an action and deontology with the intent, virtue ethics is concerned with the character of the actor and how it fits within a holistic view of society at large. For example, say that it can be agreed that a particular person in need should be helped. A teleological approach, like utilitarianism, would argue that you should help that person because the cost of you helping that person is less than the value that person gets from being helped. A deontological approach would argue that you should help that person because it is your duty to do so. A virtue ethics approach would argue that you should help that person because doing so would be charitable or benevolent, characteristics that individuals in an ideal society should display.

A virtue is a good trait of character, so well-entrenched in an individual that it influences which actions he or she wishes to take. For example, honesty is a virtue. An honest person is one who tells the truth simply because he likes truth and dislikes dishonesty. An individual is not an honest person if they avoid dishonesty out of fear of being caught and punished, nor are they honest if they have to override their natural inclination to be dishonest in conformity with a grander narrative of morality or duty.

Virtue ethics focuses on identifying which characteristics should be taught and acquired. Within the business context, the goal is for those involved in market decision making to properly internalize the appropriate virtues. Of course, virtues sometimes contradict one another and a characteristic that might be a virtue in one context or culture might be a vice in another. For example, frugality might be a virtue when running a business but a vice when helping the needy. Acceptance is a virtue, except when the situation calls for assertiveness. Depending on the culture, justice or mercy could be the appropriate virtue when dealing with an individual who has committed an offense.

Virtue ethics is concerned with the type of person we should be in the context of our relations with others and our positions in society. Virtue ethics, therefore, differs from other theories, as it primarily revolves around individual character, attitudes, and other dispositions and preferences, including values and guiding norms.[64] The characteristics of consistency,

[64] Mirakhor (2016).

impartiality, reciprocity, and fairness become the foundation of moral reason and the justification for claims that the golden rule is the only moral principle and virtue that can attract universal adherence and the basis of business ethics.

2.4.1 What Is Virtue Ethics?

The virtue theory of ethics is widely recognized as a workable model which can be the basis of ethics in business. Virtue ethics—the study of moral character—has been an important strand in moral philosophy for literally thousands of years, but has received little attention from contemporary economists.[65] Virtue theory of ethics advocates developing and strengthening certain desirable virtues and avoiding certain undesirable vices in order to achieve higher goals of a society or organization. The ethicist who relies upon a theory of virtue has a rich history of philosophical thought from which to draw, though theories of virtue with specifically commercial applications are fairly recent. Several modern thinkers—David Hume, Adam Smith, Samuel Smiles, Robert Solomon, and Deirdre McCloskey—base their writings to application of virtue to commerce. Despite challenges, virtue theory provides a plausible model for considering how one may conduct business in an ethical and successful manner.[66]

The guiding principle underlying the theory of virtue is how one is to live and therefore such a theory should also be applicable to how one ought to create, produce, and exchange. The key element is a powerful emphasis on ***being rather than doing*** such that right actions arise only from persons who have good qualities of character. Virtues are acquired character traits or dispositions that are judged to be good. In virtue ethics, actions are judged to be good because they are in character for a virtuous person—they are constitutive of living well, of "flourishing." A morally well-constituted individual cultivates virtues not as rules of thumb for moral action, but because such virtues are characteristic of the kind of person she is or wants to be.[67]

The theory of virtue ethics can be applied to business in various ways. For example, market conduct and operations could be based on the virtue of universality such that the disposition would be to make mutually

[65] Bruni and Sugden (2013).
[66] Heath (2013).
[67] Bruni and Sugden (2013).

beneficial transactions with others on terms of equality. If the market is to be viewed as an institution with the objective to provide the widest possible network of mutually beneficial transactions, universality has to be seen as a virtue. Its opposites—favoritism, patronage, protectionism—are all barriers to the extension of the market and therefore are vices to achieve universality of markets.[68]

The idea that markets rely on trust and trustworthiness has a long history in economics, especially when discussing enforceability and monitoring of contracts. Smith (1763 [1978], pp. 538–539) recognizes the importance of "probity" for the workings of markets and describes this trait as a "virtue." Significantly, Smith sees this virtue as consistent with long-term self-interest. The idea that commercial transactions typically depend on an element of trust has continued to be recognized by leading economists such as Marshall (1920), Arrow (1984), and Ackerlof (1982) whose work incorporates trust relationships in their economic models.[69]

The virtues of sympathy and benevolence are important in Smith's earlier work *The Theory of Moral Sentiments*, even though they play only minor roles in his economic analysis. And for Smith, self-interest expressed within the rules of a commercial society is not opposed to virtue. To the contrary, character traits associated with the pursuit of long-term self-interest, particularly prudence, temperance, and self-command, are virtues.[70]

Virtues of integrity and honesty are regarded as key elements of the mission statements of a large number of corporations. For example, a review of the codes of conduct of major organizations showed that the virtue of honesty or integrity in particular (and the related concepts of transparency and openness) is generally perceived to be important for the financial sector.[71] Similarly, honesty and transparency are virtues ensuring that full disclosure is made to the stakeholders. If financial institutions are not honest or transparent in their dealings, markets will make sub-optimal choices with respect to the use of their resources. A lack of transparency

[68] See Bruni and Sugden (2013) for a detailed discussion on applying virtue ethics theory to markets.

[69] Bruni and Sugden (2013).

[70] Bruni and Sugden (2013).

[71] Graafland and van de Ven (2011) discuss virtues which were ignored or were absent from the conduct of bankers leading to the financial crisis. They list reference to integrity and honesty in the statements and mission objectives of several major financial institutions such as Deutsche Bank, Goldman Sachs, and ING. However, in practice adherence to such virtues was in question.

would lead to typical asymmetric information in financial contracts raising age-old moral hazards and adverse selection problems. This information-asymmetry together with the incentive to increase profits creates an agency-problem or the problem of moral hazard (Stiglitz 2010, p. 14). Commitment to ethical norms and values is one way to deal with this kind of problem, since these values indicate that one should not deceive or mislead the customer, even if it pays to do so.[72]

The theory of virtue ethics applied to business provides a plausible theory of business ethics. It is based on internalizing virtues in each organization's and person's conduct such that that organization or person is a living manifestation of the virtues as opposed to doing them out of necessity. The set of virtues such as compassion, benevolence, due care, and truthfulness are desirable to conduct ethical business. Whereas virtues are desirable, vices are undesirable. Vices are opposite to virtues and ought to be avoided by a virtuous person. For example, recklessness and imprudence are vices which any business ought to avoid. Adam Smith (1759) argues that recklessness stands in opposition to prudence, because security is the first and the principal object of prudence. Another vice which a business leader should avoid is arrogance.

2.5 Islamic Perspective on Business Ethics

As compared to conventional economic thought, ethics, morality, and justice are firmly embedded in the Islamic vision of how an economy and its finance are to operate.[73] They are defined by a set of behavioral rules prescribed in *al-Qur'an*.[74] These include property rights, faithfulness to terms

[72] Graafland and van de Ven (2011).

[73] Musa (2011) highlights the importance of ethics in Islam by citing that classical scholars of Islam such as Al-Ghazālī, in his famous encyclopedia *Iḥyā' 'Ulūm al-Dīn* (Revival of Islamic Sciences) dedicates a full chapter on the ethics of earning and living (*Kitāb al-Ādāb al-Kasb wa al-Ma'āsh*).

[74] For an early historical source for the application of Islam's ethical rules for behavior, see Nasirean Ethics, translated into English by G.M. Wickens, George Allen, Unwin LTC, London. Nasir al-Din Tusi who wrote in 633/1235 is primarily concerned with human behavior and deals with concepts of rationality, reason, justice, and equilibrium and how all creation "is called to ascend the hierarchy of grades within the limits of capacity. This ascent is the end of all existence, and it is by reference to man's potentially supreme elevation that this behavior is to be determined" (p. 11) Tusi deals with individual's behavior in relation to the Creator and the Creation, then at the economic level and, finally, as a member of the community. See also Nasir al-Din Tusi on Finance by M. Minovi and V. Minorsky in The Bulleting of the School of Oriental and African Studies, Vol. X, 1940 (p. 755).

and conditions of contract, maintenance of trust, honesty, transparency, cooperation, reciprocity, and consultation, and a number of other institutional and behavioral rules. Participants internalize these rules before entering the market, which has rules governing its operations as well. Hence, what would be considered as moral, ethical values in contemporary parlance are endogenized within the economic and financial activities in Islam.[75]

Within an Islamic context, the term most closely related to ethics in *al-Qur'an* is *khuluq* (قُلُخ Arabic for moral character and trait, plural *akhlāq* (قالخأ)) but there are other terms to describe the concepts of morals or positive values such as *khayr* (goodness), *birr* (righteousness), *qist* (equity), *'adl* (balance and justice), *haqq* (truth and righteousness), *ma'ruf* (known, approved), and *taqwa* (piety). Allah (SWT)[76] uses the same word *khuluq* in describing the Prophet's (SAAS)[77] behavior and character (*al-Qur'an*, 68:4).[78] These virtues were fully manifested through the character of the Prophet (SAAS), who is the role model to follow for the believers. The Prophet (SAAS) is reported to have said that he was sent for the purpose of perfecting the noblest of morals (قالخألا مراكم).[79]

Kamali (2011) explains the relevance of ethics to the higher goals and purposes of the *Sharīʿah* by pointing out the objectives of *Sharīʿah* (*maqāṣid al-Sharīʿah*) in relation to embedded ethical substance and integrity, which are reflected in business rules and transactions in the form of applied Law or *fiqh*. He concludes that ethics are the foundation of business and economics because *Sharīʿah* laws are richly endowed by ethical content and the rules of moral propriety that govern all human relations. For example, in the sphere of financial transactions, *Sharīʿah* rules on *ḥalāl* (permitted) and *ḥarām* (prohibited) are essentially aimed at fair trading, market stability, accountability, and the public good. He extends the argument that prohibition of interest (*ribā*) has an inward ethical dimension to promote fairness and justice, and avoid financial repression.

[75] Mirakhor and Alaabed (2013).

[76] Use of the term (SWT) with Allah denotes "Subhanahu wa ta'ala" meaning "Glory to Him, the Exalted" as a sign of reverence.

[77] Use of the term (SAAS) with the mention of the Prophet denotes "SallaAllah o 'Alayhi wa Aalihi wa Salaam" meaning the graces of Allah (SWT) be upon him, and peace as sign of reverence.

[78] See Beekun and Badawi (2005).

[79] Musnad Ahmad Ibn Hanbal, No: 8595.

Ethics are embedded in expected behavior and character of a rule compliant believer as long as he/she adheres to the principles prescribed by Islam. Ethical principles established based on the primary sources of Qura'n and sayings of the Prophet (SAAS) emphasize not only the action itself but the intention, outcome, character, and the manner in which it is executed.[80] While all actions are judged by intentions irrespective of outcome, virtues such as preservation of rights, responsibility and accountability to contracts, truthfulness, and striving for excellence determine the foundation of business ethics in Islam.

Based on moral philosophy aimed at promoting economic and social justice and to enhance solidarity among communities, internalization of rules and virtues of Islam determine all facets of an economy ranging from the rules of market conduct, production, consumption, distribution, and redistribution. Emphasis is placed on the ethics of work and ethical treatment of workers and to maintain an ethical relationship between employee and employers, business and customers, business and stakeholders, and finally business and society at large including the environment.

The next two chapters provide further details of the virtues underlying business ethics and how a framework of business ethics is formed in an economy in the Islamic perspective.

Annex I: Golden Rule Chronology

c. 1450 BC to 450 BC	The Jewish Bible has golden-rule like passages, including: "Don't oppress a foreigner, for you well know how it feels to be a foreigner, since you were foreigners yourselves in the land of Egypt" (Exodus 23:9) and "Love your neighbor as yourself" (Leviticus 19:18)
c. 563–483 BC	Buddha in India teaches compassion and shunning unhealthy desires. His golden rule says: "There is nothing dearer to man than himself; therefore, as it is the same thing that is dear to you and to others, hurt not others with what pains yourself" (Dhammapada, Northern Canon, 5:18)
c. 551–479 BC	Confucius sums up his teaching as: "Don't do to others what you don't want them to do to you." (Analects 15:23)
c. 500 BC	Jainism, a religion of India that promotes non-violence, compassion, and the sacredness of life, teaches the golden rule: "A monk should treat all beings as he himself would be treated." (Jaina Sutras, Sutrakritanga, bk. 1, 10:1–3)

[80] Ali (2014).

c. 500 BC	Taoist Laozi says: "To those who are good to me, I am good; and to those who are not good to me, I am also good; and thus all get to receive good." (Tao Te Ching 49) A later work says: "Regard your neighbor's gain as your gain and your neighbor's loss as your loss." (T'ai-Shang Kan-Ying P'ien)
c. 500 BC	Zoroaster in Persia teaches the golden rule: "That character is best that doesn't do to another what isn't good for itself" and "Don't do to others what isn't good for you."
c. 479–438 BC	Mo Tzu in China teaches the golden rule: "Universal love is to regard another's state as one's own. A person of universal love will take care of his friend as he does of himself, and take care of his friend's parents as his own. So when he finds his friend hungry he will feed him, and when he finds him cold he will clothe him." (Book of Mozi, ch. 4)
c. 440 BC	Socrates (c. 470–399 BC) and later Plato (c. 428–347 BC) begin the classical era of Greek philosophy. The golden rule, while not prominent in their thinking, sometimes leaves a trace. As Socrates considers whether to escape from jail, he imagines himself in the place of the state, who would be harmed (Crito). And Plato says: "I'd have no one touch my property, if I can help it, or disturb it without consent on my part; if I'm a man of reason, I must treat the property of others the same way" (Laws). (Wattles 1996, pp. 32–6)
c. 400 BC	Hinduism has positive and negative golden rules: "One who regards all creatures as his own self, and behaves towards them as towards his own self attains happiness. One should never do to another what one regards as hurtful to one's own self. This, in brief, is the rule of righteousness. In happiness and misery, in the agreeable and the disagreeable, one should judge effects as if they came to one's own self." (Mahabharata bk. 13: Anusasana Parva, §113)
384–322 BC	Aristotle says: "As the virtuous man is to himself, he is to his friend also, for his friend is another self" (Nicomachean Ethics 9:9). Diogenes Laertius (c. 225 AD) reports Aristotle as saying that we should behave to our friends as we wish our friends to behave to us
c. 150 BC	Various Jewish sources have golden-rule sayings. Tobit 4:16 says "See that you never do to another what you'd hate to have done to yourself." Sirach 31:15 says "Judge the needs of your guest by your own." And the Letter of Aristeas says "Insofar as you [the king] do not wish evils to come to you, but to partake of every blessing, [it would be wise] if you did this with your subjects."
c. 4 BC–27 AD	Jesus proclaims love (of God and neighbor) and the golden rule to be the basis of how to live. Luke 6:31 gives the golden rule in the context of loving your enemies, later illustrated by the Good Samaritan parable. Matthew 7:12 says: "Treat others as you want to be treated, for this sums up the law and the prophets."

c. 70 AD	"The Two Ways," a Dead Sea Scroll discovered in the 1940s, says: "The way of life is this: First, you shall love the Lord your maker, and secondly, your neighbor as yourself. And whatever you don't want to be done to you, don't do to anyone else." (Wattles 1996, p. 47)
c. 80 AD	The Didache, summarizing early Christian teachings, begins: "There are two paths, one of life and one of death, and a great difference between them. The way of life is this. First, you shall love the God who made you. Second, you shall love your neighbor as yourself. And whatever you wouldn't have done to you, don't do to another."
c. 90 AD	The ex-slave Stoic Epictetus writes: "What you shun enduring yourself, don't impose on others. You shun slavery – beware of enslaving others!"
c. 90 AD	The apocryphal gospel of Thomas attributes a negative golden rule to Jesus (verse 6): "Don't do what you hate."
c. 120 AD	Rabbi Akiba says: "This is the fundamental principle of the Law: Don't treat your neighbor how you hate to be treated yourself." (G. King 1928, p. 268) His students support the golden rule: Rabbi Eleazar ("Let another's honor be as dear to you as your own") and Rabbi Jose ("Let another's property be as dear to you as your own"). (Wattles 1996, p. 202)
c. 130 AD	Aristides defends his fellow Christians, who "never do to others what they would not wish to happen to themselves," against persecution
c. 150 AD	The Ethiopian version of the apocryphal Book of Thekla ascribes a negative golden rule to Paul: "What you will not that men should do to you, you also shall not do to another."
c. 150–1600	Many Christians, seeing the golden rule's wide acceptance across religions and cultures, view the golden rule as the core of the natural moral law that Paul saw as written on everyone's heart (Romans 2:14f). The golden rule is proclaimed as the central norm of the natural moral law by Justin Martyr, Origen, Basil, Augustine, Gratian, Anselm of Canterbury, William of Champeaux, Peter Lombard, Hugh of St. Victor, John of Salisbury, Bonaventure, Duns Scotus, Luther, Calvin, and Erasmus.
222–235	Roman Emperor Alexander Severus adopts the golden rule as his motto, displays it on public buildings, and promotes peace among religions. Some say the golden rule is called golden because Severus wrote it on his wall in gold
c. 263–339	Eusebius of Caesarea's golden-rule prayer begins: "May I be an enemy to no one and the friend of what abides eternally. May I never quarrel with those nearest me, and be reconciled quickly if I should. May I never plot evil against others, and if anyone plot evil against me, may I escape unharmed and without the need to hurt anyone else."

610	Muhammad receives the Qur'an, which instructs us to do good to all (4:36) and includes the golden-rule like saying: "Woe to those who cheat: they demand a fair measure from others but they do not give it themselves" (83:1–3). Several Hadiths (Bukhari 1:2:12, Muslim 1:72f, and An-Nawawi 13) attribute this golden rule to Muhammad: "None of you is a true believer unless he wishes for his brother what he wishes for himself."
c. 650	Imam Ali, Muhammad's relative, says: "What you prefer for yourself, prefer for others; what you find objectionable for yourself, treat as such for others. Don't wrong anyone, just as you would not like to be wronged; do good to others just as you would like others to do good to you; that which you consider immoral for others, consider immoral for yourself."
c. 700	Shintoism in Japan expresses the golden rule: "Be charitable to all beings, love is God's representative. Don't forget that the world is one great family. The heart of the person before you is a mirror; see there your own form."
c. 1093	Muslim Abu Hamid al-Ghazali in his Disciplining the Soul (the section on discovering faults) uses the golden rule: "Were all people only to renounce the things they dislike in others, they would not need anyone to discipline them."
1140	Gratian, the father of canon law, identifies natural law with the golden rule: "By natural law, each person is commanded to do to others what he wants done to himself and is prohibited from inflicting on others what he does not want done to himself. Natural law is common to all nations because it exists everywhere by natural instinct. It began with the appearance of rational creatures and does not change over time, but remains immutable."
c. 1230	Muslim Sufi thinker Ibn Arabi sees the golden rule as applying to all creatures: "All the commandments are summed up in this, that whatever you would like the True One to do to you, that do to His creatures." (See my §3.1c.)
1259	Gulistan, by the Persian poet Sa'di, has these verses, which are now displayed at the entrance of the United Nations Hall of Nations: "Human beings are members of a whole, in creation of one essence and soul. If one member is afflicted with pain, Other members uneasy will remain. If you have no sympathy for human pain, The name of human you cannot retain."
1265–74	Thomas Aquinas's Summa Theologica (I-II, q. 94, a. 4) says the golden rule is common to the gospels and to human reason. He adds (I-II, q. 99, a. 1) that "when it is said, 'All things whatsoever you would that men should do to you, do you also to them,' this is an explanation of the rule of neighborly love contained implicitly in the words, 'You shall love your neighbor as yourself.'"

c. 1400	Hindu Songs of Kabir (65) teach the golden rule: "One who is kind and who practices righteousness, who considers all creatures on earth as his own self, attains the Immortal Being; the true God is ever with him."
c. 1400	Sikhism from India teaches: "Conquer your egotism. As you regard yourself, regard others as well." (Shri Guru Granth Sahib, Raag Aasaa 8:134)
1688	Four Pennsylvania Quakers sign the first public protest against slavery in the American colonies, basing this on the golden rule: "There is a saying, that we shall do unto others as we would have them do unto us – making no difference in generation, descent, or color. What in the world would be worse to do to us, than to have men steal us away and sell us for slaves to strange countries, separating us from our wives and children? This is not doing to others as we would be done by; therefore we are against this slave traffic."
1827	Joseph Smith receives the Book of Mormon, which has the golden rule: "Therefore, all things whatsoever ye would that men should do to you, do ye even so to them, for this is the law and the prophets" (3 Nephi 14:12)
1854	Abraham Lincoln quips: "Although volume upon volume is written to prove slavery a very good thing, we never hear of the man who wishes to take the good of it, by being a slave himself."
1858	Abraham Lincoln gives this golden-rule evaluation of slavery: "As I would not be a slave, so I would not be a master." The next year, he says: "He who would be no slave, must consent to have no slave."

Source: http://www.harryhiker.com/goldrule.htm. See also Gensler (2013)

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CHAPTER 3

Key Virtues of Business Ethics in Islam

A framework of business ethics in Islam can be developed by identifying key virtues that are the preferred character traits of a human being. This chapter discusses select virtues that have direct implications on any economic, social, business, or financial activity such that a decision taken in light of such virtues would be ethical. By embracing and living the virtues and avoiding vices, an ethical economic and financial system could emerge that is just as well as efficient.

In Islam, virtues or moral character traits are termed as *aḫlāq* (sing. *ḫuluq* or *ḫulq*) meaning moral qualities and good traits.[1] These virtues were identified as preferred traits in the Qur'an and were manifested through the practice by the Prophet (SAAS) who perfected these in daily life. There are numerous references in both the Qur'an and hadith in this respect. For example, the Qur'an (3:104) lays the broad foundation of the preferred character of humans to (a) do what is good; (b) be righteous; and (c) forbid and refrain from what is wrong.[2] After a broad classification of desirable behavior is prescribed, the Qur'an (49:13) states, "The noblest

[1] Zilio-Grandi (2015) compiles a list of the virtues and their corresponding vices. She reports that the use of aḫlāq in the sense of good moral qualities is based on a number of Prophetic traditions of the kind collected by al-Tirmiḏī (d. 279/892) in his famous work, Ğāmiᶜ.

[2] Qur'an (3:104), "Let there arise out of you a band of people inviting to all what is good, enjoining what is right, and forbidding what is wrong: they are the ones to attain felicity."

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of you in the sight of God are the best of you in conduct." This implies that the ones practicing and living virtues that make up good character are the successful ones. Throughout Islamic history, different scholars have compiled sets of virtues based on various verses of the Qur'an and have identified virtues that would constitute an ethical act.[3]

Furthermore, the Qur'an (68:4) makes a strong endorsement of the character traits of the Prophet when it acknowledges the Prophet's character (*huluq*) as of an exalted standard that can be interpreted as adherence to and practice of virtues and sacred values forming the basis of ethical behavior.[4] In addition, there are several authenticated sayings of the Prophet that indicate the significance of possessing good character and virtues for a successful life. Practicing these virtues is considered a sign of having perfect faith and therefore it is highly desirable to incorporate these in one's life.[5] In a famous saying, the Prophet (SAAS) said that **"I have been sent for the purpose of perfecting good morals**."[6]

Qur'an (3:110), "You are the best nation that has been raised up for mankind; You enjoin right conduct, forbid evil and believe in Allah."

[3] For example, Ali (2014) quotes Al-Mawardi's list of 10 virtues, which included capacity to reason, sound faith, knowledge, forbearance, generosity, adherence to accepted custom, righteousness, patience, thankfulness, and flexibility as virtues that could deem an act ethical.

[4] Qur'an (68:4) "thou [standest] on an exalted standard of character." The other occurrence of the term *ḫuluq*, in the Poets sura (*ḫuluq al-awwalīn*, 26:137), can also carry the sense of "trait," "quality," "way of being" as observed by Zilio-Grandi (2015). She notes al-Rāzī's observation that, according to some commentators, Muhammad's qualities are indicated by a passage in the Cattle sura (Chap. 2) where it is said, speaking of the antecedent prophets: "Those are the ones whom God has guided, so take an example from their guidance (*hudā*)" (9:90). Al-Rāzī asks in what sense we should understand this "guidance" and concludes that we are dealing with good moral qualities.

[5] Interpreting the saying of Prophet, "nothing weighs on the Scales like a good quality of character (*ḥusn al-ḫuluq*)," Zilio-Grandi (2015) argues that this identifies such virtues (*ḫuluq*) with the interior features (*awṣāf bāṭina*) of the individual.

Prophet said that "those with the best character traits among you are dearest to me and will sit closest to me on the day of the resurrection." In another version, it is stated that "those of you that I love the best and who will be seated closest to me on the day of the resurrection are those of you who have the best *aḫlāq*." In another instance, when asked who is the believer most perfect in his faith, the Prophet answered, "who has the best *aḫlāq*." Ibn Ḥanbal (d. 241/855) no. 909. Cf. http://library.islamweb.net/hadith/display_hbook.php?bk_no=13&hid=909&pid=2021

[6] (Ibn Hambal, No: 8595).

Recognizing the importance of good character traits or virtues alone is not sufficient unless one understands a subtle and strong relationship between the intentions, actions, and the outcomes. In the Islamic concept of ethics, there is an emphasis on virtue, intention, action, and the outcome as a basis for judging whether an act is ethical or not. Although intention or *niyya* of an action plays a critical role in determining the legal aspect of the action, Islam recognizes the moral significance of intention in advocating sincerity of intent (*iḫlāṣ*).[7] Each virtue is judged in light of the intention behind in the practice of the virtue. The distinction between having intention to serve humanity and the betterment of society as opposed to achieve personal gain could make an action ethical or unethical.[8]

The nexus of virtues, intention, action, and outcome defines a framework of ethics that goes beyond legal or juridical ethics that focus exclusively on actions. For this reason, Kamali (2011) emphasizes that a jurist needs to go beyond the mere legal requirement of the validity of a contract to include discussion on the higher objectives (*maqāṣid*) of Shari'ah to deem the contract ethical. This means going beyond the form and including the substance in evaluating the validity of any contract. Zilio-Grandi (2015) articulates that the Islamic conception of ethics dependent on virtues covers a much broader discipline than the restricted juridical understanding of practice and, therefore, finds virtues behind every example of good conduct and not merely behind behavior answerable to the Islamic law.[9]

[7] Select sayings of Prophet emphasizing the significance of intentions are:

> "Actions are according to intentions" (*al-aʿmāl bi-al-niyyāt*), e.g. al-Buḫārī, Al-ṣaḥīḥ, bāb badʾ al-ḫalq, no. 1, after ʿUmar b. al-Ḫaṭṭāb"A Muslim's intention is the best part of his action" (*niyyat al-muʾmin ḫayr min ʿamali-hi*), quoted for example by al-Ṭabarānī (d. 360/971), Al-muʿǧam al-kabīr, after Sahl b. Saʿd (d. 91\710), no. 5803
>
> "God does not look upon either your appearance or wealth, rather God examines your intentions and actions" as reported by Ali (2014)
>
> "Work is contingent upon intention and to each according to his intention" as reported by Ali (2014)

[8] Ali (2014). This is the reason that the Prophet insists that "God examines your intentions and actions," adding that "God does not accept any claim without action and no claim or action without intention".

[9] She argues that so far as good qualities are attributed to the Prophet they demand as such to be imitated, and therefore, for a "true Muslim" virtue ethics are at least as important as observance of juridical ethics, indeed more so, because the one precedes and underpins the other.

To summarize, Islamic virtue ethics are chiefly concerned with "'good character traits," which may then be exemplified into actions. **Being is preferred over doing**. The relationship between virtues, intentions, and actions lays the foundation of ethical behavior such that virtue ethics have a logical priority over juridical ethics. Actions driven by good intentions and in the spirit of the practice of virtues would become ordinary behavior that is not only ethical but is internally consistent in terms of intent, means, and outcomes.

The rest of this chapter discusses key virtues that constitute good qualities of moral character as envisioned by Islam. These virtues can be divided into two categories; one category deals with philosophical virtues having esoteric meaning and lays the ground for a way of life optimizing human welfare. Examples of these virtues are embracing the unity of mankind and viewing the other the same as oneself, being just to promote economic and social justice, preservation of rights, striving for excellence, and being truthful. The other category of virtues specifically deals with economics and business conduct but have roots in the philosophy of the first category. These virtues include giving right measures and being transparent in business transactions. For example, the virtue of giving right measure derives its moral ground from being just and preserving the rights of others.

Discussion on distinct virtues of Islam relevant to business practices are presented below.

3.1 Embracing the Unity of Creation

The core and fundamental axioms of Islamic ideology are the belief in the Unity and Oneness of the Creator (*Tawhid*), a corollary of which is the unity of the creation, particularly the unity of mankind. A number of verses of the Qur'an affirm and confirm the unity of humankind. These verses plus those recounting the provision of physical-material as well as non-physical faculties and facilities created for all humans that empower them economically and spiritually, form the cornerstone of the legislative framework of rules (institutions) for the socio-economic-political behavior of humans. Resources are created for all humans of all generations, who compose one humanity, their diversity does not and should not mean their disunity, and, by the primordial covenant,[10] not only do all

[10] See virtue on contracts for details on primordial covenant between the Creator and man.

humans recognize their own unity, they also have full cognition of their responsibility to maintain the unity and integrity of the rest of creation through their service to humanity and to the rest of creation.[11]

The axiom of the Unity and Oneness of the Creation requires one to believe that all creation has only one omniscient and omnipresent Creator and that all His creation constitutes a unity as well. The Qur'an calls attention to the fact that despite all apparent multiplicity, human beings are fundamentally of one kind; they were created as one being (*nafs*) and will ultimately return to Allah (SWT) as one (*nafs*) as well.[12] In a series of verses, the Qur'an exhorts humans to take collective and unified social action as well as to preserve and protect the collectivity from all elements of disunity.[13] These and many other verses order human beings to work hard toward social unity and cohesion, construct their societies, and preserve and defend that unity. Unity and social cohesion are so central among the objectives of the Qur'an for mankind that it can be argued that all conducts prohibited by Islam are those that ultimately lead to disunity and social disintegration. Conversely, all righteous conducts prescribed by Islam are those that lead to social integration, cohesiveness and unity. As a result, Islam is not only a call to individuals but also to the collectivity and has given the latter an independent personality and identity, which will be judged on its own merits or demerits separately from the individuals that constitute the collectivity. The final judgment on individual actions will have two dimensions, one as the individual and the other as a member of the collectivity.

[11] "O mankind! We created from you from a single (pair) of a male and a female, and made you into nations and tribes, that you may know each other…" (Qur'an 49:13).

"All mankind is from Adam and Eve, an Arab has no superiority over a non-Arab nor a non-Arab has any superiority over an Arab; also a white has no superiority over black nor a black has any superiority over white except by piety and good action." Prophet's last sermon. http://www.islamicity.com/Mosque/lastserm.htm

[12] See Qur'an (31:28), "Neither your creation nor your resurrection is possible other than as one united *nafs*."

[13] Select verses emphasizing the principle of unity are:

> "And indeed this is my straight path therefore follow it — and do not follow other ways because that will lead to disunity amongst you" (6:153) "Grab hold of the rope of Allah collectively and do not disunite." (3:103)
>
> "Cooperate with one another unto righteousness and piety and do not cooperate with one another unto unrighteousness and enmity." (5:2)

One implication of the virtue of embracing the unity of creation and mankind is that it establishes the relationship of brotherhood or sisterhood and equality among communities and societies irrespective of their belief system. In this sense, unity is a coin with two faces: one implies that God is the sole creator of the universe and the other implies that people are equal partners or that each person is a brother or sister to the other. Adoption of this virtue has far reaching implications for business ethics such cooperation, solidarity, and equality of effort and opportunity.[14]

3.2 Being Just and Striving for Justice

Justice[15] in Islam is a multifaceted concept, and several words or terms exist for each aspect. The most common word in use, which refers to the overall concept of justice, is *adl*. This word and its many synonyms imply the concepts of "right," as an equivalent of "fairness," "putting things in their right place," "equality," "equalizing," "balance," "temperance," and "moderation." These latter concepts are more precisely expressed as the principle of the "golden mean," according to which believers are not only individually urged to act in conformity with this principle, but also the community is called upon, by the Qur'an, to be a "nation in the middle."[16] Thus, justice in Islam is the aggregation of moral and social values, which denotes fairness, balance, and temperance. Its implication for individual behavior is, first of all, that the individual should not transgress his bounds and, secondly, that one should give others, as well as oneself, what is due.

[14] Rice (1999).

[15] Select verses from the Qur'an on justice are:

> "…stand out firmly for justice, as witnesses to God, even against yourselves, or your parents, or your kin, and whether it be (against) rich and poor". (52:21)

> "O you who have attained to faith! Be ever steadfast in your devotion to God, bearing witness to the truth in all equity; and never let hatred of any-one lead you into the sin of deviating from JUSTICE. Be just: this is closest to being God-conscious. And remain conscious of God: verily, God is aware of all that you do".(5:8)

> "O you who have attained to faith! Be ever steadfast in upholding equity, bearing witness to the truth for the sake of God, even though it be against your own selves or your parents and kinsfolk. Whether the person concerned be rich or poor, God's claim takes precedence over [the claims of] either of them. Do not, then, follow your own desires, lest you swerve from **justice**: for if you distort [the truth], behold, God is indeed aware of all that you do!". (4:135)

[16] Qur'an (2:143).

It is through the scaffolding of that the *raison d'etre* of the rules governing the economic behavior of the individual and economic institutions in Islam can be understood. What gives the behavior of a believer its orientation, meaning, and effectiveness is acting with the knowledge that justice evokes Allah's (SWT) pleasure; and injustice, His displeasure. Whereas justice in Western thought is a quality of the behavior of one individual in relation to another and his actions can be perceived as unjust only in relation to the "other," in Islam it has implications and consequences for the first individual as well. That is, even when one does injustice to someone else, there is always reciprocity, in that through injustice to others, ultimately, one also does injustice to oneself.

A just economy is part of a just, healthy, and moral society, which is the central objective of Islam for the human collectivity. What underpins all the rules of behavior prescribed by Islam is its conception of justice, which maintains that all behavior, irrespective of its content and context, must, in its conception and commission, be based on just standards as defined by the Shari'ah. Islam considers an economy, in which the behavior of its agents is so conceived, as an enterprising, purposeful, prosperous, and sharing economy in which all members of society receive their just rewards. Such an economy is envisioned as one in which economic disparities that lead to social segmentation and divisiveness are conspicuously absent.

The economic justice that is envisaged in Islam does not call for equal incomes and wealth. The focus of economic justice is not solely placed on the outcome. Again, if Allah (SWT) had wanted this He would have so designed His Creation. Instead, the focus of justice is on the available means and opportunities to all humankind.

Thus the central framework and operation of rules concerning economic and social life is justice. The Prophet understood the essential objective of his selection, appointment, and message to be to encourage and insert justice in human societies, as emphasized in the Qur'an. The Prophet taught the responsibility of the individual, the collectivity, and the state. He particularly emphasized the equality of individuals before the law, and that all rules that are incumbent on individuals and their collectivity must be more strictly observed by those in positions of authority. Thence the famous saying attributed to him: "Authority may survive disbelief but not injustice." In Islam economic justice is centered on affording all humans an equitable chance (the means) to flourish while affording the disabled a dignified life and erasing poverty everywhere.

All humans should have the same (similar) opportunity and the freedom to achieve their economic goals (a level playing field in education, healthcare, and basic nutrition) through hard work, while preserving the rights (not to be confused with charity) of the disabled and less privileged. After humans have worked and received their just rewards, then they must help the less fortunate to eradicate poverty and avoid great disparities in wealth; this is a test for humans to show their love for their Creator and His creation as contrasted with a love of fleeting wealth. Individuals as well as the state should remove all roadblocks, importantly including oppression, from the path of human development. Any injustice perpetrated by individuals against other humans and against the rest of creation is ultimately an injustice to the self.[17] Allah (SWT) Loves justice; it is a central part of His Universal Love. Humans must live a life that is just and must stand up to and eradicate injustice wherever they find it.

As mentioned earlier, a central aim of Islam is to establish a just and moral social order through human agency. This all-embracing desideratum of the Islamic system is the ruling principle from which human thought and behavior, the substantive and regulative rules of the *Shari'ah*, the formation of the community, and the behavior of polity and of political authority derive their meaning and legitimacy. It is this emphasis on justice that distinguishes the Islamic system from all other systems.

3.3 Preservation of Rights

Ethics in Islam can be best understood in light of principles governing the rights of the individual, society, and state; the laws governing property ownership; and the framework of contracts. Islam's recognition and protection of rights is not limited to human beings only but encompasses all forms of life as well as the environment. Each element of Allah's (SWT) creation has been endowed with certain rights and each is obligated to respect and honor the rights of others. These rights are bundled with the responsibilities for which humans are held accountable. Scholars consider that the human self or soul (*nafs*) has "rights" as well as many duties and responsibilities. The basis of this is the fact that when a person

[17] There is the Prophetic saying that on the Day of Reckoning the oppressor, the oppressed, and the person(s) who stood by and observed the oppression will be called upon to answer: the oppressor for oppression, the oppressed for not resisting the oppression, and the bystander for not assisting the oppressed.

violates these rights he is said to have "wronged" (*zulm*) his/her soul.[18] Shari'ah offers a comprehensive framework to identify, recognize, respect and protect rights of every individual in creation, community, society, and the state. Islamic scholars and jurists have defined and codified detailed principles identifying these rights.[19] The importance of being conscious and mindful of the rights of others[20] (including stakeholders—human or nonhuman) and the significance of discharging the responsibilities associated with such rights are reflected by the following saying of the Prophet (SAAS)[21]:

> So give to everyone who possesses a right his right. (*kull dhi haqin haquhu*)

The term right (*haq*) denotes something that can be justly claimed or the interests and claims that people may have been granted by Shari'ah. The majority of Shari'ah scholars and jurists hold that similar to a physical property, rights are also property (*al mal*) because, like physical property that has beneficial uses and is possessable, rights have beneficial uses and are regarded as capable of being possessed.[22] Rules defining the property rights in Islam deal with the rights of ownership, acquisition, usage, and disposition of the property. Any violation of these rules is considered a transgression and leads to disruption in social order.

In Islam, contrary to popular opinion, self-interest is not negated. Islam, in fact, considers it a primary factor in its incentive-motivation system; a necessity in any organized society if the individual is to find it

[18] See for example, verses 2:231 or 37:113 of the Qur'an.

[19] Imam Zayn al-Abidin's treatise on the rights, *Risalat Al-Huquq* covers a full spectrum of rights in Islam. For example, the right of one's property (*al-mal*) is that one takes it only from what is lawful and spends it only on what is proper. The right of the associate is that one neither misleads him, nor acts dishonestly toward him, nor deceives him. The right of the adversary (*Khasm*) who has a claim against one is that, if his claim is valid, one gives witness to it against oneself Ali ibn al-Husayn (1990).

[20] See below verses condemning violating property and rights.

> "Do not devour one another's property wrongfully, nor throw it before the judges in order to devour a portion of other's property sinfully and knowingly." (2:188)

> "Do not devour another's property wrongfully – unless it be by trade based on mutual consent." (4:29)

[21] Ali Ibn al-Husayn (1990).

[22] Islam (1999). The term *mal* or its derivatives have been mentioned in the Qur'an in more than 90 verses and in numerous sayings of the Prophet (SAAS).

utility maximizing to follow behavioral virtues prescribed by the system. Provided that self-interest is defined to cover spiritual and temporal or temporary and eternal interests, there is not a single rule in the Shari'ah that does not carry with it its own justification in terms of individual self-interest. It is for his own benefit, material and spiritual, in this world and for his ultimate salvation and felicity in the next, that the individual is invited to follow the rules of the Shari'ah. This is made clear by the Qur'an in which all injunctions are generally coupled with the assertion that internalization of prescribed virtues by the individual is for his/her own benefit. Often the incentives and the rewards for compliance and the retribution for noncompliance, both here and in the hereafter, are enumerated. It is in the context of the pursuit of self-interest that individual obligations and rights as well as the limits and accountabilities to these rights are specified by the Shari'ah.

3.4 Sanctity of Contracts

Islam forcefully anchors all social-political-economic relations on contracts. More generally, the whole fabric of the Divine Law is contractual in its conceptualization, content, and application.[23] In a direct, clear, and unambiguous verse, *al-Qur'an* commands: "fulfill the Covenant of Allah" (6:152). In an equally clear verse it generalizes this imperative to all contracts: "fulfill all contracts" (*al-Qur'an*, 5:1). A believer will only take on contractual obligations that he or she intends to fulfill.[24] Believers are said to protect their contractual obligations as a shepherd protects his sheep.[25]

Muslims are constantly reminded of the importance of contractual agreements, as they are required by their faith to honor their contracts.[26]

[23] See Mirakhor (1989). The sanctity of contracts' very foundation is the Primordial Covenant between the Creator and humans—the mīthaq—which imposes an obligation to comply with the rules prescribed by their Supreme Creator as its Cherisher Lord (*Rabb*). In Islam, faithfulness to the terms of all contracts entered into is linked to the fulfillment of obligations incurred under the Primordial Covenant. The rule of remaining faithful to the discharge of contractual obligations derives its power and authority from the generalization of the responsibility of remaining faithful to the Primordial Contract.

[24] See *al-Qur'an*, (16: 91–92; 17:34).

[25] See *al-Qur'an* (23:8). A tradition of the Prophet (sws) states that "the Muslims are bound by their stipulations" (Abu Da'ud, No: 3120). Another tradition condemns promise-breaking as the hallmark or trait of a hypocrite: "If he makes a promise, he breaks it, and if he makes a compact, he acts treacherously" (Bukhari, No: 32).

[26] See, for example, *al-Qu'ran* (5:1; 2:282; 6:151,153; 9:4; 16:91–4; 17:34–6; 23:8).

As directed in *al-Qur'an*, Muslims put their contracts in writing in order to reduce the possibility of any misunderstanding or ambiguity concerning the responsibilities of the parties to the contract. Shari'ah scholars often point out that one of the reasons why the Islamic system of *mu'āmalāt* (transactions) is so highly articulated is that it is based on solid principles of contracts and the rights and obligations of the parties to the contract.[27]

In Sharīa'h, the concepts of justice, faithfulness, reward, and punishment are linked with the fulfillment of obligations incurred under the stipulations of the contract. Justice links man to Allah (SWT) and to his fellow men. It is this bond that forms the contractual foundation of the Sharīa'h, which judges the virtue of justice in man not only by his material performance but also by the essential attribute of his intention (*niyyah*) with which he enters into every contract. This intention consists of sincerity, truthfulness, and insistence on rigorous and loyal fulfillment of what he has consented to do (or not to do). This faithfulness to contractual obligations is so central to Islamic belief that the Prophet (saws) defined a believer as the person from whom the people's lives and possessions are safe.[28] He is also reported to have said that a person who is not trustworthy has no faith, and a person who does not keep one's word (*'ahd*) has no religion.[29] So basic is the notion of contracts in Islam that every public office is regarded, primarily, as a contract and an agreement that defines the rights and obligations of the parties. The highest temporal office, that of *khalīfah*, is inaugurated by *mubāya'ah*, which is a contract between the ruler and the community that he will be faithful in discharging of his duties.

Preserving the sanctity of contracts and accountability to one's commitment to a contractual agreement is a key character trait and virtue.

[27] In order to safeguard the interests of both the buyer and the seller, it is desirable, according to the Islamic teachings, to clearly define all the necessary details concerning the business deal. Each business contract should clearly specify the quality, the quantity, and the price of the commodity in question. Thus, in a business contract, the offer and acceptance should be made between the parties concerned on a commodity which is with the buyer and which he is able to deliver. Any commodity that is nonexistent or not deliverable is not allowed to be transacted. A contract must be explicit with regard to the rights and obligations of the parties concerned so that it does not lead to disputes and disagreements between them.

[28] Reference is made here to hadith from as-Sunnah of the Prophet (saws) as narrated in Sunan an-Nasaa'i in the book on faith and its signs.

[29] Reference is made to hadith in the musnad of Imam Ahmad ibn hanbal.

Having right and clear intention before entering the contract is a critical determinant of the ethics of a contractual agreement. The contract may meet legal requirements and be considered a valid contract but if the intention, the means, or the outcome is in conflict with core objectives of Sharīa'h, the contract would be questionable on ethical grounds.

Kamali (2011) highlights the importance of the objective (*maqṣad*) of a contract that is an integral part of the ethics of that contract. He emphasizes that "for any stipulations that amount to a distortion of the *maqṣad* or purpose of a contract is likely to vitiate the contract in question. To distort the *sharīʿah*-ordained purpose (*maqṣad)* of a contract through questionable stipulations, and worse still, through recourse to legal tricks and stratagems (*ḥiyal*) becomes problematic, and if allowed unchecked would naturally affect the ethical propriety of the contract in question."

3.5 Truthfulness and Integrity

Being truthful and keeping one's word are the core traits of a true human being. This is further emphasized when a trader or a businessman is truthful in his/her dealings.[30] A true believer or *Mu'min* is expected to be honest in dealings, has strong commitment to his or her word, and speaks truth. The ultimate case of commitment to truthfulness is that one is expected to be truthful while giving evidence, even if it is against him or herself. An honest and truthful trader is given tidings of blessings from the Creator while in absence of these traits, the transaction would be devoid of any blessing.[31] Truthfulness or transparency also enhances trust between the parties and in the market and in all fairness, each party expects full transparency and disclosure regarding the transaction.

Integrity is another key virtue that is highly appreciated in Islam. The Prophet (SAAS) was known to be a truthful and trustworthy person who always kept his word. Given the status of the Prophet (SAAS) as the archetype and a role model, each Muslim is expected to maintain truthfulness

[30] A well-known saying of the Prophet is that "the truthful merchant [is rewarded by being ranked] on the Day of Resurrection with prophets, veracious souls, martyrs and pious people" (Tirmidhi, No: 1130).

[31] The Prophet (SAAS) has also exhorted the believers to strictly adhere to truthfulness in business transactions. He said, "if both the parties (seller and buyer) spoke the truth and described the defects and qualities [of the goods], then they would be blessed in their transaction, and if they told lies or hid something, then the blessings of their transaction would be lost" (Bukhari, No: 1937).

and integrity. Integrity of a person or entity indicates that the person or the entity is truthful, honest, and honors his or her word, which implies that such person or entity is most likely to fulfill their commitments and promises in full and in timely fashion. Honoring your word means that you are honest and are not hiding any relevant information, and there is no element of deception or any violation of contracts or property rights. Integrity is important to individuals, groups, organizations, and society because it develops valuable social capital of trust in the society. Such behavior as an employee or as the manager or leader of an organization would lead to the integrity of the entity, which is trusted by all economic agents and therefore, achieves higher efficiency and performance.

3.6 Trustworthiness

Islam places a strong emphasis on trust and considers being trustworthy as an obligatory personality trait. At a philosophical level, the role of man on earth is to act as vicegerent or trustee of the Creator. The root of the word for "trust" *(amānah)* is the same as that for "belief" (*īmān*), for *al-Qur'an* insists that a strong signal of true belief is faithfulness to contracts and promises. It makes clear that performing contractual obligations or promises is an important and mandatory characteristic of a true believer.[32]

The life of the Prophet (*saws*) is a shining illustration of the implementation of the guidance of *Allah* (*swt*) in maintaining trust and remaining trustworthy. Regarded as eminently trustworthy even before his divine appointment (the community conferred upon him the title of *Al-Ameen*—"Trustworthy"), the Prophet (saws) expended a great deal of effort in modifying when possible and changing when necessary the behavior of the community in respect of trustworthiness. Numerous statements, actions, and circumstances are attributed to him in which trust was the preeminent concern.

Contract and trust are interdependent. Without trust, contracts become difficult to negotiate and conclude and costly to monitor and enforce. When trust is weak, complex and expensive administrative devices are needed to enforce contracts. Both *al-Qur'an* and the tradition of the Messenger (saws) stress the importance of trustworthiness as

[32] There are various verses on the virtue of being trustful. For example, *al-Qur'an* (8:27) states "O you believers! Do not betray Allah and the Messenger, nor knowingly, betray your trusts." Also, see, *al-Qur'an* (2:58; 2:283; 12: 52; 23:1–8; and 42:107, 125, 143, 162, 178, 193).

the benchmark that separates belief from disbelief.[33] Trustworthiness and remaining faithful to promises and contracts are absolute, regardless of the costs involved or whether the other party is a friend or a foe.[34] There is also a network of micro-level rules that ensure transparency and the unhindered flow of information. This includes the requirement incumbent upon sellers that they must inform the buyers of prices, quantities, and qualities; a body of rules governing the consumer's option to, under various circumstances, annul a transaction; the rule of noninterference with market supplies; the rule against hoarding; and the rule against collusion among market participants.

Problems are exacerbated when, in addition to lack of trust, property rights are poorly defined and protected (Sheng 2009). Under these circumstances, it becomes difficult to specify clearly the terms of contract since transaction costs—that is, search and information costs, bargaining and decision costs, contract negotiations and enforcement costs—are high. Consequently, there is less trade, fewer market participants, less long-term investment, lower productivity, and slower economic growth.

Weakness of trust creates the problem of lack of credible commitment which arises when parties to an exchange cannot commit themselves or do not trust that others can commit themselves to performing contractual obligations. Empirical research has shown that where the problem of lack of commitment exists and is significant, it leads to disruption in economic, political, and social interaction among people. Considering these issues, one can appreciate the strong emphasis that the Qur'an as well as the Prophet (SAAS) has placed on trust, trustworthiness (see Verse 27, Chapter 8 and 57:4), and on the need to fulfill terms and conditions of contracts, covenants, and promises one makes. These rules solve the problem of credible commitment and trust, thus facilitate long-term contracts. To illustrate the importance of trust, consider the role of complete contracts in the neoclassical theory of competitive equilibrium (Arrow 1971). A complete contract fully specifies all future contingencies relevant to the exchange. In the real world a vast majority of contracts are incomplete. This requirement, therefore, is considered too stringent and unrealistic. Not only ignorance about all future contingencies make writing complete contracts impossible, even if all future contingencies are known, it would

[33] See *al-Qur'an* 2:282; 4:105, 107–08; 6:152; 8:127 and 75–6.
[34] See *al-Qur'an* 9:4.

be nearly impossible to write a contract that can accommodate them all. However, if the parties to a contract trust each other, they can agree to enter into a simple contract and commit to revising its terms and conditions as contingencies arise.

3.7 Goodness and Excellence (*Ihsān*)

The virtue of *Ihsān*, meaning benevolence, goodness, and excellence, is recognized in the Qur'an as well as in the sayings of the Prophet.[35] The concept of *Ihsān* is the embodiment of goodness and excellence in interaction and conduct at the personal, organizational, and societal levels. As a projection of goodness, it practically and spiritually encompasses mercy, justice, forgiveness, tolerance, and attentiveness. The concept of *Ihsān* is much broader that simply being good to others but includes striving for excellence in goodness so much so that one is willing to go beyond what may be expected under norms to achieve the welfare of fellow humans, the community, or the society.

Ihsān goes beyond legal and social requirements to include welfare of others even if it is at the cost of personal sacrifice, and therefore it is a necessary element to develop good intentions and virtues as prerequisite for ethical actions. In absence of societal welfare and a disposition toward goodness, neither good intentions nor virtues could be cultivated. The virtue of goodness in an attempt to advance public interest, i.e. advocating good and denouncing wrong, defines a code of conduct that exceeds what is expected by law or the existing market ethos.[36]

Striving for excellence in doing good or performing a task is another aspect of *Ihsān* that is suggested by a saying of the Prophet: "God likes that when someone does anything, it must be done perfectly well."[37] This has implications for work ethics in Islam.

[35] In a famous saying of the Prophet also known as hadith of *Ihsān*, when asked "what is goodness?", He replied: "that you worship God as if you see Him, for if you see Him not, surely He sees you" (Rahman 1996).

[36] Ali (2014).

[37] Sayings of Muhammad (Sallam and Hanafy 1988). Reported by Badawai (2013).

"Allah (SWT) has ordained excellence in everything…."

"Allah (SWT) loves, when one of you is doing something, that he/she do it in the most excellent manner."

3.8 Compassion and Generosity

Compassion (*rahma*) is a virtue that is greatly desired and admired. Compassion is stressed in the Qur'an as the basic attribute of God and all humans are expected to practice and exhibit it. Compassion calls for showing mercy, kindness, and passion toward others in all economic and social matters. One application of compassion is leniency in economic transactions in case of hardship and feeling the pain and suffering of the others.[38] Leniency is especially encouraged with respect to debtors who are in difficult conditions provided that they made sincere efforts to meet their obligations.[39]

Generosity is a virtue that calls for giving someone's due right beyond normal expectations and sharing one's time, wealth, and knowledge with others.[40] Generosity can take several forms such as generosity toward others in redeeming their rights or generosity in voluntary social welfare contributions or not taking advantage of customers. Virtues of compassion and generosity play an important role in strengthening social bonds among humans and bringing humans closer.

3.9 Prudence and Humility[41]

The role of man as vicegerent (*khilāfah*) of the Creator carries very heavy responsibility to act with prudence because any violation of this trust itself would be unethical. This responsibility demands prudent management of an organization's or a country's as well as earth's resources; care and concern for animals; and protection of the natural environment.[42] Utilization of resources whether scarce or abundant, requires careful

[38] The Prophet is reported as saying, "May Allah's (swt) mercy be on him who is lenient in his buying, selling, and in demanding back his money [or debts]" (Bukhari, No: 1934).

[39] Kamali (2011). The Prophet (saas) said, "Truly the best of people are those who are best and most courteous in their demand for repayment." He takes a strong position that for those who take unfair advantage and procrastinate in their repayment of obligations, their conduct is tantamount to oppression (*ẓulm*) that falls outside the scope of lenient treatment.

[40] The Prophet is reported saying, "Allah (swt) is generous, He loves generosity; He is noble, He loves nobility" (al-Tirmidhi), and "the best amongst you is he who repays the rights of others handsomely" (Bukhari, Vol 3, Book 038, No. 502).

[41] Qur'an (4:36–37) "God loves not the arrogant, the vainglorious (nor) who are niggardly, enjoin niggardliness on others…"

[42] Kamali (2011).

management keeping in mind the well-being of the community and the society. No one is authorized to destroy or waste God-given resources.[43] Wasting of resources is strongly condemned in Islam. Several externalities including sustainable development could follow if the vice of wasting resources is overcome.

Whereas wasting resources is condemned, having excessive control on resources and not spending or utilizing for good causes is equally condemned.[44] Islam calls for moderation and to have a balance in social and economic dealings. Prudency calls for restoring balance in managing and utilizing resources to optimize the benefit and welfare for all. Prudence is an essential virtue for those who are in the position of leadership or management.

Islam links piousness with nobility and the highest form of an individual character that appears as a role model for others. Character and personality of a manager or leader would be expected to be above others as a role model, as well as someone whom employees could trust and has integrity. A manager's approach to decision-making, solving problems, resolving conflicts, and leading the objectives of the organization should reflect the virtues he/she follows. A manager will not only have the responsibility of doing the task well but also of ensuring that the actions of his team and the organization lead to ethical outcomes.

Humility is a valuable virtue considering that a person should be fully conscious of the state of humans with respect to the Creator. Being humble is appreciated and arrogance is considered the worst of vices. Arrogance is particularly disliked due to it being the root cause of many other evils. Spiritually, arrogance signifies man's claim of having better knowledge than the Creator and therefore, developing a sense of over-confidence and superiority with respect to other humans. History is witness to the destruction of civilizations or leaders due to arrogance.

[43] Rice (1999). She gives the example of the 1st Caliph after the Prophet, Abu Bakr, who instructed not to kill indiscriminately or to destroy vegetation or animal life, even in war and on enemy territory, as an example of high ethical standards and the virtue of protecting the environment. She argued that if these were the standards in wartime, there would be no question of any waster or destruction during the time of peace.

[44] Qur'an (6:141) "…and do not waste [God's bounties]: verily, He does not love the wasteful."

Qur'an (7:31) "O children of Adam! Beautify yourselves for every act of worship, and eat and drink [freely], but do not waste: verily, He does not love the wasteful."

Qur'an (25:67) "…and who, whenever they spend on others, are neither wasteful nor niggardly but [remember that] there is always a just mean between those [two extremes]."

Prudency calls for showing humility in making short-term and long-term decisions and being conscious of one's limitations and of its potential impact on other humans and the society. Since there is a very strong concept of accountability to the Creator of one's acts, one needs to be conscious of the consequences of the acts individually, and strive for developing a culture of the organization that encourages humility.

3.10 Honesty in Business Transaction

The virtue of being honest in business transactions is the very basic character trait of a believer. The Qur'an binds faith and action through righteous deeds as inseparable. The Prophet (SAAS) explicitly declared honesty an article of faith as he said that there is no faith for one who lacks honesty.[45] Honesty does not only come from being truthful but requires avoidance of vices for worldly gains. There are several vices that are discouraged greatly when one is engaged in business transactions. Examples of such vices are purposefully deceiving others, engaging in cheating and fraud, and willfully holding or manipulating information pertaining to the transaction. One full chapter of the Qur'an is dedicated to manipulating weights and measures, and giving short-measures such as the act of giving short-measures while demanding full measures from others. The chapter emphasizes the grave consequences of such behavior.[46] The Qur'an also makes reference to the community of the Prophet Shu'ayb (sws), which was known for engaging in deceitful business practices, especially the manipulation of weights. Consequently, the community was destroyed for its persistence in deceit.

Therefore, honesty in business transactions has to be the core virtue of any business person.

[45] Badawi (2013).

[46] Qur'an (83:1–3) "Woe to those that deal in fraud. Those who, when they have to receive by measure from men, exact full measure, but when they have to give by measure or weight to men, give less than due."

Qur'an ((17:35) "And give full measure when you measure, and weigh with a just balance. That is good and better in the end."

The Prophet (SAAS) is reported to have said: "if both the parties (buyer and seller) have spoken the truth and described the defects as well as the merits thereof (the goods), they would be blessed in their deal. If they have told lies or concealed something, then blessings of their transaction would be lost." (Bukhari, No: 1937)

3.11 Cooperation and Solidarity

Islam seeks to guide man to direct individual action and responsible participation in economic affairs in a manner that commits him to community solidarity and cooperation, resulting in a dynamic and growing economy. Thus, the individual is made accountable for the moral effects of his social actions, including those in economic affairs, so that his own inner personal-spiritual transformation and growth is bound to the progress of the community.

Hence, Islam utilizes cooperation and competition in structuring the ideal society through harmonization and reconciliation between these two opposite, but equally primeval and useful forces at every level of social organization. From this perspective, one can argue that one of the greatest distinguishing characteristics of Islam is its forceful emphasis on the integration of human society as a necessary consequence of the unity of Allah (SWT). To this end, the personality of the Prophet (SAAS) is inseparable from what the Qur'an considers as the optimal approach necessary for the emergence of solidarity in human society. Every dimension of the personality of the Prophet (SAAS), manifested in his various social roles in the community, is directed toward maximum integration and harmony in the society. Moreover, every rule of behavior, including those in the economic area, is designed to aid the process of integration. Conversely, all prohibited practices are those, which, one way or another, lead to social disintegration.

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CHAPTER 4

Business Ethics in Islam

Discussion on business ethics in Islam is not new; it has been dealt with extensively since the early history of Islam. Significant discussion and analysis of the positions of the Qur'an and the Sunnah on morality and ethics were provided by the 4th Caliph Imam Ali (AS) in his book, Nahjul Balaghah, and by his grandson, Imam Zayn al-'Abedin (AS) in his book, *Risalah al-Huquq* (Treatise on Rights), which also included the *Risalah Al Huquq* (Treaties on Rights) covering moral and ethical behavior toward others according to the Qur'an and Sunnah.[1] Another important early work on morality and ethics in Islam is by Abu Ali ibn Mohammad ibn Ya'qub Miskawayh (born 320 AH, died 421). His work is considered to have influenced the thinking of leading thinkers such as Al-Ghazali and Nasiruddin Tusi on this topic.

Subsequently, the discussion mainly took place while developing principles underlying legal axioms. For example, scholars such as Al-Ghazālī (2005) dealt with the ethics of earning and living as he dedicated one full chapter in his classical work *Iḥyā' 'Ulūm al-Dīn* (Revival of Islamic Sciences).[2] He identifies virtues of justice, truthfulness, and benevolence

[1] See Ali Ibn Abu Talib (1973, 1988) and Zayn Al'Abidin (1988). More recently Lakhani (2006) presented the concept of justice in light of the teaching by Imam Ali (AS).

[2] He dedicated a chapter on the ethics of earning and living (Kitāb al-Ādāb al-Kasb wa al-Ma'āsh), which precedes the chapter on lawful and unlawful matters (Kitāb al-Ḥalāl wa al-Ḥaram). Musa (2015).

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as the main ethical values that must be internalized by agents in any business transactions. Similar work has been carried out throughout the history of Islam as ethics has always been considered as an integral part of Islamic teachings and Law.[3] With deteriorating values and ethics globally, particularly in the financial markets and institutions, and the growing presence of Islamic finance, there is renewed interest in the ethics driven by religious principles. Recently, efforts have been made to partner with other religious groups to bring back ethics in business.[4]

The previous chapter discussed core virtues and character traits desirable in a human being in the Islamic perspective. These virtues lay the foundation of defining business ethics, and the internalization and actual realization of these virtues in day-to-day social and economic matters would ensure that decisions and actions taken lead to ethical practices. For example, internalization of core virtues such as the realization of the unity of creation, justice, and protection of rights would lead to ethical business practices in all cycles of business starting from production to consumption to distribution. In addition, core virtues would determine market conduct rules to promote transparent and just markets void of malpractices.

This chapter expands the application of virtues to business ethics and develops a framework of ethical business that has universal appeal and could address prevalent ethical challenges in economic and financial markets as highlighted in earlier chapters.

4.1 Market Conduct[5]

In the realm of conventional economics, reliance on markets is an ideology to some economists; this is not so in Islam. This is because markets and competition do not by themselves guarantee that social and economic justices will be served. In Islam, markets are seen as affording the best

[3] Al-Nabahānī (1990) collected verses of the Qur'ān, Prophetic Traditions and sayings of scholars, which he felt should be given attention by those involved in business, in his treatise that serves as a simple reference for those who would like narrations on ethical issues related to business.

[4] Prince Philip of Great Britain and Prince Hassan bin Talal of Jordan initiated consultations in 1984 with the objective to produce a common inter-religious (between Abrahamic/monotheist faiths; Judaism, Christianity, and Islam) declaration on ethics in international business (Dion 2002). As a result, in 1993 a Code of Ethics in International Business for Christians, Muslims, and Jews was finalized in Amman, Jordan.

[5] See Mirakhor (1989) and Askari et al. (2015).

signaling mechanism to producers and consumers and thus the most efficient intermediary for resource allocation, economic production, distribution, and consumption. Therefore, markets are encouraged. Even then, markets must have rules that are just and insure their proper operation, and they must be supervised to guarantee that rules are followed and enforced. While these rules and their supervision and enforcement are seen as sufficient in the workings of the conventional market system, it is not so in Islam. In Islam, market participants, both buyers and sellers, must embrace a code of morality before they enter the market. Under such a system, the price that emerges from markets can be considered "just" in the sense that it is the result of proper functioning markets that are based on just rules that are followed and enforced and with market participants who are moral in their behavior. In the absence of morality and moral behavior by all market participants, markets can result in allocations that are socially unjust and even perverse—gross income inequities, opulence alongside poverty, excessive consumption and little savings, hoarding, and the like. Thus, markets left alone may not fulfill human material needs and are also not equipped to address human spiritual needs.

Islam's emphasis on moral and just conduct in the marketplace is remarkable in its vigor. A producer or a businessman whose behavior complies with Islamic rules is said to be like the prophets, martyrs, and the truthful friends of Allah (SWT). He is ranked with the prophets because he, like the prophets, follows the path of justice; like martyrs because they both fight with heavy odds in the path of honesty and virtue; and like the truthful because both are steadfast in their resolves. It asks participants to go beyond the rules of the Sharīa'h and extend beneficence to one another as a safeguard against injustice. Beneficence implies helping others in ways not required by justice. It is thus different from justice, which prescribes just limits to selfishness. While justice regulates and limits selfishness, beneficence rises above it. Moreover, participants in the market are not only responsible for their own just behavior, but because of the obligation of "enjoining the good and forbidding the evil" (Qur'an 3:104), they are also made responsible for the behavior of their fellow participants. Islam maintains that if a man sees another committing an injustice toward a third party and fails to attempt to remove that injustice, he becomes a party to that injustice. If the person failing to help is himself a beneficiary of this injustice, then his failure is considered tantamount to supporting it. Although provisions are made for coercive and corrective action by legitimate authorities, the

clear preference is for self-management of the market. Any interference in the operations of such a market—through price controls, for example—is considered unjust, and represents a transgression and sin.

It was in response to the rules of market behavior imposed by Islamic tenets and laws that Muslims early in their history structured their markets in the form of bazaars, which looked almost the same all over the Muslim world and possessed characteristics that promoted compliance with the rules. Physically, bazaars were structured to guarantee maximum compliance with these rules. Each physical segment of the market was specialized with respect to specific products, and the prices showed little variation from one part of the market to the next. The institution of guilds made self-regulation of each profession and trade possible. Additionally, markets were inspected for compliance by a market supervisor (*muhtasib*) who was appointed by local judges. Unfortunately, the institution of bazaars did not have the opportunity to evolve to meet the requirements of an expanding economy or the growing complexity in economic relations. The bazaars that still exist in many parts of the Muslim world, while maintaining their underdeveloped physical and infrastructural nature—most are centuries-old and have not been expanded—lack many of the Islamic characteristics and requirements in their operations.

The market's institutional structure is built around five virtues: (a) protection of property rights; (b) free flow of information or transparency; (c) trust; (d) commitments to contracts; and (e) the right not to be harmed by others and the obligation not to harm anyone. Together, these virtues serve to reduce uncertainty and transaction costs and to enable cooperation and collective action to proceed unhindered.

Before the advent of Islam, trade had been the most important economic activity of the Arabian Peninsula. A number of thriving markets had developed throughout the area. Upon his arrival in Medina, the Prophet organized a market that was structured and governed by rules based on the Qur'an. He implemented a number of policies to encourage the expansion of trade and the market. The Prophet (SAAS) prohibited the imposition of taxes on individual merchants as well as on transactions. He also implemented policies to encourage trade among Muslims and non-Muslims by creating incentives for non-Muslim merchants in and outside of Medina. After the conquest of Mecca and the rest of Arabia, these and other market rules were institutionalized and generalized to all markets. These rules included, in addition to those mentioned above:

- No restrictions on international or interregional trade (including no taxation of imports and exports)
- Free spatial movement of resources, goods, and services from one market to another
- No barriers to market entry and exit
- Free and transparent information regarding the price, quality, and quantity of goods, particularly in the case of spot trade
- Specification of the exact date for the completion of trade in instances when trade was to take place over time
- Specification of the property and other rights of all participants in every contract
- Guaranteed contract enforcement by the state and its legal apparatus
- The prohibition against hoarding commodities and productive resources for the purpose of pushing up their price
- Prohibition on price controls
- A ban on sellers or buyers harming the interests of other market participants by, for example, allowing a third party to interrupt negotiations between two parties in order to influence the negotiations to the benefit of one of the parties
- A ban on the shortchanging of buyers by, for example, not giving full weight and measure

Moreover, sellers and buyers were given the right of annulment of a business agreement in these seven instances:

- Before leaving the location in which it was taking place.
- In the case of a buyer who had not seen the commodity and after seeing it found it unacceptable.
- If either the seller or the buyer discovered that the product had either been sold for less than, or bought for higher than, it was worth.
- If the buyer discovered that the quality of the product was not as expected.
- If side conditions were specified during the negotiations that were left unfulfilled.
- If a delivery period was specified but the product was not delivered on time.
- If the subject of the negotiations were pack animals, the buyer had the right to return the animal up to three days after the deal was finalized.

The moral-ethical foundation of market behavior prescribed by the Qur'an and implemented by the Prophet (SAAS) ensured the minimization of risk and of uncertainty for market participants and increased the efficiency of exchange. Its aim was to reduce transaction costs. Moreover, rules specified in the Qur'an regarding faith to the terms of contracts and the knowledge of their enforcement increased certainty and reduced transaction costs. Another important rule promulgated by the Prophet (SAAS) was the prohibition of interference with supply before entrance into the market. From the earliest period of operation of the Medina market, the Prophet (SAAS) appointed market supervisors, whose job was to ensure rule compliance, which in turn would result in markets that were just. The Prophet (SAAS) advised the participants to go beyond mere rule compliance and to treat their fellow humans with beneficence. The Prophet (SAAS) strongly encouraged market participants to accept the duty of "commanding the good and forbidding evil" by engaging in self-regulation.

4.2 Work and Work Ethics[6]

The concept of work (*al-amal*) in Islam is far broader, and has different characteristics and objectives, than the concept as it is understood in the Western economic tradition. In Islam, the work ethic is defined by the Qur'an itself, which stresses the need for work and action by human beings.[7] Nasr (2011) articulates the following moral and ethical dimensions of the concept of work in Islam:

(a) Work is tightly coupled with human action and the ethical considerations of Islam.
(b) The basis of all work ethics in Islam is to be found in the inescapable moral character of all human action and the responsibility that

[6] Possumah et al. (2013) provides useful background reference reading on work ethics in Islam.

[7] See Nasr (2011) for the philosophical underpinning of the concept of work in Islam. For example, he maintains that the term "work" (*al-amal*) in Arabic is not distinguished from the word "action" in its most general sense and is treated by Shari'ah under the same category. In fact, if one were to look for the translation of the word "work" in an English-Arabic dictionary, one would usually find the two terms "*amal*" and "*sun*" given as its equivalents. The first of these terms means "action" in general as contrasted with "knowledge" and the second "making" or "producing" something in the artistic and artisanal sense of the word.

a human being bears for his or her actions, not only before the employer or employee, but also in relation to the work itself, which must be executed with the utmost perfection of which the "actor" or worker is capable.

(c) There is no emphasis in Islam upon the virtue of work for the sake of work. Work is considered a mean and necessity to establish equilibrium in one's individual, family, and social life but not to lead to greed and excessive accumulation of wealth.

(d) Work considered in its economic aspect, should be carried out following a contract based upon justice and responsibility on the side of the employer as well as the employee. The worker is responsible to both the employer and to God to carry out, to the best of his or her ability, the work which he or she has undertaken to accomplish on terms agreed by the two sides.[8]

It is because of this emphasis on work that Islam is considered a religion of action. The Qur'an exalts work and raises it to the level of worship, considering work as an inseparable dimension of faith itself. Conversely, it considers idleness—or the squandering of time in pursuit of unproductive and non-beneficial work—as the manifestation of lack of faith and of unbelief.

Man is called on to utilize time in pursuit of work by declaring that Allah (SWT) has made the day as a means of seeking sustenance. A person who, through hard work, seeks the "bounty" of Allah (SWT)—which includes all appropriate means of earning one's livelihood—is most highly praised. All able-bodied persons are exhorted to work in order to earn their living. No one who is physically and mentally able is allowed to become a liability to his family or to the state through idleness and voluntary unemployment. The work that everyone is required to perform must be "good" or "beneficial" (*al-amal as-salih*), but no work is considered inconsequential in relation to its rewards or punishments in this world and in the next. One will have to reap whatever rewards or retributions are due as a result of one's work.

[8] There is a very strong element present among traditional Muslims concerning eating "halal bread'"; that is, gaining an earning that one deserves in accordance with the accomplishment of an agreed piece of work. Any element of cheating on part of either employer or employee would make it non-halal (Nasr 2011).

Work, therefore, is regarded not only as a right but also as a duty and an obligation. Hence, based on its notion of individual rights and responsibilities, Islam extends to individuals the right to choose the type of work they desire. Along with this freedom come the obligation to consider the needs of society and to select the type of work permitted by the Shari'ah.

Since all class distinctions are negated by Islam, no line of work permissible by the Shari'ah is considered demeaning by Islam, which countenances only diversification on the basis of natural talents, skills, and technology—which are considered to be a grace or blessing (*fadl*) from Allah (SWT)—and which all Muslims are urged to acquire. Based on its concepts of justice and contracts, Islam makes it an obligation for workers to perform the tasks that they have contracted to the best of their abilities. But since individuals are endowed with different abilities and talents, this productivity will differ. Justice, however, demands that the return for every individual's work must be commensurate with his or her productivity, but not that all humans receive the same remuneration.

Virtues of unity and justice lay a bilateral working relationship and ethics between an employer and an employee. Elements of fairness and solidarity with fellow humans irrespective of race, religion, and creed are the corner stones of the employer-employee relationship. An employer has moral responsibility for the overall welfare, fair treatment, fair wages, good working conditions, suitable work, and the opportunity to have work-life balance.[9] In return, the employee is expected to deliver work according to the best of his efforts and skills, work conscientiously and diligently,

[9] Azmi (2013). Several sayings of the Prophet (SAAS) support just treatment of workers emphasizing the obligations of the employer to the employee.

> "Those are your brothers [workers under you] who are around you, Allah has placed them under you. So, if anyone of you has someone under him, he should feed him out of what he himself eats, clothe him like what he himself puts on, and let him not put so much burden on him that he is not able to bear, [and if that be (the case], then lend your help to him". (Bukhari, No: 2359)

> "I will be foe to three persons on the Last Day: one of them being the one who, when he employs a person that has accomplished his duty, does not give him his due". (Bukhari, No: 2109)

> "The wages of the laborers must be paid to him before the sweat dries upon his body". (Ibn Majah, No: 2434)

protect the property of the employer, and act as a trustworthy worker. Finally, Islam's concepts of work ethics and economic and social justice lay the foundation for policy-makers in formulating policies related to discrimination, minimum wages, avoidance of exploitation, facilitating adequate working environments, protection from any industrial hazards, and managing work-life balance.[10]

4.3 Production, Consumption, and Distribution

Islam emphasizes that one must remain fully conscious of the human partnership throughout the process of wealth creation and the fact that they must redeem the rights of others in the created income and wealth. In practical terms, the Qur'an makes clear that the objective is to create a balanced society that avoids the extremes of wealth and poverty, a society in which all understand that wealth is a blessing provided by the Creator for the sole purpose of providing support for the lives of all. This can be achieved if the rules and ethics of the cycles of production, consumption, and distribution of Islam are followed.

Work ethics as described above and by which work is considered as an act of worship especially when it is done well is the corner stone of production. Properly understood, this concept is instrumental in motivating productivity to gain the ultimate pleasure of the Creator through productive work and is far beyond the mechanical concept of production and productivity. The production process itself is subject to large set of virtues such as contracts, property rights, excellence in work, and trustworthiness. Some examples of ethical concerns in the production processes are given below:

(a) The production of goods and services can be considered as part of man's trusteeship role and therefore requires that all the conditions and obligations of that trust are met.
(b) The method of production should not cause an undue and excessive harm to the Creator's resources and bounties that are for the benefit of all mankind.[11]

[10] Chapra (1983) quotes hadith "God loves that when any one of you does a job, he does it perfectly"; cited on the authority of Bayhaqi's Shu'ab al-iman by Suyuti, v.1, p. 75.

[11] The Qur'an speaks repeatedly against spreading mischief or corruption in the land (2:60,2:205,5:46,7:56). Prophet (SAAS) spoke of the punishment of anyone who kills a sparrow without a legitimate reason [e.g., for food], or one who cuts a tree for no good reason (Badawi 2013).

(c) Productive resources are not to be left idle in the name of private ownership, especially resources that are crucial to the lives of people.[12]
(d) The production process should not cause harm to others including to the environment. In situations where some harm is inevitable, a careful weighting of relative harms and benefits should be made. Furthermore, a party that may be harmed must be compensated, based on the cardinal rule in Islamic Law that harm must be removed or compensated if inevitable.[13]
(e) The production process should maintain a healthy work-life balance and ensure that the processes do not put the workers under excessive stress. Processes should be designed to have fair opportunities for workers to maintain physical, mental, and spiritual health.

An imbalance in the production cycle could lead to an imbalance in wealth and income accumulation in any economy. The Islamic view holds that it is not possible to have many rich and wealthy people who continue to focus all their efforts on accumulating wealth without simultaneously creating a mass of economically deprived and destitute. The rich consume opulently while the poor suffer from deprivation because their rights in the wealth of the rich and powerful are not redeemed.

To avoid this, Islam prohibits the accumulation of wealth, and imposes limits on consumption through its rules prohibiting waste (*itlaf*), overspending, ostentatious and opulent spending (*israf*).[14] It then ordains that the net surplus, after moderate spending necessary to maintain a modest living standard, must be returned to members of the community who, for a variety of reasons, are unable to work and hence whose resources they could have used to produce income and wealth have been utilized by the more able. The Qur'an considers the more able as trustee-agents in using

[12] Badawi (2013) quotes the following saying of the Prophet (SAAS) to endorse this argument and implying that resources should not be kept idle on the basis of personal preferences or constraints:

> "If one of you possesses a piece of [cultivable] land, let him cultivate it. And if he is not able to cultivate by himself, let him give it to his brother."

[13] Badawi (2013).

[14] For example, see Qur'an (7:31) "…eat and drink, but be not excessive. Indeed, He [Allah] likes not those who commit excesses"; and Qur'an (5:87) "O believers, do not prohibit the good things that Allah has made lawful to you and do not transgress. Indeed, Allah does not like transgressors."

these resources on behalf of the less able. In this view, property is not a means of exclusion but inclusion, in which the rights of those less able are redeemed in the income and wealth of the more able. The result would be a balanced economy without extremes of wealth and poverty.

Distribution takes place post-production and sale when all factors of production are given what is due to them commensurate with their contribution to production, exchange, and sale of goods and services. Redistribution refers to the post-distribution phase when the charge due to the less able are levied. These expenditures are essentially repatriation and redemption of the rights of others in one's income and wealth. Redeeming these rights is a manifestation of belief in the Oneness of the Creator and its corollary, the unity of the creation in general and of mankind in particular. It is the recognition and affirmation that Allah (SWT) has created the resources for all of mankind who must have unhindered access to them. Even the abilities that make access to resources possible are due to the Creator. This would mean that those who are less able or unable to use these resources are partners of the more able.

4.4 Competition and Cooperation

The economic system designed in accordance with the fundamental principles of Islam ensures that humans can exercise their eminent dignity, freedom, responsibilities, and rights in the conduct of economic affairs. The economic system must be so ordered as not to assign to man a purely instrumental role in achieving the goals of the economy or the state. Islam seeks to guide man to direct individual action and responsible participation in economic affairs in a manner that commits him to community solidarity and cooperation, resulting in a dynamic and growing economy. Thus, the individual is made accountable for the moral effects of his social actions, including those in economic affairs, so that his own inner personal-spiritual transformation and growth is bound to the progress of the community.[15]

The Qur'an and the traditions of the Prophet (SAAS) make clear references to the dual nature of competition and cooperation; that is, human beings can cooperate and compete for good or evil. It is this that leads to the integration or disintegration of society. The fundamental sources, however, emphasize that competition and cooperation must be utilized in

[15] Askari et al. (2015).

probity and piety rather than in evil and enmity. Thus the Qur'an declares: "Cooperate with one another unto righteousness and piety. Do not cooperate with one another unto sin and enmity" (5:2). Similarly, Muslims are urged to compete with one another in beneficial and righteous deeds. These sources do not allow suppression of competition or cooperation in favor of the other when they are used within the Shari'ah framework. Rather, all of the regulatory and supervisory authority invested in the legitimate political authority is directed toward a balanced and constructive utilization of these forces. The Shari'ah rules regarding the structure of the market and the behavior of market participants are examples of such balance. Although the rules of the Shari'ah regarding economic affairs demarcate limits and boundaries of desirable competitive and cooperative behavior necessary for the provision and preservation of the solidarity of society, the individual always remains the identifiable agent through whose action (and on whose behalf) all economic activity takes place.

4.5 Stakeholders' Rights

Business ethics in Islam provide recognition and protection of the rights of stakeholders to the business under the virtues of preservation of rights, honoring of implicit contracts, mutual trust,[16] and just treatment. These virtues define the ethical framework of bringing stakeholders their due right and giving a say in the governance framework of businesses.[17]

Whereas discussion on recognizing the rights of stakeholders is one matter, how to draw a line of distinction between a stakeholder and a non-stakeholder is another important issue. The existence of a stakeholder entity and its rights are easy to recognize, but the question still remains who really qualifies as an actual stakeholder? Another issue deals with the stakeholders' right to influence management decision making or to participate in governance of the firm. Questions arise why stakeholders should be given such a right and why managers should have a fiduciary duty to protect rights of non-investor or non-owner stakeholders if such stakeholders have protected their rights through bargaining in the terms

[16] Quddus et al. (2005), "God does command you to render back your trusts to those to whom they are due…" (Quran 4:58).

Quddus, Munir, Henri Bailey, III, and Larry White, Business Ethics—Perspectives from Judaism, Christianity and Islam, 2005 Proceedings of the Midwest Business Economics Association.

[17] Iqbal and Mirakhor (2004).

of the contracts. Whereas there appears to be a consensus on identifying the rights of non-owner stakeholders and an implicit agreement to protect these rights, there is still a debate on why such stakeholders should participate in the control and management processes of a firm. For example, the notion that property rights are embedded in human rights and that restrictions against harmful uses are intrinsic to the property rights concept clearly highlights the interests of other non-owner stakeholders, but it remains unclear which uses of property should be restricted and which persons should count as stakeholders. Simply bringing non-owner stakeholders into the conception of property rights does not provide by itself a justification for assigning any specific groups of stakeholders, such as employees and customers, managerial responsibilities.[18] So far, discussions of the stakeholder model have not been able to articulate a convincing argument on either theoretical, moral, or legal grounds to recognize an active role of stakeholders in the management and control of a firm.

In considering an Islamic view of the role of stakeholders, it is noted that two fundamental concepts of the Islamic economic system pertaining to property rights and contracts govern the economic and social behavior of individuals, society, and the state. These two principles also dictate the objective function of economic agents, including legal entities like firms. A firm in the Islamic economic system can be viewed as "nexus-of-contracts" whose objective is to minimize transaction costs to maximize profits and returns to investors subject to the constraints that these objectives do not violate the property rights of any party whether it interacts with the firm directly or indirectly. In pursuit of these goals, the firm honors its obligations to explicit and implicit contracts without impinging on the social order. This definition incorporates the stakeholders' role in its view of the firm and supports the recognition and protection of their rights.[19]

4.6 Transparency

The virtue of truthfulness is the cornerstone of conducting ethical business where decisions are made in a transparent fashion and full disclosure is made to internal and external stakeholders. Islam encourages truthfulness in business transactions and raises the status of a truthful merchant so much so that he will be at par with the martyrs who give their lives in good causes. A business transaction void of transparency or

[18] Donaldson and Preston (1995).
[19] Iqbal and Mirakhor (2004).

willful misinformation may give the business monetary benefits but such a transaction will not only be considered void of any blessings but also subject to accountability on the Day of Judgment. The virtue of trustfulness would require both parties to a business transaction to be transparent and have full disclosure on all aspects of the transaction including the terms of the contract, quality of the product or services subject to exchange, and the terms and the modes of payment.

Transparency is becoming more important than ever due to market-based economies, where information is valuable and any relevant information could have an immediate impact on the value of a business. Corporations whose shares are traded on the stock markets are subject to share price volatility when the market's expectations change as result of the arrival of new information. Hiding or delaying bad information with potential negative impact on the share price, or creating a hype and increasing expectations to increase share prices, would be examples of unethical behavior.

Similarly, Islamic business ethics would expect full transparency of financial reporting and would disapprove of any tinkering or misrepresentation of information to mislead reporting, which therefore would be considered unethical. Despite efforts such as the Sarbanes–Oxley Act of 2002 introduced to enhance the transparency of financial statements and the conduct of business leadership, management, and boards of directors, unethical practices and reporting continued and led to the financial crisis. This pattern clearly calls for complementing laws with building the character of management and leadership for transparent business practices as advocated by Islam.

4.7 Business Leadership

Business leader or manager carries significant responsibility on his/her shoulders. First and foremost, manager is expected to carry best of character or virtues in conducting business and be accountable to superiors, subordinates, and stakeholders. Deteriorating values and ethics of top business leaders witnessed during the financial crisis is testimony to the importance of business leaders internalizing ethical behavior rather than focusing on personal interest and greed. As stated in previous chapter, in Islam, the character of the Prophet (saas) is the ultimate role model and his character traits are to be emulated in all personal, social, and economic behavior.

A good business leader ought to possess virtues of truthfulness, trustworthiness, striving for excellence, being conscious of the rights of all

stakeholders, and acting in prudence. A business leader should be truthful about financial statements, products being sold, and business practices. A business leader is expected to reflect the virtue of trustfulness in his/her conduct. Such trust has different dimensions. Whereas at one level, he/she is entrusted with the responsibility of managing the wealth of shareholders, at another level, internal stakeholders such as employees have put their trust in the expectation of fair treatment. Thus it becomes the responsibility of the leader to maintain a fair balance and be conscious of the responsibility and accountability of this trust.

The business manager will have the responsibility of developing and enforcing a complete code of ethics for the organization and have a comprehensive program to internalize these ethics by the employees and managers. Having a code of ethics itself is not sufficient; a business leader has the responsibility of ensuring that periodically training is provided to the employees making them aware of their ethical responsibilities. Having an incentive system in place to reward ethical behavior would be essential.[20] Finally, it would be the responsibility of the leader to have an internal justice system in place to which all are answerable, irrespective of their rank or position in the organization.

Leaders who are fully conscious of their responsibilities, limitations, and obligations as expected in Islam could never fall into a behavior that would promote arrogance, ignorance, greed, deceitfulness, non-transparency, and delinquency. Islam governs the behavior of leaders at least no less stringently than those of individuals. Although each member of society is expected to exhibit high moral values in the observance of contracts and covenants, many scholars are of the view that these requirements apply with even greater force to the actions of leaders. Therefore, a breach of faith on the part of a leader is more heinous in its nature and more serious in its consequence than a similar breach by an ordinary individual.

Finally, a business leader is to exhibit the virtue of humility rather than arrogance.[21] Arrogance is considered a vice to be avoided because arrogance could lead to impairment of judgment to the point that one could violate the virtues of justice and preserving the rights of others. Arrogance has been known to be the cause of downfall not only of businesses but even of civilizations. Collins (2009) observed corporate behavior of leaders in

[20] Abbas et al. (2012).

[21] See Quran (17: 36–37) "Do not be arrogant in one's claims or beliefs: And pursue not that of which thou hast no knowledge; for every act of hearing, or of seeing or of (feeling in) the heart will be enquired into (on the Day of Reckoning). Nor walk on the earth with insolence: for thou canst not rend the earth asunder, nor reach the mountains in height."

his famous work, *How the Mighty Fall*, and identified different stages through which a corporate leader might go through during the course of his fall. He notes that in the first stage, managers become arrogant, considering success virtually as an entitlement, and lose sight of the true underlying factors that created success in the first place. As a result, the leaders overestimate their own merit and capabilities and finally succumb to hubris. During the second phase, there is the undisciplined pursuit of more—more scale, more growth, more acclaim, more of whatever those in power see as "success." Finally, in the third stage, leaders discount negative data, amplify positive data, and put a positive spin on ambiguous data. Those in power start to blame external factors for setbacks rather than accept responsibility. This represents the behavior of corporate leaders of the financial industry very accurately, as such behavior is prevalent industry-wide. In short, vices of arrogance, greed, untruthfulness, and no sense of accountability would destroy businesses and economies, having serious social impact.

4.8 Respecting and Protecting Environment

Islamic scholars have maintained that humans have the responsibility toward actions that could degrade or destroy the environment. Professor Seyed Hossein Nasr was one of the earliest scholars to warn about the environmental crisis. His seminal work *The Encounter of Man and Nature: The Spiritual Crisis of Modern Man* published in 1968 remains one of the earliest writings on the environmental crisis by any conventional or Muslim writers. He cites gross ignorance as a leading cause of the on-going environment crisis, which he believes can be alleviated if the global community begins to recognize the multiple states of being that are possible within the environment.

Islam is a rules-based economic and social system with guidance for all human behavior, and includes teachings on protecting the environment. If for nothing else, Islam maintains that the environment was not a byproduct of human creation, or in any way random, but rather, its creation was incontrovertibly purposeful.[22] "The creation of the heavens and the earth is far greater than the creation of mankind. But most of mankind do not know it," is another Qur'anic verse that establishes the notion that man's ability to analyze may lead him into thinking humans are superior to other species and systems found in the environment. The Qur'an

[22] The Qur'an declares that the creation of the physical universe is purposeful. "We have not created the heavens and the earth and all that is between them for mere idle play…" (44: 38–39).

specifically indicates the fact that the significance of the environment should, in no way, be made reductive.

Unfortunately, man's presence on earth has altered the Creation in directions that are arguably negative when it comes to the environment and its depletable natural resources, as well as more generally for their preservation for generations to come. This is especially ruinous for the developing world, which relies largely on water, wood, and other commonly exploited resources for economic survival. As a result of greed and the absence of sharing among current generations and making provisions for future generations, some natural resources are rapidly deteriorating from waste and exhaustion. Aside from the obvious environmental issues, the economic stability of many regions of the world is likely to continue to be impaired by changes in resource availability. However, conventional economic policies for growth and development invariably ignore pertinent environmental issues. But in Islam, the physical development of the earth is an integral component of development that includes human and social dimensions.

The development of the physical-material world and the human collectivity alike can only be achieved if the actions of humans are made in consonance with the environment. The Islamic concept of development includes individual human development, physical-material development, and development of the human collectivity.[23] The simple fact that the physical world is integral to the first and third concepts makes clear its unquestionable importance. Therefore, environmental preservation is essential for the well-being of all humans today and for future generations. It is in part for this reason that Islamic teachings direct humans to modest living (avoiding opulence), limiting their wants to only their needs, and to sharing (with current and future generations). Excessive consumption, *israf*, is prohibited explicitly as it leads to the unbalancing of the earth's harmonies. Highlighted in this passage is the important implication of creating a harmonious balance between the environment and man in prohibiting "extravagance." Similar explicit prohibitions against opulent consumption underline the need for balance in the use of resources.

As "regents," or trustees, humans are ordered to act preemptively and reactively to natural resource-related environmental events. Indisputably, enjoining environmental protection and discouraging its degradation are covered by this capstone rule of Islamic teachings. Therefore, it is incumbent on business in the Islamic perspective to ensure that their actions do not lead to degradation of the environment and all efforts are made to

[23] See Chap. 7 on ethical and responsible economic development.

protect the environment either through individual business or collectively through collaboration across the industry. Business leaders and stakeholders including shareholders or owners should be pro-active in the preservation of the environment as expected by Islamic virtues.

4.9 Avoidance of Vices or Unethical Practices

Virtues and vices are two faces of the same coin. Each virtue has implicit an opposite in the form of a vice that is a negative character trait to be avoided as it would lead to unethical behavior. For example, whereas truthfulness is a virtue, deceitfulness would be a vice. Whereas internalization of virtues is to be admired, the act of avoiding vices itself would become a virtuous act. There are several examples of vices that when practiced in a business would be considered unethical. A business practice would be considered unethical if one or more vices exist in the practice or in the intentions of an act.

In the Islamic perspective, corruption and bribery in any form are considered immoral and unacceptable. Corruption can take various forms ranging from favoritism, abuse of power or position, nepotism, and having personal gains. Corruption would violate the virtues of just behavior and encroach upon the rights of others. Similarly, bribery is another form of corruption that is condemned strongly by Islam. Bribery is a vice applicable not only to the receiver of the bribe but the giver is equally considered guilty and therefore subject to sanction.[24]

Vices of dishonesty, deceitfulness, and untruthfulness give rise to common business mal-practices of fraud, misappropriation, non-disclosure, and cheating the stakeholders and are strongly condemned in Islamic ethics' teachings. In the Qur'an, one full chapter is devoted to traders and businessmen with warning of giving short-measures and corrupting the weights to defraud customers. The practice of giving short-measures violates the virtue of encroachment of someone's property and the vice of greed for personal gains. The Qur'an is strict in making the point that

[24] Quddus et al. (2005). The Quran deals with bribery indirectly in the following verse (Chapter 2; v: 188), "And do not eat up your property among yourselves for vanities, nor use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people's property." This verse includes the use of one's own property for corrupting those in power or authority to obtain material gain even under the cover and protection of law. Definition of "other people's property" would apply to "public property."

traders and businesses who indulge in fraud are committing a grave sin in the eye of God and therefore, will be answerable.[25]

The practice of giving short-measure could be extended to any business practice where values of goods or services exchanged are not based on fair exchange, i.e., giving too little in exchange for more than the fair value. This core principle is therefore applicable to business dealings with not only customers or suppliers but also to other stakeholders including employees when they are given less than they deserve as fair remuneration.

4.10 Conclusion

Moral and ethical theory of Islam can be summarized simply as set of rules or virtues specified by the Creator for the well-being and welfare of the humans. This set of rules and virtues applies to all aspects of human life without any exception. Adoption and internalization of these virtues ensure justice. Despite what some scholars suggest and write that there is a separate theory of Islamic justice or moral/ethical position of Islam, there is none. Once the virtues are internalized and behavior becomes compliant with the rules, then morality, ethics, justice all are obtained. This is why Allah (swt) points to the role of the Messengers and Prophets as to read His book of rules to people, cleanse them, then teach them the wisdom behind the rules in the book and then induce them to establish interpersonal justice (*qist*).

Based on the set of virtues that are to be internalized by individuals, businesses, and corporations, a framework of business ethics in Islam is drawn. Whereas the character traits of individuals are easy to understand and explain, the application of similar traits on businesses or legal entities such as corporation is not straightforward. Businesses and corporates are the sum of the character traits of the individuals managing and running the businesses. There is a need to develop a character of business entities that emulates the desirable moral character of individuals. Therefore, a business entity should also strive for internalizing virtues of justice, preservations of rights, commitment to contracts, transparency, and fairness. Once businesses adopt such core virtues and avoid associated vices, their practices and actions would be considered ethical.

[25] See Chapter 83 of Quran titled, "The Dealers in Fraud," which states "(1) Woe to those that deal in fraud; (2) Those who, when they have to receive by measure from men, exact full measure; (3) But when they have to give by measure or weight to men, give less than due; (4) Do they not think that they will be called to account? (5) On a mighty day, (6) A day when all mankind will stand before the Lord of the Worlds."

This chapter developed the framework of business ethics based on the virtues of Islam as explained in the previous chapter. Ethical business practices would reflect the application of single or multiple virtues and would ensure that a business' conduct is ethical and is devoid of any vices. Table 4.1 lists select business practices or issues and the relevant virtue or virtues to be applied.

Table 4.1 Virtues and business ethics

Business practice/issue	*Relative virtues*
Financial inclusion	Justice Unity Preservations of rights
Transparency	Truthfulness Trustful Honesty
Predatory lending	Truthfulness Trustworthiness Justice
Consumer protection	Preservations of rights Truthfulness Trustworthiness
Investor protection	Preservations of rights Trustworthiness Justice
Fair treatment of employees	Justice Preservation of rights Compassion Generosity and leniency
Equal opportunity and discrimination	Unity Justice Preservation of rights
Price fixing	Truthfulness Trustful
Work-life balance	Work ethics Compassion
Fair compensation	Justice Preservation of rights Work ethics
Bargaining	Truthfulness Trustworthiness Generosity
Dumping	Truthfulness Preservation of rights
Sweat shops	Work ethics Justice Preservation of rights

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CHAPTER 5

Ethical Dimensions of Islamic Economics and Finance

Having developed a framework of virtues and business ethics in previous chapters, this chapter discusses the application of the ethical framework to Islamic economics and finance. An in-depth analysis of risk sharing, materiality, social and economic justice, and governance aspects of Islamic economics and finance are provided, arguing that such a framework provides rich ethical standards and ensures finance that is responsible and good for the society.[1]

Ethics are embedded in the core principles of Islam and each rule prescribed has explicit or implicit ethical dimensions reflecting its adherence to core values and virtues.[2] The philosophical foundation underlying the development of legal rules as well as its objectives (*maqasid*) is based on Islam's core values and virtues ensuring ethical outcomes. Following of the rules will set the standards of an overall ethical behavior for individuals, firms, community, state, and the society. This defines a perimeter by sanctioning immoral and harmful activities with the objective to achieve the overall welfare of the society as a whole. The perimeter defined by the rules becomes the limit beyond which ethics would be compromised. As long as one is rule-compliant, there would not arise any question of any unethical behavior.

[1] For further details on Islamic finance and Islamic economics see Mirakhor (1989), Iqbal and Mirakhor (2011), and Askari et al. (2015).

[2] See Naqvi (1981, 1993, 2003) for earlier discussion of ethics and economics.

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Similar to business ethics, rules applicable to economic and financial transactions have a specific ethical framework that has been discussed and debated for centuries. Two key features of Islamic finance are the prohibition of interest in any form and the prohibition of excessive risk taking (*gharar*). Each prohibition has its embedded system of values and virtues defining its ethical dimensions. For example, prohibition of interest is characterized with virtues of preservation of property rights and condemnation of economic and social exploitation. In the case of prohibition of excessive uncertainty and risk (*gharar*), a transaction can be declared null and void in considerations of fairness and justice, as *gharar* in a transaction may cause injustice and loss of property to one or both of the parties.[3]

We now discuss various features of Islamic economics and finance and describe the ethical dimension of each.

5.1 Risk Sharing[4]

Islam endorses risk sharing as the preferred organizational structure for all economic activities, and in fact the most comprehensive application of risk sharing that goes beyond anything put forward by modern economic theories. Islam prohibits, and without any exceptions, explicit and implicit interest-based contracts of any kind and requires mandatory risk sharing with the poor, the deprived, and the handicapped based on its principles of property rights. Moreover, even after these rights are redeemed, the remaining wealth is not to be accumulated, wealth is considered as the strength of the economy and the means of support for the society.

Wealth must not be withheld from circulation through accumulation. Noncirculation of wealth among the members of the society creates a sclerosis in the body-economic of the society, restricting the flow of resources needed for the growth of its economy. To allow a healthy circulation of wealth, the Islamic paradigm envisions a financial system based on risk and return sharing. Within the Islamic framework, the central proposition of Islamic finance is the prohibition of interest-based transactions in which a

[3] Kamali (2011). *Gharar* refers to elements of uncertainty in contracts that expose one or both of the contracting parties to risk. *Gharar* can also be caused by doubt or ignorance of one or both of the parties over the existence, quality, deliverability, or other material attributes of the subject matter of contract. The question whether risk taking in transactions amounts to *gharar* often depends on its scale and magnitude.

[4] For in-depth discussion on risk-sharing aspect of Islamic economics and finance, see Askari et al. (2010).

rent is collected as a percentage of an amount of the principle loaned for a specific time period without the full transfer of the property rights over the money loaned to the borrower.[5] One result of this type of transaction is that the entire risk of the transaction is shifted to the borrower. Instead, Islam proposes a mutual exchange in which one bundle of property rights is exchanged for another, thus allowing both parties in the exchange to share the risks of the transaction.

The ideal Islamic finance points to a full-spectrum menu of instruments serving a financial sector imbedded in an Islamic economy in which the institutional "scaffolding" (rules of behavior or virtues as prescribed by Allah (SWT) and operationalized or internalized by the Noble Messenger, including rules/virtues of market behavior prescribed by Islam) is fully operational (Iqbal and Mirakhor 2011; Chapra 2000). The essential function of that spectrum would be spreading and allocating risk among market participants rather than allowing it to concentrate among the borrowing class. Islam proposes three sets of risk-sharing instruments:

(a) Risk-sharing instruments in the economic and financial transactions (*mu'amelat*);
(b) redistributive risk-sharing instruments through which the economically more able segments of society share the risks facing the less able segment of the population[6]; and

[5] The starting point of the risk-sharing feature of Islamic finance is verse 275 of Chapter 2 of the Qur'an, particularly the part of the verse that declares contract of *Al-Bai'* permissible and that of *Al-Riba* nonpermissible. Arguably, these few words can be considered as constituting the organizing principle—the fundamental theorem as it were—of the Islamic economy. Much has been written by Muslim economists about this verse. As an example, Dr. Abdul Halim Ismail presented a comprehensive paper in this context in 1989. He chose to rely on well-known interpreters of the Qur'an on this verse, as well as on verse 282 of Chapter 2 and verse 29 of Chapter 4. After presenting the views of the interpreters, Dr. Ismail then gave his own hermeneutics, i.e., his personal-professional view, of the verses based on interpretations. The result was the following conclusions: (a) *Al-Bai'* is a contract covering all types of exchange except those prohibited by the Shari'ah; (b) in this contract "a given quantity of a commodity or service is exchanged for a given quantity of a commodity (including money) or service"; (c) the delivery of a commodity being exchanged can be spot or deferred; (d) both *Al-Bai'* (contract of exchange) and *Al-Tijarah* (contract of trade) "connote contract of exchange" and are synonymous; (e) the spectrum of contracts of exchange covered include cash sale at one end and *mudharabah* and *musharakah* at the other; (f) in between are *salam* sale, sale on order, leasing, cost plus, and deferred sale (Ismail 1989, p. 22, 33, 38, 42).

[6] Mirakhor (2004) argues that the second set of instruments is used to redeem the rights of the less able in the income and wealth of the more able. These are not instruments of

(c) the inheritance rules specified in the Qur'an through which the wealth of a person at the time of passing is distributed among present and future generations of inheritors.

Several observations can be made about risk sharing in the economic and financial transactions. First, all Islamic contractual forms, except spot exchange, involve time. From an economic point of view, time transactions involve a commitment to do something today in exchange for a promise of a commitment to do something in the future. All transactions involving time are subject to uncertainty, and uncertainty involves risk. Risk exists whenever more than one outcome is possible. Consider for example a contract in which a seller commits to deliver a product in the future against payments today. There are a number of risks involved. There is a price risk for both sides of the exchange; the price may be higher or lower in the future. In that case the two sides are at risk, which they share once they enter into the contract agreement. If the price in the future is higher, the buyer would be better off and the price risk has been shed to the seller. The converse is true if the price is lower. Under uncertainty, the buyer and seller have, through the contract, shared the price risk. There are other risks that the buyer takes including the risks of nondelivery and quality risk. The seller, on the other hand, also faces additional risks including the risk that the price of raw material may be higher in the future, and transportation and delivery cost risk. These risks may also be lower. Again, these risks have been shared through the contract. The same argument applies to deferred payment contracts.

Second, it may appear that spot exchange or cash sale involves no risk. But price changes post-completion of spot exchange are not unknown. The two sides of a spot exchange share this risk. Moreover, from the time of the classical economists it is known that specialization through comparative advantage provides the basis for gains from trade. But in specializing, a producer takes a risk of becoming dependent on other producers specialized in production of what he needs. Again, through exchange the two sides to a transaction share the risk of specialization. Additionally, there are pre-exchange risks of production and transportation that are shared through the exchange. It is clear that the other contracts at the other end of the spectrum of Islamic contracts, i.e.,

charity, altruism, or beneficence. They are instruments of redemption of rights and repayment of obligations.

mudharabah and *musharakah*, are risk sharing transactions.[7] Therefore, it can be inferred that by mandating *Al-Bai'*, Allah (SWT) ordained risk sharing in all exchange activities.

Third, the reason for the prohibition of the contract of interest (*al-riba*) is the fact that opportunities for risk-sharing are nonexistence in this contract. It may be argued that the creditor does take risk—the risk of default. But it is not risk taking per se that makes a transaction permissible. A gambler takes risk as well but gambling is *haram*. Instead what seems to matter is opportunity for risk sharing. *Al-riba* is a contract of risk transfer. As Keynes emphasized in his writing, if interest rates did not exist, the financier would have to share in all the risks that the entrepreneur faces in producing, marketing, and selling a product (see Mirakhor and Krichene 2009). But by decoupling his future gains, by loaning money today for more money in the future, the financier transfers all risks to the entrepreneur. Fourth, it is clear that by declaring the contract of *Al-Riba* nonpermissible, the Qur'an intends for humans to shift their focus to risk sharing contracts of exchange.

Finally, a further implication is that finance based on risk-return sharing means that the rate of return to finance is determined *ex-post*, by the rate of return on real activity rather than the reverse, which is the case when interest-based debt contracts finance production. This has a further economic implication in that risk-return sharing finance removes interest payments from the pre-production phase of an enterprise and places it in the post-production and after-sale distributional phase. In turn, this has price-quantity consequences. It should be clear that compliance with the behavioral rules prescribed by Islam reduces risk and uncertainty, both of which are facts of human existence. When risks to income materialize they play havoc with people's livelihood. It is, therefore, welfare enhancing to reduce risks to income and lower the chances of its volatility in order to allow consumption smoothing. By focusing on trade and exchange in commodities and assets, Islam promotes risk sharing.

[7] Borrowed from Muslims and known as commenda in Western Europe, *mudharabah* became quite popular as means of financing long-term trade and investment (Mirakhor 1983; Al-Hassani and Mirakhor 2003; Udovitch 1970); Lopez (1976) suggests that there is a consensus among medieval historians that the commenda was of the highest importance and contributed greatly to the fast growth of trade and investment which led to economic change and growth in Europe. Commenda's contribution to industrial development of Ruhr Valley in Germany and in building railroads in Europe was particularly pronounced.

5.2 Ethics of Risk Sharing

It is important to recognize—though maybe difficult, given our mind-sets—that there is nothing magical about the recent historical prominence of debt financing. Before the rise of debt financing, equity financing was preeminent, but a host of factors and developments catapulted debt financing to the forefront. Risk sharing finance is trust-intensive, and trade financing during the Middle Ages was based on risk sharing, which, in turn, was based on mutual trust. Upheavals of the late Middle Ages in the fourteenth and fifteenth centuries, including the Black Death, strife within the Church and between the Church and hereditary rulers, and general economic decline, contributed to the breakdown of trust in communities and among their members.

While risk-sharing techniques continued to prevail in Europe until the mid-seventeenth century, beginning in the mid-sixteenth century, the institution of interest-based debt financing also began to be used more widely and extensively. The catalyst for debt financing was primarily the breakdown of trust, in Europe and elsewhere, and the adoption of securitization in finance. Over time, government deposit insurance schemes, tax treatments, rules, and regulations have all heavily favored debt-based contracts over risk-sharing contracts. Thus, risk sharing is still at an early stage of development in all countries, to say nothing of its even more modest international practice. These developments have helped perpetuate a system that a number of renowned economists, such as Keynes, have deemed detrimental to growth, development, and equitable income and wealth distribution.

Risk sharing in economic and financial transactions is embedded with several virtues such as justice and is void of vices such as repression. Here we provide select features of risk-sharing finance and argue that risk sharing in economic and financial transactions when practiced by other virtues of Islamic ethics, would lead to an ethical and responsible finance. An important performance dimension of risk-sharing finance, in general, and of Islamic finance in particular, is whether it is more or less vulnerable than conventional finance (which relies heavily on debt finance) to principal–agent and informational issues. Agency issues arise because of asymmetric information between agents (entrepreneurs) and principals (investors) and the possibility that the agent's utility maximization may not maximize the utility of the principal. The agency problem is normally addressed by incorporating incentive structures in contracts for the complete sharing of

information and for the agent to behave in a way to maximize rewards for the principal. In addition, there are implications on risk transfer, cooperation among economic agents, and the stability of a financial system when risk sharing is widespread and encouraged across the system.

Let's discuss examples of embedded ethics in risk-sharing aspects of Islamic economics and finance in the following.

5.2.1 Avoidance of Risk Shifting and Exploitation

Islamic finance encourages risk sharing in its many forms but generally discourages risk shifting or risk transfer, in particular, interest-based debt financing. It is in part so designed to promote social solidarity by encouraging finance to play an integrating role between humankind. This form of finance would be inclusive of all members of society and all entities, especially the poor, in enjoying the benefits of economic growth, and to bring humankind closer together through the sharing of risk. Since risk sharing is the foundation and a basic activity in Islamic finance, it is governed by rules that, if and when observed, lead to lower transaction costs than in conventional finance. Risk sharing is a contractual or societal arrangement whereby the outcome of a random event is born collectively by a group of individuals or entities involved in a contract, or by individuals or entities in a community. In a company, all shareholders share in the risk inherent in the operations of the company. At the community level, a family or a nation shares in the risks affecting the wellbeing of the family or the nation. In finance, risk sharing is an essential feature of equity financing, where risk of loss and gain are shared, as opposed to interest-based debt financing, where the lender does not share in the risk of losses, thus all the risk of loss is shifted to the borrower.[8]

[8] In order to fit into this framework, financial intermediation and banking in the Islamic financial system (and more generally in a risk-sharing system) has been proposed as having two tiers. The first is a banking system that accepts deposits for safekeeping without accruing any return and requiring 100 percent reserves, thus protecting the payment system of the economy while concurrently limiting the credit-creating ability of the banking system and thus obviating the need for a deposit guarantee, as in the conventional fractional reserve system. The second tier is an investment component that functions as a classical financial intermediary, channeling savings to investment projects, and where deposits in investment banks are considered as equity investments with no guarantees for their face value at maturity and subject to the sharing of profits and losses. Depositors are investors in the pool of assets maintained by the bank on the assets side of its balance sheet.

Interest-rate-based debt contracts are instruments of risk shifting, risk shedding, and risk transfer, which are considered exploitative when compared to risk-sharing finance. Different rationales have been given about the prohibition of interest but each reaching the same conclusion. Property rights rationale of prohibition argues that in interest-based debt contracts, the creditor acquires a property rights claim on the debtor, equivalent to the principal plus interest and whatever collateral may be involved, without losing the property rights claim to the money lent, which violates the property rights principles of Islam (Mirakhor 1989). Other schools of thought argue that the prohibition of interest (*ribā*) is to prevent economic exploitation among the transaction parties, which is contrary to the core values of economic and social justice (Chapra 2000; Kamali 2011). Since in Islam, money could only be a medium of exchange or measure of account rather than a commodity, paying rent for the use of money is not recognized unless money is converted to capital subject to a return. Therefore, money-lending without investment is forbidden as it involves exploitation and violates the spirit of social justice because it shifts all the risk from the financier to the borrowers and leads to imbalances in wealth and income distribution in society.

5.2.2 Materiality and Financing of Real Economy Versus Financialization

By prohibiting renting of money and encouraging trade, financial instruments facilitate direct financing of the real economy and therefore promote allocation of resources to the real sector. Although debt obligations are created in the financial system, such obligations are results of the sale or lease of real assets through sale and lease-based modes of financing. The objective is to impose a fiscal discipline on individuals and firms to allocated financial resources to the real sector according to their capacity to pay back. Conditions stipulated by Islamic law such as (a) the asset that is being sold or leased must be real, and not fictitious or notional; (b) the seller must own and possess the goods being sold or leased; (c) the transaction must be a genuine trade transaction with full intention of giving and taking delivery; and (d) the debt obligation as result of the sale or lease contract cannot be sold or transferred to someone else and must be borne by the creditor himself, are put in place to encourage financing of the real economy and to discourage uncontrolled expansion of debt.[9]

[9] Kamali (2011).

These conditions ensure availability of financial resources for the real sector and thus expand employment and self-employment opportunities through the production of goods and services.

An interest-based financial system invariably creates a phenomenon known as “financialization” that results in a divergence between the real sector and the financial sector of the economy. This dimension of Islamic finance is discussed at length in the next chapter. The conventional fractional banking system allows multiple amounts of money to be created out of a given amount of deposits received, facilitating and enhancing the process of debt creation. The development of complex financial derivatives has resulted in credit expansion outpacing the growth of the real sector of the economy. As layer upon layer of securitization decouples the connection between the financial and real sectors, an inverted credit pyramid is created to the extent that the liabilities of the economy become a large multiple of real assets needed to validate them (Mirakhor 2011). Additionally, such a system is characterized by mismatched maturity and values of the asset and liability structure of the balance sheets of banks. These institutions borrow short and lend long. When subjected to asset price shocks, the liability side of the balance sheet is very slow to adjust, while the asset side adjusts rapidly. Both mismatches create a potential for instability that can spread rapidly through contagion. The result can be an increase in the frequency, contagion, and severity of financial and economic crises (Askari et al. 2012).

5.2.3 Reduced Information and Agency Problems

Informational and agency problems have generally been discussed in the context of one risk-/reward-sharing instrument: equity. Stiglitz (1989), for example, suggests that there are two informational problems in such cases: (a) an adverse signaling effect, which leads good firms not to issue as much equity as they might wish to for fear that it may signal poor quality; and (b) an adverse incentive effect, which suggests that equity finance weakens the incentive for the entrepreneurs (agents) to exert their maximum effort for the highest maximum joint returns for themselves and their shareholders (principals). This happens because, once the project is financed, the entrepreneur knows that the net return will have to be shared with the financier (the principal) and, therefore, may not have a strong motivation to work as hard as when the return is not shared. There are also agency and informational problems in interest-rate-based debt financing.

Stiglitz (1989) points out that there is an inherent agency conflict in debt financing in that the entrepreneur (the agent) is interested in the high end of the risk–return distribution. The lender (the principal) on the other hand, interested in safety, focuses on the low end of the risk–return distribution, and therefore discourages risk taking. This, Stiglitz asserts (p. 57), has "deleterious consequences for the economy." He further suggests that "from a social point of view equity has a distinct advantage: because risks are shared between the entrepreneur and the capital provider, the firm will not cut back production as much as it would with debt financing if there is downturn in the economy."

The agency problem has been generalized to bank lending. Banks, being highly leveraged institutions that borrow short (deposits) and lend long, are exposed to an asset–liability mismatch that creates potential for liquidity shocks and instability. Stiglitz (1989) suggests that to protect their financial resources, banks generally discourage risk taking. Additionally, their behavior toward risk often creates informational problems that lead to phenomena that can be classified as market failure, such as credit rationing. By contrast, Hellwig (1998, p. 335) argues that there is an oft-neglected informational problem in the lending behavior of banks, which he refers to as "negative incentive effects on the choice of risk inherent in the moral hazard of riskiness of the lending strategy of banks." This risk materialized dramatically in the run-up to the recent financial crisis (see Askari et al. 2010; Sheng 2009).

Given this background, the question is whether Islamic contracting (with risk sharing) is better suited to solving this contractual dilemma through its reliance on risk/reward sharing under conditions where interest-based debt financing is prohibited. In the presence of informational problems such as asymmetric information (where only one side of the contract, usually the agent, has information not available to the other parties) there is a transaction cost as well as a cost of monitoring the agent's activities and the project(s) to be taken into account. It could be plausibly argued that in Islamic contracts, asymmetric information issues would be minimized. This assertion is supported by the strict rules governing contracts, exchange, and trade. Such rules with the exercise of virtues such as justice, truthfulness, and trust by economic agents would reduce information asymmetry to a minimum. These include the need for written contracts that stipulate terms and conditions fully and transparently, the direct and unequivocal admonition that commitments to the terms and conditions of contracts must be faithfully carried out, and the strong emphasis on trust, cooperation, and consultation. Ethics governing

market behavior also create incentives—both positive and negative—to enforce honest, transparent, and compliant behavior on the part of participants. Hence, risk-sharing contracts designed under Islamic rules would mitigate informational problems (Khan and Mirakhor 1987; Haque and Mirakhor 1987; Presley and Sessions 1994) and could be better structured than interest-based debt contracts with incentives to maximize both parties' expected joint rewards.

5.2.4 Stability of the Financial System

While, in our opinion, Islamic finance would be inherently stable because it is structured on a foundation of equity financing and risk sharing, conventional finance, a debt-and-interest-based system, has proven to be unstable. Minsky has dubbed the instability of conventional finance as "endogenous instability" because conventional finance experiences a three-phased cycle: relative calm, speculation and fictitious expansion, and then crisis and bankruptcy. Bankruptcy in conventional finance is not limited to the private sector as governments can also face bankruptcy. Again, recent historical analysis has demonstrated that all financial, banking, and currency crises are, at their core, a crisis arising from debt.[10] In the recent past, the widespread bankruptcies of many developing countries have entailed debt cancellation or forgiveness. This is often because governments that borrowed at what were considered reasonable debt levels (normally as measured by debt/GDP) later found themselves in an unsustainable debt spiral as a result of increased debt-service obligations. Some countries even found themselves with debt levels many times larger than the original amount of borrowed principal.

These developments have helped the perpetuation of a system that a number of renowned economists, such as Keynes, have deemed detrimental to growth, development, and to equitable income and wealth distribution. Whereas many American economists saw fractional reserve banking as a source of financial instability, Maynard Keynes saw the role of interest and the rentiers who demanded it as the greater evil. In his renowned book, *The General Theory* (1936), Keynes called for steps toward the "euthanasia of rentier." The issue of interest as rent on money occupied no less than three chapters (12, 17, and 23), that is, a good part of Keynes *General Theory*.[11]

[10] See Reinhart and Rogoff (2009).
[11] Keynes (1936). Also See Kamali (2011).

More recently, a growing literature and proposed reforms have argued that the stability of a financial system can only be assured by limiting credit expansion and leveraging; this in turn requires the elimination of subsidies that fuel moral hazard, such as subsidized deposit insurance schemes and guarantees that support "too large to fail" institutions, and restrictions to limit the creation of money through the fractional reserve conventional banking system. Islamic finance, based on risk sharing and limiting fractional reserve banking, has been shown to be inherently stable and socially more equitable. In such a system, there is a one-to-one mapping between the growth of financial and real sector activities, meaning that credit cannot expand or contract independently of the real sector as in the conventional system. In other words, the real and the financial sectors are closely connected and cannot be decoupled as in conventional finance.

In addition to its risk-sharing characteristics, an Islamic economic system has the potential of greater stability than its conventional counterpart. The main reason for this is the fact that when production is financed entirely by risk–return sharing or equity finance, in the case of rapid changes in the price, assets and liabilities both move in the same direction simultaneously—thus the financial structure adjusts in tandem on both sides of the ledger. A number of analytic models have investigated the adjustment process and have demonstrated the stability of Islamic finance in response to shocks as well as the growth implication of such a system in closed and open economy situations (Khan 1987; Mirakhor and Zaidi 1988; Khan and Mirakhor 1987; Mirakhor 1990). An important feature of these models was the assumption of 100 percent reserve banking based on the understanding of bank deposits as a safekeeping operation firewalled from the risks involved in investment operations, i.e., the so-called two window model (Khan 1987). This feature of requiring banking depository institutions to hold 100 percent reserves against demand deposits removes two sources of instability associated with conventional interest-based, fractional reserve banking. Nonavailability of interest-based financial transactions and 100 percent reserve banking eliminate the ability of the financial system to create money out of thin air (Krichene and Mirakhor 2008) and impairs the ability to leverage an asset base into much larger liabilities (Mirakhor and Krichene 2009). Moreover, when risk-return sharing replaces an interest-based debt system, a much closer relationship is forged between the financial and the real sectors of the economy. As early as the 1930s, the negative consequence for the real activities, in terms of income and employment, of interest-based debt financing has

been the subject of discussion by economists (Keynes 1930, 1932, 1936). The world has witnessed repeated, periodic episodes of financial crises originating in systems with interest-based debt financing at their core in the last two centuries. The frequency of these crises increased in the last decades of the twentieth century and culminated in the devastating global crisis of 2007–2008. As unfortunate as these crises have been, they have held lessons for Islamic finance still in its nascent stage of development, especially since Islamic finance is presently operating in an institutional framework that is basically that of the conventional debt-driven system.

5.2.5 Overcoming Financial Repression

It is clear that the nexus of fractional reserve banking—credit creation—debt creation—leverage—financial instability—financial crisis is the cause of financial instability and fragility. The evidence for this process is the massive debt build up in the world economy estimated to be US$ 50 trillion larger than the period of run up to the 2007–2008 crisis. Recently, many books and articles (see for example, Adair Turner: *Between Debt and the Devil*, 2016) have appeared focusing on the dangers of "excessive debt" without realizing that the culprit is the mispricing of financial resources attributable to the interest rate mechanism. If there is an eternal proposition of economics, it is that mispricing of any resource gives rise to disequilibrium and misallocation of that resource. Excess debt is a clear indication that financial resources are not priced to reflect their opportunity costs. By definition, the opportunity cost of a resource is the price it could receive from its best alternative use. By this definition, the opportunity cost of financial resources is what these resources could earn in the real sector of the economy, that is, its rate of return in the production sector. According to the data-base Morningstar, the global rate of return to the industrial sector averaged about 14 percent in 2014. Compare this with the negative interest rate prevailing in major economies. Is there then a surprise that there is "excess debt?"

Financial repression, the deviation of the "administered" interest rate from the "market" interest rate, leads to market distortions, thus discouraging saving, investment, and economic growth. In the succeeding decades of the fierce application of financial liberalization, a basic question never asked was how and in what sense did the "market" rate of interest reflect the true opportunity cost of financial resources, and whether indeed deviation between it and the prevailing rates of interest truly measured the

magnitude of financial repression. To the extent that neither the financial sector nor the governments are paying the true opportunity cost of financial resources, there is financial repression. In that sense, there is nothing new about "financial repression." It has existed and will continue to exist until and unless reforms force true "liberalization" of markets where prices all reflect opportunity costs.

Islamic finance addresses this mispricing and its consequent misallocation of financial resources through its requirement of materiality that financial resources must be used directly in production; a one-to-one correspondence between the financial sector and the real sector of the economy. This means that the rate of return to finance is determined by its productivity in the production sector rather than predetermined by policy or the monopoly power of rentiers. Islamic finance rules out maturity, value, and balance sheet asset–liability mismatches that create the dynamics of volatility. The result would be an anti-fragile and robust financial system by requiring risk sharing among participants in transactions each of which will have to have "skin-in-the-game." Consequently, financial resources receive their true opportunity cost in a market-determined process where these resources are priced according to their most productive use. This process puts an end to financialization, financial repression, and excessive reliance of financial activities on speculation.

5.2.6 *Enhancing Cooperation Among Economic Agents*

At the same time, it should be noted that there is an important moral dimension to Islamic risk sharing as it strengthens social solidarity by enhancing cooperation among all economic agents, which would also go some way in easing the coordination problem (for detail of these and other rules governing the economy).[12] Moreover, when risk is spread by means of risk-/reward-sharing contracts, closer coordination is forged between the real and financial sectors of the economy. Risk transfer by means of interest-based debt contracts, in contrast, weakens that linkage. Particularly when risk transfer is combined with high leverage, the growth of interest-based debt contracts and their pure financial derivatives—those with little or no connection to real assets—outpace the growth of the real sector, leaving the liabilities in the economy a large multiple of real assets needed to validate them. This phenomenon is called "financial decoupling"

[12] See Mirakhor and Askari (2010, pp. 158–170), and Mirakhor (2010, pp. 8–19).

(Menkoff and Tolksorf 2001) or "financialization" (Epstein 2006; Palley 2007), whereby finance is no longer anchored in the real sector. The result is financial instability leading to frequent crises. Reinhart and Rogoff (2009) have cataloged the high frequency of historical occurrences of crises in the conventional interest-based system and have clearly shown that all crises, whether classified as a currency or banking crisis, have been at their core a debt crisis.

Arguably, it can be claimed that through its rules (institutions) and ethics governing resource allocation, property rights, production, exchange, distribution and redistribution, financial transactions, and market behavior, the Islamic paradigm orients all economic relations toward risk–reward sharing. This can be said to be a logical consequence of insistence on the unity of mankind, since through risk sharing, social solidarity is promoted through Islamic finance. "Massive risk sharing can carry with it benefits far beyond that of reducing poverty and diminishing income inequality. The reduction of risk on a greater scale would provide substantial impetus to human and economic progress" (Shiller 2003). The most meaningful human progress is achieved when all distinctions the basis of race, color, income, wealth, and social-political status are obliterated to the point where humanity, in convergence with the Qur'anic declaration (Qur'an, 31:28), truly views itself as one and united. It can be argued that implementation of Islamic finance will promote maximum risk sharing, thus create the potential for enhanced social solidarity (Mirakhor 2007; Iqbal and Mirakhor 2011; Askari et al. 2009).

5.2.7 Government as Agent for Risk Sharing

Generally, governments do share risks with their people. They share risks with individuals, firms and, corporations through tax and spending policies. They are silent partners. They also share the risk of the life of the poor and disadvantaged through social expenditure policies. They share the risk of the financial system through monetary policy and deposit guarantees. They could choose to finance part of their budget, at least development spending, through risk sharing and direct ownership of development projects with their citizens. This way they would reduce the debt burden on the budget. This reduction in government borrowing reduces the burden on monetary policy as well. Governments undertake public goods projects because the characteristics of these goods—importantly, indivisibility and nonexclusivity—prohibit their production by the private sector and therefore are undertaken

by governments. However, their social rate of return is substantial and much higher than private rates of return. A recent popular proposal suggests that these projects should be undertaken jointly with the private sector, hence the Public Private Partnership (PPP) label. The proposal has a number of problems: market distortion, informational and governance problems being just three of these (see Choudhry and Mirakhor 1997).

Financing a portion of the government's budget through the stock market has advantages, some of which are summarized here. First, it can energize a stock market—provided that all preconditions, in terms of human capital, legal, administrative, and regulatory framework are met—and helps strengthen the credibility of the market. Second, it deepens and broadens the stock market. Third, it demonstrates that stock markets can be used as a tool of risk and financial management. Fourth, it reduces reliance of the budget on borrowing, thus imparting greater stability to the budget and mitigating the risk of "sudden stops." Fifth, it has a positive distributional effect in that the financial resources that would normally go to service public debt can now be spread wider among the people as returns to the shares of government projects. Sixth, it enhances the potential for the financing of a larger portfolio of public goods projects without fear of creating an undue burden on the budget. Seventh, it makes the task of monetary management simpler by limiting the amount of new money creation and limiting the number of objectives of monetary policy. Eighth, it promotes ownership of public goods by citizens; thus can have a salutary effect on the maintenance of public goods as it creates an ownership concern among the people, and to some extent mitigates "the tragedy of commons." Ninth, it has the potential of strengthening social solidarity. Tenth, it also has the potential to promote better governance by involving citizens as shareholder-owners of public projects. Eleventh, it provides an excellent risk-sharing instrument for financing of long-term private sector investment. Twelfth, it is also an effective instrument for firms and individuals to use to mitigate liquidity and productivity risks. Thirteenth, by providing greater depth and breadth to the market and minimizing the cost of market participation, governments convert the stock market into an instrument of international risk sharing as other countries and their people can invest in the domestic stock market. Fourteenth, it will change the basis of monetary expansion from credit to equity as economic expansion in the real sector maps onto the financial sector. Finally, it will help demystify Islamic finance and will create an environment of cooperation and coordination with international finance.

The design of risk sharing instruments to be issued by governments is not difficult. These instruments can be traded in the secondary market if the shareholders experience a liquidity shock. Their rate of return can be structured as an index of return tied to the rate of return to the stock market. If the domestic stock market is not deep, then an index of regional and/or international stock market returns can be included. The argument is that since the social rate of return to public goods is much higher than to privately produced goods and services, the investment in public goods should have a rate of return at least as high as the return to the stock market to promote efficient resource allocation. Of course, since governments are usually less risky, the rate of return to government-issued shares has to be adjusted downward to take account of governments' risk premium. Depending on the country and the interest rate its government pays on borrowed money, it is not likely that the rate of return it would pay to holders of equity shares it issues—adjusted for the credit rating of the government reflected in lower risk—would be any higher than the rate interest. Even in the unlikely event that a few basis points higher have to be paid, the trade-off is worthwhile considering the positive contributions the instrument would make to the economy and the society. (see Choudhry and Mirakhor 1997; Ul-Haque and Mirakhor 1999).

5.3 Economic and Social Justice

The central Islamic values are the welfare of society and socioeconomic justice. All members of an Islamic society must be given the same opportunities to advance, such as the availability of education, in other words, a level playing field. All members of society must be afforded the minimum required for a dignified life—shelter, food, and healthcare. The rights of future generations must be respected and preserved. Whereas the basis of Western economics is to accept selfish utility maximizing individuals and profit maximizing firms, Islam does not accept such behavior but advocates a behavior that conforms to Islamic teachings. Thus Islam advocates an environment where behavior is molded to support the goals of an Islamic society—societal welfare and socio-economic justice. In the words of Umar Chapra[13]:

[13] See M.U. Chapra, "What Is Islamic Economics," Islamic Development Bank Winner's Lecture Series No. 9, Jeddah, Saudi Arabia (1996, pp. 25–26).

> Unlike the secularist market paradigm, human well-being is not considered to be dependent primarily on maximizing wealth and consumption; it requires a balanced satisfaction of both the material and the spiritual needs of the human personality. The spiritual need is not satisfied merely by offering prayers; it also requires the moulding of individual and social bahavior in accordance with the *Shari'ah* (Islamic teachings), which is designed to ensure the realization of the *maqasid al-Shari'ah* (the goals of the *Shari'ah*, hereafter referred to as the *maqasid*), two of the most important of which are socio-economic justice and the well-being of all God's creatures. Negligence of either the spiritual or the material needs would frustrate the realization of true well-being and exacerbate the symptoms of anomie, such as frustration, crime, alcoholism, drug addiction, divorce, mental illness and suicide, all indicating lack of inner contentment in the life of individuals.

"There is a consensus among scholars of Islamic economics that social justice is the most important objective of an Islamic economy and abstract models have been proposed based on the desiderata of justice and beneficence (العدل والإحسان). Even a cursory look at Islamic sources suggests a comprehensive conception of justice that permeates throughout individual and community life.[14] Every dimension of individual behavior affecting individual and social interactions is subject to some conception of justice. Each conception of justice, as applied in the Qur'an, refers to a specific dimension of individual and collective behavior. Associated with each conception are a term and a context. In case of "justice" terms such as حق، عدل، قسط، ميزان، and others are used in various contexts. Based on the already available literature, the conception of justice plays a major role in the initial allocation of resources, production, exchange, market, distribution, and redistribution.

A just economy is part of a just, healthy, and moral society, which is the central objective of Islam. What underpins all the rules of behavior

[14] It is important to compare and contrast the discussion of justice in the economic discipline and in Islam. Whereas the former looks at various dimensions and concepts of justice as a systemic phenomenon, i.e., allocations, exchange, market, distribution system, the latter considers them to be first and foremost as part and parcel of an individual's adherence to and implementation of the "rights" of others. There is a specific right for every dimension of individual's behavior. As a member of a family, as an employer/employee, as a member of a community, there are rights for the individual and there are rights for all those with whom the individual interacts. One of the earliest sources of Islam in which these rights are systematically cataloged and defined is the رسالة الحقوق of Imam Zain ul Abedeen who lists 47 rights.

prescribed by Islam is its conception of justice, which maintains that all behavior, irrespective of its content and context, must, in its conception and commission, be based on just standards as defined by the Shari'ah. Islam considers an economy, in which the behavior of its agents is so conceived, as an enterprising, purposeful, prosperous, and sharing economy in which all members of society receive their just rewards. Such an economy is envisioned as one in which economic disparities that lead to social segmentation and divisiveness are conspicuously absent.

The components of economic justice in an Islamic society are (a) equality of liberty and opportunity for all members of society with respect to the utilization of natural resources; (b) justice in exchange; and (c) distributive justice—all accomplished within the framework of the Shari'ah.

In the Islamic conception, liberty means that others do not prevent a person from combining his creative labor with resources, which are designated by the Shari'ah for the use of the individual members of society. Opportunity, on the other hand, represents a favorable conjunction of circumstances, which gives the individual the chance to try it and success is dependent on the individual's efforts and abilities. This equality of opportunity must be secured deliberately by the collectivity. It not only denotes free and equal access to physical resources, but, generally, also extends to technology, education, and environmental resources. The basis for this equality of access to resources and equality of opportunity to use them is Islam's position that natural resources are provided for all members of society. Even if the opportunity to use these resources is not available to some, either naturally or due to some other circumstances, their original claims to resources remain intact and are not nullified. They must be remunerated for these claims, at some point in time, by the other members who happen to have "or get" greater opportunity to use them.

The concept of justice in exchange and economic transactions is that, by mixing their creative labor with resources, individuals create a claim of equity to the possession of the assets thus produced, by virtue of which they can participate in exchange. To allow exchange to take place on the basis of just standards, Islam places a great deal of emphasis on the market and its moral, just, and—based on these two factors—efficient operation. To assure justice in exchange, the Shari'ah has provided a network of ethical and moral rules of behavior, which cover in minute detail the behavior of all participants in the market. It requires that these norms and rules be internalized and adhered to by all participants before they enter the market. A market that operates on the basis of these rules, which are intended to

remove all factors inimical to justice in exchange, yields prices for factors and products that are considered "fair" and "just." Unlike the scholastic notion of "just price," which lacks an operational definition, the Islamic concept refers to the price prevailing as a result of the interaction of economic forces operating in a market in which all rules of behavior specified by the Shari'ah are observed and adhered to by all participants. It is an ex-post concept, meaning that a just price has been paid and received.

While justice regulates and limits selfishness, beneficence rises above it. Moreover, participants in the market are not only responsible for their own just behavior, but because of the obligation of "enjoining the good and forbidding the evil" they are also made responsible for the behavior of their fellow participants. Islam maintains that when a man sees another committing an injustice toward a third and fails to attempt to remove that injustice, he becomes a party to that injustice. If the person failing to help is himself a beneficiary of this injustice, then his failure is considered tantamount to supporting it. Although provisions are made for coercive and corrective action by legitimate authorities, the clear preference is for self-management of the market. Any interference in the operations of such a market—through price controls, for example—is considered unjust, and a transgression.

5.4 Redistributive Justice

The last component of Islamic economic justice, distributive justice, is the mechanism by which equal liberty and equity are reconciled without the least possible infringement. Insofar as the distribution of resources—the just and equal access to these resources, as well as equal opportunity in their use—is guaranteed, the claim to equity on the basis of reward and effort is just. The moral basis of property is the primacy given to equity and it is derived directly from human efforts and achievements.[15]

Assuming equal liberty and opportunity, whenever work has to be performed for the production of wealth, the output of humans may vary greatly both in quality and quantity. Equity then demands that, commensurate with their productivity, humans receive different rewards. Hence, starting from the equality of liberty and opportunity of access to resources, equity may lead to inequality. Moreover, the allocation of resources arising from the operation of the market will reflect the initial distribution of

[15] Askari et al. (2015, 2016), Mirakhor (1989).

wealth as well as the structure of the market. Assuming that both the operation and the structure of the market are just, there is no logical reason to assume that the market outcome will automatically and naturally lead to relatively equal wealth distribution. Consequently, the result may be (and often is) that inequalities, equitably created, will have immediate and longer-term implications. It is here that the distributive mechanisms of Islamic economic justice attempt to modify inequalities that are equitably created.

As we saw earlier, Islam recognizes claims based on equality of liberty and opportunity, which are reflected in the degree of access to resources, the degree and extent of the ability of persons to actualize their potential liberty and opportunity, and the right of prior ownership. The right that the less able have in the wealth of those who have greater ability and opportunity to produce greater wealth is redeemed through the various levies (*zakat, khums, sadaqa, nafaqa,* and so on), the payment of which is not beneficence but a contractual obligation that must be met. Islam also encourages beneficence over and above these obligatory dues, but these levies are in the nature of returning to others what rightfully belongs to them. Shirking from this obligation causes a misdistribution of wealth, which Islam considers as the major source of poverty.

In Islam, the rules of inheritance modify the distribution of wealth to the next generation based on the principle that the right of the owner to his wealth ceases upon his death. The power of the person to bequeath his wealth as he wishes is recognized, but is basically restricted to a maximum of one-third of his net assets. The Qur'an (4:11–12) clearly specifies the exact manner in which the shares of heirs are to be determined in inheritance. Among the same category of heirs there is neither preferential treatment nor discrimination, though a woman's share is generally one-half of a man's share because, under the rules of the Shari'ah, responsibility for the maintenance of the family rests upon the husband. Even if the wife has a larger income and greater wealth (from her own work or from inheritance), she is not required to share that wealth or income with her husband and is under no legal obligation to make any contribution toward her family. Considering the nature of the (extended) family ties and mutual responsibilities exhorted by Islam, its institution of inheritance breaks up the wealth of each generation and redistributes it to the next in such a way that a large number should receive a modest portion of such wealth, rather than it going to a single heir or a small number heirs.

5.5 Role of Regulations[16]

The complexity of the financial system is reflective of the complexity of the financial relations underlying its structure. Financial relations driven by debt arrangements are characterized by risk transfers. The incompleteness of markets places a constraint on the ability of economic agents to hedge against risks. But it is the incompleteness of contracts that places even stronger constraints on their ability to share risks inherent to economic activity. The negative externalities and regulators' capture and lack of incentives to reduce risks, manifested by the existence of moral hazards, are the natural result of a regulatory approach based on deposit insurance and prudential supervision. The regulatory framework for debt-based financial systems is thus, by necessity, complex. When financial relations are based on risk sharing, however, economic activities are undertaken by agents with full knowledge and awareness of systematic and unsystematic risks and according to their ability to bear risks.

In particular, risk sharing is more conducive to information sharing and it implies thus a reduction of agency cost problems due to information asymmetry. As argued by Mirakhor (2014), a compelling argument can be made that the regulation of risk sharing financial systems would be less complicated and more effective than risk transfer—and debt-dominated financial systems. The risk sharing financial system precludes fractional reserve banking, which facilitates risk transfers. It excludes interest-based transactions, which are conducive to the pro-cyclicality of the financial system. It also operates within the confines of an institutional framework governed by a network of rules of behavior aimed at achieving a just and efficient distribution of financial resources to the economy.

The need for a simplified regulatory framework is also compelling in light of the recurrence of credit crises. Brunnermeier et al. (2009) argue that in light of the recurrent character of banking crises, it is not sufficient to simply reinforce the basic structure of a regulatory mechanism that has failed to prevent the formation of the cycles in the first place. Also, Drew (2010) contends that the US financial crisis presents a direct challenge to conventional wisdom regarding the integrity of the global financial architecture and warrants a new paradigm of financial regulation. The structural changes should not be confined to routine reassessment of systemic risk, reformulation of internal risk control models, or recalibration of regulatory agencies. The argument by Prates (2013) that prudential regulation

[16] See Maghrebi et al. (2016).

cannot prevent financial crises may be understood in light of the dynamics of the financial system and complexity of regulatory enforcement.

A paradigm shift in financial regulation may be difficult without recognizing the nature and complexity of financial arrangements themselves. These difficulties stem from the inherent instability of the financial system, which is related to the incompleteness of contracts. The source of financial instability does not lie in aggregate shocks related to the uncertain outcomes of economic activity. When contracts are complete in the sense that payoffs are contingent on states of nature, risk sharing can be conducive to the alignment of incentives and reduction, if not elimination, of moral hazards associated with systemic prudential regulation and deposit insurance. It is noted that Islamic finance has no systemic risk, as argued by Askari et al. (2010), and this crucially implies that there is no economic rationale for systemic regulation either. There is thus greater clarity in the definition of the objectives of financial regulation. As argued by Mirakhor (2014), prohibition of interest-based financing and reliance on risk-sharing arrangements based instead on rates of return to the real sector are not merely indicative of the adherence to a set of behavioral norms prescribed in *al-Qur'an* and *as-Sunnah*. These conditions also pave the way for a regulatory approach to financial stability that does away with fractional reserve banking and deposit insurance, and focuses solely on the structure of the balance sheets of financial intermediaries. The risk-sharing nature of financing relations brings some clarity to financial regulation and possible remedies to complexity deriving from the dominance of debt, transfer of risk, and proliferation of moral hazards.

Whereas the primary objective of contractual arrangements in debt financing is to protect investors against the risk of default on promised payments, alternative financing based on equity and risk sharing promote the incentives for information sharing and reduce moral hazards. Given the nature of risk-sharing relations, regulation of the financial system can be guided by the following principles about the maturities of assets and liabilities and the levels of risk and valuation. First, *materiality-matching structure* implies that the nominal value of each financial transaction is matched with the value of real assets such that the expected payoffs to stakeholders in financial intermediaries are reflective of the rates of return to the real sector of the economy. Second, *risk-matching structure* is required to ensure that no asset is associated with a more risky corresponding element on the liabilities side. Third, *maturity-matching structure* imposes a strict correspondence of assets to liabilities with similar maturities. Fourth, *value-matching structure* requires that

price fluctuations leading to asset re-evaluation are systematically offset by appropriate changes on the liabilities side.[17] Fifth, *full transparency* is required about each item on both sides of balance sheets. Sixth, *governance structure* requires that all stakeholders in financial intermediaries are empowered with the appropriate rights of participation in the decision-making process. These guiding principles provide greater clarity to the debate about the objectives of financial regulation. The balance sheet structures of financial intermediaries are fundamentally altered when financial relations are founded on the concept of sharing rather than transferring risks and when financial returns are completely determined by the real sector of the economy. These conditions provide an inner adjustment process through which any mismatch in terms of maturity, risk, value, or linkage with the real economy is systematically corrected. The corrective dynamics of balance sheet structures can take place without undermining the crucial functions of financial intermediaries in the economy, which lie essentially in the provision of payment services and conduits of savings toward real investment.

It can be also argued, as in Askari et al. (2010), that Islamic finance has reduced systemic risk, and this implies that there is thus little rationale for systemic regulation. Thus from the macro-prudential perspective, the supervisory function of regulatory agencies does not rely on the identification of "too-big-to-fail" or "too-connected-to-fail" financial institutions. The existence of systemic risk is due to the web of interdependencies and the interconnectedness of financial intermediaries. But, irrespective of the degree of connectedness or size of balance sheets, the idiosyncratic event of bank failure is not necessarily conducive to increased systemic risk. Liquidity shocks can be absorbed through risk sharing arrangements even in the absence of markets for Arrow securities, which would otherwise allow for hedging against liquidity shortages. Conventional theory suggests that bank panics tend to exacerbate business cycle downturns as shown by Zarnowitz (1992), and that deposit insurance can be useful in preventing bank crises. But it can be also argued that the need for such insurance does not arise when interest-free deposits made for investment purposes are state-contingent. As such, these deposits do not constitute insured debt-like obligations, and they do not appear on the liabilities side of balance sheets of financial intermediaries.

[17] It may be argued that the concept of value-matching structure is consistent with the marking-to-market process, which underlies the fair value accounting rules set forth by the Financial Accounting Standards Board and the organized exchange of futures contracts.

The symbiotic nature of financing relations and the regulatory framework aimed primarily at avoiding abuses of the financial system also warrants the rethinking of the central bank's monetary policy transmission and its role as lender of last resort. Under the conditions that financing is founded on risk sharing rather than debt, regulatory concerns about credit risk associated with lending activities by commercial banks and shadow banking system are rather limited. The transmission of monetary policy through interest rate channels is also impeded in the absence of lending and borrowing cycles, but the effects of credit distress on the real sector are also distilled. The isolation of the credit channel of monetary policy from other transmission channels is also useful in distinguishing between money and bank credit, as discussed in many studies such as Brunner and Meltzer (1972), among others. The prohibition of interest does not impair monetary policy in an Islamic economy. There is also evidence that monetary policy is still effective under zero-interest rates. Mishkin argues that the notion that monetary policy would be ineffective in stimulating the economy when short-term nominal interest rates approach their zero-bound is "demonstrably false." (1996, p. 22) The substitution of rates of interest by rates of return from the real sector weakens the influence of interest rates on financial cycles and the extent of systemic risk. It can be thus argued that to some extent, the rationale for the central bank's role as lender of last resort melts away in the absence of leverage in the balance sheets of financial intermediaries.

Thus, Islamic finance considers the role of economic uncertainty and focuses on the completeness of markets and completeness of contracts to manage risks in the financial system. As noted by Rocco (2012), there are at least two dimensions to uncertainty and risk, including the temporal and cross-sectional dimensions. There are indeed risks that derive from changes in the prevailing state of nature over time as well as from the imperfect knowledge of the states of nature. Thus, the occurrence of financial crises may not be entirely predictable, and the values at risk or expected losses may not be fully hedgeable given the incompleteness of markets. Nevertheless, from the complementary perspectives of regulatory reform and contract theory, there is a pressing need to ensure that the concerned parties, as argued by Lo (2009), bear the appropriate risks. The reliance of prudential regulation on an elusive definition of systemic risk, more transparency in the shadow banking system, new definitions of leverage ratios, and counter-cyclical capital ratios cannot absolve from the necessity of promoting financial systems dominated by risk-sharing arrangements.

Given its inherent instability, suggestions for regulatory reforms of the financial system, such as those offered by Stiglitz (2010), among others, take the form of restrictions on credit and leverage on and off balance sheets. The controls on credit expansion can be achieved through higher capital adequacy requirements and restrictions on proprietary-bank trading, and can tilt the balance toward more equity than debt in the financial system.[18] It may be argued that under a fractional reserve banking system and deposit insurance, no amount of regulation can eliminate the risk of financial crises, which are related to credit cycles. In this respect, Chamely et al. (2012) note that deposits contracts are not essential to liquidity risk sharing and that the elimination of fractional reserve banking would restrict the money multiplier to unity without undermining the role of central banks in the determination of the money supply. Convergence in favor of equity can be also achieved through contingent convertible capital instruments. These hybrid securities, part debt and part equity, turn automatically into common shares at times of financial distress.[19] This provides a role for convertible capital, increasing the loss-absorbing capacity of banks and thereby their degree of risk bearing as well. There is indeed a risk-sharing function for bank capital, which provides, as argued by Allen and Gale (2009), a cushion against loss of deposits in the event of bank failure. It is thus clear that arguments about bearing appropriate risks are consistent with the principle of risk sharing that underlies investment relations in Islamic finance.

5.6 Governance and Prudence[20]

The one thing that all economists and financial experts can surely agree upon is the importance of institutions in all areas of economic activity. In the case of Islamic finance, as its operational essence is risk sharing, it calls for the promotion of the development of an institutional environment that

[18] In addition to automatic recapitalization, the resolution plans according to which too-big-to-fail financial institutions would, under certain conditions, liquidate themselves in an organized manner without precipitating widespread panic and increasing systemic risk are consistent with the notion of contingent claims. The so-called living wills define the terms under which liquidation can take place and facilitate, to some extent, the convergence toward the completeness of contracts.

[19] Reference can be made to the study by Avdjiev et al. (2013) for an interesting discussion about the structure, issuance, and pricing of contingent convertible-capital instruments.

[20] For further details, see Iqbal and Mirakhor (2004, 2011).

is conducive for market participants to implement risk-sharing principles. An enabling environment where risk and reward are shared in a fair and systematic manner, rather than being transferred or shifted, can further foster trustworthiness, social solidarity, cooperation, and the protection of property rights.

The framework of the governance system in Islam can be best understood in light of the virtues concerning property rights of the individual, society, and state; the laws governing property ownership; and the framework of contracts. Islam's recognition and protection of rights is not limited to human beings only, but encompasses all forms of life as well as the environment. Each element of creation has been endowed with certain rights and each is obligated to respect and honor the rights of others. These rights are bundled with the responsibilities for which humans are held accountable. The *Shari'ah* offers a comprehensive framework to identify, recognize, respect, and protect the rights of every individual, community, society, and the state. Islamic scholars and jurists have defined and codified detailed principles identifying these rights.

Islam demands high standards of ethical behavior from everyone in society, but emphasizes these standards for those who govern or represent others. Within the framework of economic justice, emphasis is placed on being mindful to give full measure and weight in all business transactions. Taken in conjunction with the principles of property rights, it establishes an important rule of business that full measure and weight is not limited to physical quantities but is equally applicable to measuring intangible rights and obligations. In other words, it is the responsibility of those in charge of others' property—tangible or intangible, financial or nonfinancial, explicit or implicit—to ensure that all obligations are accounted for with great care and all claims and rights are returned in full to the rightful recipient.

In Islam, the behavior expected of a firm is not any different from the behavior of any other member of the society. Since the firm itself does not have a conscience, the behavior of its managers becomes the behavior of the firm and their actions are subject to the same high standards of moral and ethical commitment expected of a Muslim. In other words, the firm's economic and moral behavior is shaped by its managers acting on behalf of the owners and it becomes their fiduciary duty to manage the firm as a trust for all stakeholders and not for the owners alone. Consequently, it is incumbent upon the managers to ensure that the behavior of the firm conforms to the principles and rules of the *Shari'ah*. If there is any deviation, institutional arrangements discourage it.

The framework of a corporate governance system in the Islamic economic system, therefore, entails implementation of a rule-based incentive system in which compliance with the rules ensures an efficient governance system to preserve social justice and order among all members of society. This implies institutions and rules that are designed to compel managers to internalize the welfare of all stakeholders. The rights that are claimed for stakeholders are not ends in themselves—which ought to be recognized in any form of economic organization—but a means of protecting constituency rights.[21] In an Islamic system, the observance of the rules of behavior guarantees the internalization of stakeholder rights (including those of the society at large). No other institutional structure is needed. It is the Islamic government that specifies the appropriate corporate -governance structure, "incorporating all stakeholders' rights into fiduciary duties of managers" of the firm on behalf of none—investors or stakeholders. So no other institutional arrangement that would allow individual noninvestor stakeholders to negotiate directly with the firm is necessary. Incorporating all stakeholders' rights into the fiduciary duties of managers is counterproductive and leads to suboptimal results. The important point is that each stakeholder is given the freedom of bargaining to protect their rights and there are systematic institutional arrangements in place to provide protection and to mediate where disputes and disagreements arise.

Islam governs the behavior of leaders no less stringently than that of individuals. Although each member of society is expected to exhibit high moral values in the observance of contracts and covenants, many scholars are of the view that these requirements apply with even greater force to the actions of leaders. Therefore, a breach of faith on the part of a leader is more heinous in its nature and more serious in its consequences than a similar breach by an ordinary individual.

The current financial crisis has highlighted the role of managers and corporate leaders in shaping the crisis: the lack of transparency, greed, misrepresentation, fraud, and breach of trust displayed by certain financial managers and leaders all contributed to the chaos. Collins (2009) has observed the corporate behavior of leaders and identified the different stages they might go through during the course of a fall—from the hubris of considering success as an entitlement, to the undisciplined pursuit of more (more scale, more growth, more acclaim, more of whatever they see as "success"), to putting a positive spin on ambiguous data and being

[21] Boatright (2002).

unable to accept responsibility for setbacks. Such behavior was prevalent across the industry in the lead-up to the current financial crisis.

Leaders who are fully conscious of their responsibilities, limitations, and obligations as expected in Islam would never fall into behavior that would promote arrogance, ignorance, greed, deceitfulness, nontransparency, and delinquency. To assist the development of leaders with higher moral and ethical values, integrity, introspection, and humility, the governance infrastructure needs to be strengthened.[22] These principles define the social norms in Islam that determine the behavior expected of individuals and institutions and establish a set of socially approved values. While the values and expectations in any given society may shift or change with the passage of time, Islamic values are inviolable at all times. Therefore, these values set a benchmark against which the behavior of individuals and institutions will be judged.

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[22] Considering the fact that several of the "renowned" corporate leaders involved in the current financial crisis are graduates of top academic institutions in the USA, including the Harvard Business School, a national discussion has started to review academic programs. Schools have also started to make one course in corporate responsibility a requirement for graduation.

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CHAPTER 6

Sacralizing Finance: Risk-Sharing Islamic Finance

Finance can be thought of as an engine of transformation and intermediation that bridges gaps between financial surplus and deficit units, between now and the future, and between certainty of now and uncertainty of the future. It transforms value through maturity and risk transformation. This crucial function can be considered the reason for the existence of finance. It creates incentives for surplus units to postpone the certainty of their financial resources now to the uncertainty of, and presumably, higher amount of these resources in the future. It also encourages the deficit units to bring the future, uncertain plans forward to the more certain present. Both units take risks. In other words, finance makes both units risk takers. The surplus units risk their resources now for more in a highly uncertain future; the deficit units risk being able to validate their obligations with a higher income stream in an uncertain future. How can finance become sacralized? The answer lies in paradigm governing finance. Sacralized finance requires a paradigm that focuses on: concerns for others rather than on pure self-interest; morality and ethics; giving instead of taking; cooperation rather than competition; being instead of having; and sharing the risks and uncertainties of life rather transferring or shifting them to others. Finance is sacralized (sanctified) when all the elements of the paradigm are based on the rules prescribed by the Creator. Risk-sharing Islamic

See also Mirakhor et al. (2017).

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finance meets these conditions. The rest of this paper attempts to address the risk-sharing paradigm.

As stated earlier, finance exists because of its ability to transform and manage risk and uncertainty. Humans live under conditions of uncertainty because the future is unknown. According to John Maynard Keynes, our knowledge of the future is vague, fluctuating, and uncertain. While the future is unknown, some events occur often enough that it is possible to structure frequency distributions that provide a measure of probability of events. In that case, uncertainty converts to risk. However, the environment of risk and uncertainty in real life can hardly be characterized as one in which risks are static and quantifiable, as commonly assumed by the prevailing standard theories of decision making. In reality, risks are not easily quantifiable by the expedient assumption of known distributions (Taleb 2012). For most economic and financial decisions, agents are faced with many "unknown unknowns."[1] The distribution of payoff to an economic enterprise is not known in advance with precision. Over time, unanticipated and unknowable changes in circumstances and structures often defy Bayesian reduction. In the literature, such an environment of uncertainty is characterized as Knightian uncertainty or ambiguity (Ng et al. 2015).

The question arises as to why risk and uncertainty exist. This issue becomes more acute for those who believe in the Creator of all things. Since it is believed that existence of risk and uncertainty is a source of difficulty for humans, a Creator centric question also arises: why create risk and uncertainty for humans? Bartholomeu (2008) argues that "a plausible argument for the necessity of risk is that it serves as an important ingredient in the recipe of full human development. It provides the fertility and diversity of experience to develop our skills and personalities" (p. 230). From the Islamic perspective, the Qur'an provides a more compelling explanation: the optimum path of growth and development of humans is defined by compliance with rules prescribed by their Creator. Humans are subjected to tests throughout their lives to give them a sense of the degree to which they, individually and collectively, are rule compliant (see for example 2: 155; 76: 2; 29: 2–3; 9: 126; 11: 7 of the Qur'an). Without risk and

[1] Many possible outcomes cannot even be clearly imagined, let alone tested against historical records. For example, how will the convergence of genetics and computer science affect the life expectancy of future generations? Quantification of risk is no longer possible using traditional models and tools.

uncertainty, testing would not be possible. To ease the anxiety in dealing with tests and to reduce uncertainty and the demand on humans' cognitive ability, the Qur'an prescribes rules of behavior. Principal among these rules is risk sharing (Mirakhor et al. 2012).

Risk can be defined in terms of changes in values of an asset between two dates. Risk is related to the variability of future value of a position due to market changes or more generally due to uncertain events. Uncertainty relates to knowledge across time horizons. The longer the horizon, the more radical uncertainty becomes. In a sense, finance exists to create coordination between the known present and a radically uncertain future. That is, finance brings together surplus fund holders who have delayed their present consumption to the future and deficit finance units who are bringing their future consumption forward in time.

Recently, the former Governor of the Bank of England, Mervyn King, published a book called *The End of Alchemy*. In this book, King (2016) argues that banking now lives in a state of radical uncertainty. King calls the power of banks to create money out of thin air as Alchemy. To do this, banks convert short-term deposits, which can be withdrawn upon demand, into long-term loans through leverage, thanks to the fractional reserve system. The former central banker argues that the risk of this arrangement cannot possibly be measured for regulatory purposes because there are too many unknowns and unknowable states of the world. Therefore, risk-weighted capital requirements are misleading.[2] Hence, he recommends much higher capital in relation to all assets of the bank. Andrew Sheng, another former central banker, thought that Basel III will not prevent the next crisis: "The world is not short of credit. It is short of equity in both the sense of more capital to cushion unknown risks for the 99 % and more fairness in the system. That is something outside the remit of bankers and bank regulators. So, I humbly submit that Basel III will fix some of the problems of yesterday, but not the crisis of tomorrow" (Sheng 2014).

Faced with radical uncertainty and limited human cognitive capacity (Camerer et al. 2005; Kahneman 2003), societies have three ways to manage risk: transfer it, shift it, or share it. Risk transfer is when, among two

[2] King uses the example of Northern Rock—a big mortgage lender whose failure in 2007 tipped the UK's financial system into crisis. According to standard regulatory measures, Northern Rock had the highest ratio of capital to risk- weighted assets of any major bank. The error lay in inferring that, based on decades of data, mortgages were low- risk loans. King recommends that banks should provide the banks with a pledge of their assets as collateral. See also Haldane and Madouros (2012).

parties, one party completely transfers the associated risks to the other with the consent and acknowledgement of that party. However, in risk shifting, these risks are shifted to a third party or parties without their knowledge or consent, and they end up bearing all the risks and the associated adverse outcomes. A prime example could be the 2007–2008 global financial crisis: first, the risks were transferred through mortgage securitizations, and then, once the mortgage bubble busted, those risks were eventually shifted to the general taxpayers (without their knowledge or consent). The result is, for example, higher taxes due to government bailouts of financial institutions hit by the crisis.[3]

A financial system based on risk sharing would be more stable than one based on risk transfer and on risk shifting. A main source of stability is the elimination of the interest-rate- based credit system, which has evidently created financial crises, distortions, unemployment, inflation, and unjust wealth redistribution (Mirakhor et al. 2012). In essence, risk sharing is a "contractual or societal arrangement whereby the outcome of a random event is borne collectively by a group of individuals or entities participating in an exchange contract, or by individuals or entities in a community" (Askari et al. 2011, pp. 70–71). Agents share benefits and costs in equitable proportions *a la* Arrow (1971) where efficient risk sharing means allocation of risk according to the ability of individual to bear it. In Islamic finance, there are different mechanisms for risk sharing, including the *muḍārabah* and *mushārakah* financial instruments for equity partnership initiatives. There are also other redistributive institutions for risk sharing such as obligatory levies of *zakāh*, and noncompulsory benevolent loans *qarḍ ḥasan* and charity *ṣadaqah*, and institutional endowment *waqf*. Finally, the inheritance levies constitute also a form of intergenerational redistribution of wealth and risks among the inheritors (Maghrebi and Mirakhor 2015). The idea of risk sharing goes back to the emergence of first agricultural and commercial human societies. Nor is it entirely foreign to conventional financial wisdom. Nobel laureate Professor Robert Shiller, for example, is an advocate of risk-sharing instruments, arguing that risk sharing has much to contribute to the growth of economies and to social solidarity. As an instrument for social integration, risk sharing enhances human interaction and brings humanity closer to unity by requiring

[3] Central banks create credit, but banks allocate it through loans, by transforming short-term loan deposits into long-term financial and real investment multiple of the initial credit created by the central banks through leverage.

humans to share the risks of life with one another. Risk sharing also eases coordination and informational and collective action problems. Further, it allows parties to a transaction to maximize expected joint rewards, thereby promoting cooperation among all economic agents and facilitate collective action. This is further translated into close relationship between the real and financial sectors of the economy where risk is distributed through sharing contracts. The net effect of such fundamental linkage is greater stability of the financial system; crucially important in light of the recurring episodes of financial crises stemming from the phenomenon of decoupling of the real and financial sector, and the emergence of a "paper economy" (Khan and Mirakhor 1987; Ng et al. 2015; Presley and Sessions 1994; Tobin 1984).

In this chapter, two myths and realities are discussed in the context of risk sharing. The first myth is that future payoffs on contingent claims have to be fixed because of risk and uncertainty. Therefore, contracts need to be complete in such that debt is treated as less risky than equity. However, the reality is that contracts are incomplete because they cannot include all the information to ensure that the interests of both parties are served by the contract. An interest rate based debt contract is an "impossible contract," since under the standard axioms of economics (self-interest, scarcity, and rationality) the borrower has an incentive not to repay the loan. Debt contracts cannot include provisions of truth-telling, speculative risk taking, malfeasance, and other actions that affect the borrower's promise to repay. The problem of exchanging an amount of money now for a certain larger amount in the future is that the amount in the future is validated (underwritten) by a supposed stream of income that is radically uncertain (unknown unknowns). Making debt contract a complete contract with all possible contingencies would have a detrimental impact on society.

The second myth is that risk-sharing contracts are costly and demand more information than debt based contracts. The reality is that risk-sharing contracts are incentive-compatible contracts because there is an incentive structure in place to elicit truth-telling, trust, cooperation, hard work, and efficiency in resource management; factors that could not be written into contracts and enforced. Hence, these contracts attenuate coordination problems and improve the efficiency of outcomes. Without this incentive structure, there are considerable transaction, monitoring, and enforcement costs involved in designing and implementing contracts. The new realities of platform's network effects, big data, and machine learning can equip decision makers, contractual parties, and investors with informed

decision making tools and valuable insights that can identify new sources of value that have never been visible before. This not only reduces the higher risk associated with equity investment as perceived by market participants, but also creates shared value in micro, small, and medium enterprises (MSMEs).

In the following section, the unsustainability of risk transfer and shifting will be highlighted in the context of impossible contract and inequality.

6.1 Is the Regime of Risk Transfer Sustainable? Impossible Contract and Inequality

The axioms of economics (scarcity, self-interest, and rationality) model man as an acquisitive, self-interest-motivated, noncooperative, nonsympathetic individual with perfect foresight and full information, as well as having perfect cognitive ability to choose among alternatives the one that served his or her self-interest the best. Such an individual entering the market would be highly motivated to maximize gains that serve his or her own self-interest. Hence, a person would have incentives to violate contract terms that do not give him or her maximum advantage. Since both sides of a contract are presumed to meet the axioms of economics, there is no incentive for them to cooperate. Contract theory developed during the 1980s asserts that unless contracts contain an incentive structure compelling participants to cooperate, contracts become impossible.[4] Generally, all fixed-fee contracts are of this type. For example, in fixed-wage contracts, the employees have an incentive not to be as productive as they could since they get their wages as dictated by the self-interest axiom. Experimental economics, however, showed that not only are humans cooperative, they are sympathetic, other-regarding, and engage in reciprocity (Bowles and Gintis 2011). In other words, they violate the axiom of self-interest. Behavioral experiments provided evidence that they not only share, even when amounts involved are high, they are willing to punish unfair behavior, even if it costs them, and express social preference of “inequality aversion” (Cameron 1999; Fehr and Gaechter 2000; Fong 2001, 2007).

[4] Note the 2016 Noble prize granted Oliver Hart and Bengt Holmstrom for their work on contract theory that began in the 1970s.

Another set of assumptions of the analytic framework is the idea of complete markets, complete contracts, and that all contracts are costless to enforce. That this set of assumptions is unrealistic had already been noted by economists in the 1970s. The economic theory of contracts suggested that contracts are incomplete because they cannot include all the information that participants to an exchange need to ensure that the interests of both parties are served by the contract. Hence, contracts are incomplete. For example, a labor contract cannot include many factors—such as the level of effort, honesty, trust—that influence the actions of participants in an employment contract which, in turn, impact the interest of the other party but cannot be covered by the contract. Contract theory terms the conflict between the two sides of a contract resulting from its incompleteness as the principal–agent problem that leads to coordination failures between the interests and actions of the parties to the contract. Coordination failures are results of independent actions of contracting parties and lead to sub-optimal results.

A major contention of contract theory is that the principal–agent problem arises because the incentive structure of contracts is not efficient to elicit the kind of behavior from participants that can serve the interests of both parties. This idea gave birth to the field of incentive economics (Leffont 2000). Incentive economics searches for contracts where both parties have sufficient incentive to achieve efficient outcomes to improve the gains from exchange for both as compared to contracts without such incentives. These are referred to as incentive-compatible contracts. Examples of such contracts are those in the labor and financial markets where the agents become residual claimants, in effect they become property rights owners (have "skin-in-the-game") and thus become principals themselves.

Performance-based contracts attempt to be "incentive-compatible" contracts. In 1986, Martin Weitzman published a book, called *The Share Economy* in which he argued that a wage contract in which a firm agreed to share its profit with the workers would be an incentive-compatible contract. It would lead to higher employment, higher output, and higher income, thus enabling borrowers to pay back loans. Under the Weitzman system, firms always have the incentive to employ more (productive) workers because each additional work is remunerated only a fraction of the share of the revenue he or she brings into the firm. Large corporations such as General Motors and Eastern Airlines have taken the initiatives to implement profit and revenue sharing. An example of an incentive-compatible

contract in the financial market is a risk sharing contract where the risk and reward of the project subject of the contract are shared between the two sides of the contract (Askari et al. 2011). The major advantage of these types of incentive-compatible contracts is that because agents are residual claimants, contracts enhance productivity. There is an incentive structure in place to elicit truth-telling, trust, cooperation, hard work, and efficiency in resource management; factors that could not be written into contracts and enforced. Hence, these contracts attenuate coordination problems and improve the efficiency of outcomes. Without this incentive structure, there are considerable transaction, monitoring, and enforcement costs involved in designing and implementing contracts.

In risk transfer and risk shifting financial systems, an interest rate based debt contract is an "impossible contract," since, under the axioms of conventional economics, the borrower has an incentive not to repay the loan. Debt contracts cannot include provisions of truth-telling, speculative risk taking, malfeasance, and other actions that affect the borrower's promise to repay. The problem of exchanging an amount of money now for a certain larger amount in the future is that the amount in the future is validated (underwritten) by a supposed stream of income that is radically uncertain (unknown unknowns). As previously discussed, an interest rate based debt contract makes this impossible contract possible, i.e., making an uncertain future certain, by creating a virtual world of certainty through mechanisms such as collateral requirements and an edifice of legal, administrative, policy incentive mechanisms that include positive (e.g., tax write-offs) and negative (e.g., legal enforcement) dimensions that protect the creditor. The society has to bear huge costs to make them possible. These costs (plus the costs of insuring deposits) become subsidies to creditors (banks) at the expense of the taxpayers.

Insidiously, debt compels people to work longer and consume more, and thus generates even higher debt levels and lesser leisure time. In the UK, the increase in the average working week over the past two decades has coincided with a rise in household debt-to-income ratio (unfortunately, shopping and convenience foods are serving as a relief from debt-related overwork). In many parts of the world, mortgages have catapulted to five to six times the household income. Historically, a mortgage was the last resort of a landowner or farmer. Only when faced with the risk of losing a secure means of subsistence that threatens the loss of life and well-being would a person mortgage his or her land. Such danger of a debt treadmill can probably be associated with the Latin origin of the word "mortgage":

morte (death) and *gage* (pledge), or "grip of death." For such reasons, religious laws have proscribed usury—making money out of money, and worse still, making money out of thin air in today's context—for over 4000 years (Conaty and Lewis 2010, 2012).

In modern times, doubts about the sustainability of a system based on interest -rate debt financing were expressed as early as the 1930s. John Maynard Keynes argued in his book *The General Theory of Employment, Interest and Money* in 1936 that market capitalism, left to itself, would create two major problems which, if not addressed, would cause system failure. These are (a) poor income and wealth distribution; and (b) the fact that this system is incapable of creating full employment. A major cause of these problems, Keynes asserted, was the interest rate mechanism that constituted "the villain of the piece" (Mirakhor and Krichene 2009).[5] When debt is inflated over time through the "magic wand of compound interest," wealth created by people working in the productive economy is redirected to creditors in the form of interest payments. For example, in Germany up to 50 percent of the costs of essential goods could be linked to compound interest. The GDP growth rates (600 percent) and net incomes (300 percent) between 1950 and 2000 were far outweighed by the money supply in the country (2600 percent) (Conaty and Lewis, 2010, 2012).[6] Almost a decade after the global financial crisis in 2008, the world is suffering from a debt hangover of unprecedented proportions, and have experienced the negative ramifications of numerous sovereign debt crises. As of 2015, public and private debt in the nonfinancial sector alone was estimated to be US$ 152 trillion or 225 percent of the global GDP, according to the IMF in its Fiscal Monitor report. What has emerged from many authoritative research works on the causes of the financial crises is a toxic nexus of:

Fractional Reserves → Credit → Debt → Leverage → Financial Crisis → Economic Downturn → Inequality and Poverty

While the concern with the twin problems of inequality and poverty dates back to the earliest recorded history as a dimension of justice, one of

[5] Keynes' solution was the "euthanasia of the rentier" by socializing financial resources through which financial capital would be provided for investment without the intermediation of the rent-seeking class of the money lenders.

[6] See research of Margarit Kennedy and Helmut Creutz.

the most significant post-crisis phenomena has been the depth and intensity of mainstream economics' concern with inequality. Part of this concern can be explained by the depth and breadth of inequality that has now become global. The shock of the financial crisis of 2007–2008 led to the search for its underlying causes. Aside from technical reasons, attention was also focused on the general moral failure on the part of major financial institutions. The focus now became "getting-the-values-right." The argument was that these institutions, in their pursuit of greed, had betrayed their fiduciary responsibilities and had committed "economic crimes against humanity" (Zuboff 2009). The policy implication here suggests the need for a greater emphasis on meta-economic values by focusing on the development of the social and moral capital of societies. The publication of the painstaking empirical research of Thomas Piketty and his colleagues showing that inequality of income and wealth was increasing and that the top income earners were receiving the lion's portion of income has heightened concern with inequality and has shifted policy attention to "getting-the-distribution-right" (Alvaredo et al. 2013; Piketty and Saez 2003, 2006).

There are other important inefficiencies of high asset concentration in terms of lost opportunities to would-be entrepreneurs, investors, and innovators who could well enhance the productivity of the economy but for being asset-poor. There is considerable evidence that asset-poor entrepreneurs are either shut out of credit markets or have to pay higher rates than those with a higher level of wealth. Asset-poor investors are forced to accept much lower rates of return on their meager assets than their wealthier counterparts. Bowles (2012, p. 37) argues that

> where contracts in financial markets are incomplete or unenforceable, individuals lacking in wealth are either precluded from engaging in a class of contracts that are available to the wealthy, or enter into these contracts on unfavourable terms.

The reason

> why an individual's amount of wealth influences the kinds of contract she can engage in is that only those with sufficient wealth can undertake projects on their own account, that is without borrowing. And, among those who borrow, those with more wealth borrow on better terms. This is because greater wealth on the part of the agent allows contracts that more closely align the objectives of principal and agent. This is the case, for example, when the borrower has sufficient wealth to post collateral or put her own equity in a project, and therefore has greater incentive to supply effort, to

adopt more prudent risk levels preferred by the lender (the principal), to reveal information to the principal, and to act in other ways that advance the principal's interests but that cannot be secured in a contract.

There is also evidence that the asset-poor have much higher rate of time preference as well as higher measure of risk aversion (Banerjee and Duflo 2010; Holtz-Eakin et al. 1994; Jappeli 1990).

For most observers, the last crisis and its causes have become the reference for considering the risks of the future crises. Since 2009, a number of explanations have emerged from post-crisis diagnostics. Among these, the one that has achieved considerable theoretical and empirical support from academics, practitioners, and policy-makers is the Debt-Leverage explanation. The narrative of this explanation can be summarized in the following chain of causation[7]:

Fractional Reserve System → Credit → Debt → Leverage → Fragility → Crisis

Financial and economic systems based on risk transfer are basically unstable and are prone to generating this chain of causation repeatedly.[8] Risk transfer is a method of risk management whereby one side of a transaction transfers the risks to the other side of the contact with the latter's knowledge and consent. An insurance contract is an example of risk transfer. Interest rate based debt is another. A traditional bank deposit/loan intermediation contracts is a bilateral risk transfer operation whereby a depositor transfers the risk of her/his funds to the bank and the bank, in turn, transfers the risk to its client/borrower. In this transaction, the depositor retains the full property rights on her/his deposit while, at the same time, she/he has a property rights claim on the bank for the interest on the deposit. Similarly, the bank has a property

[7] See, Gregory Phelan 2016. "Financial Intermediation, Leverage, and Macroeconomic Instability," *American Economic Journal: Macroeconomics*, vol. 8, No. 4; Jaromir Benes and Michael Kumhof 2012. "The Chicago Plan Revisited," Working Paper WP/12/202, IMF, Washington DC.; Rami Brazilier and Jerom Hericourt 2014. "The Circular relationship between inequality, leverage and financial crisis," Document de Recherche, No 2015–06 <halshe-0120821>; Rafael Torres and Pavan Sukhdev 2012. "Lethal Link: A short History of Leverage and Financial Crises," Corporation 2020, www.corp2020.net; Michael Kumhof et al. 2015 "Inequality, Leverage and Crisis," *American Economic Review*, Vol 105, No 3.

[8] As early as 2009, Reinhart and Rogoff posited that all financial crises of the past have been "debt crises." A debt- based system is a risk transfer system. See, Carmen Reinhart and Kenneth Rogoff, 2009. *This Time is Different*. Princeton: Princeton University Press.

rights claim on the borrower for the principal amount plus accrued interest without transferring the property rights of the amount to the borrower, regardless of the outcome of the project for which the borrower contracted the loan. Indeed, most bank lending contracts include a clause that the bank has the right to call in the loan any time.

Another method of risk management is risk shifting. This method is employed when the two parties to a contract or a transaction shift the risks involved to a third party explicitly, as in environmental pollution, or implicitly, as in the case of corporate managers shifting the risks of weak balance sheets to lenders without disclosing the weakness. Another example of risk shifting occurred during the 2007–2008 crisis when the financial institutions shifted the risk of their speculative activities to the taxpayers (through bailout plans) without their initial knowledge or consent. More often than not, financial risk shifting occurs during the time of stress[9] when there is regime switching where individuals, corporations, and governments switch their regime of risk management from risk transfer to risk shifting.[10] Finally, there is the regime of risk sharing in which the risk of contracts or transactions are shared among the participants. In the 1970s, Kenneth Arrow showed that when each economic agent is allocated the portion of risk of contracts or transactions commensurate with its capacity to bear it, there is optimal risk sharing.[11]

6.2 Risk Transfer System: Debt-Economy

Risk transfer is the dominant paradigm in the economies of the world. Often it is not realized that adoption of this method of risk management requires assumptions and axioms that run contrary to some of the fundamental values of many societies, including Muslim societies. Where interest rate based debt systems dominate, all social relations become imbued with the spirit of debt relations as the archetype of social interactions even between members

[9] The current practice of Islamic finance seems to be an exception since "Islamic banks" appear to have adopted risk shifting as a risk management tool even during normal times; see, Alaa Alaabed et al. 2016. "Investigating risk shifting in Islamic banks in the dual banking system of OIC countries: An application of two-stage dynamic GMM" *Risk Management*, Vol. 18, No. 236.

[10] See, Abbas Mirakhor et al. 2012. "Unsustainability of the Regime of Interest-Based Debt Financing," *ISRA Journal of Islamic Finance*, Vol 4, No. 2.

[11] See, Kenneth Arrow 1971. *Essays in the theory of risk-bearing*. Chicago: Markham Publishing Company; and, Nabil Maghrebi et al. 2016. *Intermediate Islamic Finance*. Singapore: John Wiley and Sons.

of the same household.[12] Among the axioms at the foundation of risk transfer is that of the model of man envisioned by the underlying paradigm as noncooperative, unsympathetic, and intensely self-interested.[13] On the contrary, research in experimental economics over the past three decades has shown that not only humans are cooperative, they are also sympathetic, other-regarding, and engage in reciprocity.[14] Moreover, behavioral experiments have provided evidence that not only humans share benefits and costs of transactions, even when amounts involved are substantial, they punish unfair behavior, even if it costs them. Significantly, experiments have shown that humans have a preference for "inequality aversion."[15]

During the 1980s, contract theory was born as a new field of economic inquiry.[16] One of the most important contributions of this theory[17] was the assertion that if the axioms of self-interest of humans held, then cooperation between two parties in an exchange transaction or a contract, in which the interests of both parties are served efficiently, becomes impossible due to agency problems. If both parties to a contract are self-interested, noncooperative, unsympathetic and un-empathic, then there is no reason to assume that they could engage in a contract that serves both parties interests. Even if they were able to arrive at a contract, there

[12] For an interesting article in this context see, Alessandro Somma 2016. "The biopolitics of debt-economy: market order, ascetic and hedonistic morality," in Bertram Lomfeld, et al. (eds.), *Reshaping Markets*. Cambridge: Cambridge University Press. Please also note the rich list of references of this paper.

[13] These characteristics are clearly opposed to the model of man as envisioned in the Qur'an and Sunnah. This does not mean that these sources ignore the fact that in life there are those who behave very much in the spirit of the model of man as assumed in the contemporary economics paradigm. Indeed, both sources recognize behavioral deviations in its archetypal representation with all of its manifestations.

[14] See, for example, Samuel Bowles and Herbert Gintis 2011. *A Cooperative Species: Human Reciprocity and its Evolution*. Princeton: Princeton University Press.

[15] See, for example, L. A. Cameron 1999. "Raising Stakes in the Ultimatum Game: Experimental Evidence from Indonesia," *Economic Inquiry*, Vol. 37, No. 1; also, Ernest Fehr and Simon Gaechter 2000. "Fairness and Retaliation: the Economics of Reciprocity," *Journal of Economic Perspectives*, Vol. 14, No. 3; Christina Fong 2007. "Evidence from an Experiment on Charity to Welfare Recipients: Reciprocity, Altruism and Empathic Responsiveness Hypothesis," *Economic Journal*, Vol. 117. No. 522.

[16] For a good survey in this context see, Joseph Stiglitz 1987. "The causes and Consequences of Dependence of Quality on Price," *Journal of Economic Literature*, Vol. 25, No. 1.

[17] It was not until 2016 that the Nobel Committee recognized the contributions of contract theory by awarding the Nobel Prize in Economics to two original researchers of this field: Bengst Holstrom and Oliver Hart.

is reason to believe that self-interest would motivate nonrevelation of characteristics of behavior that would conflict with one party's self-interests. Hence, even if possible, these contracts would be incomplete, thus contradicting the assumption of complete contracts of the contemporary economics. Contracts are termed "incomplete" because they cannot include all information that the participants to an exchange need to ensure that the interests of both parties are served by the contract. Contract theory terms the conflict between the interests of parties to a contract as principal–agent problem. This leads to coordination failure between the interests and actions of the parties to a contract. Coordination failures are due to the independent actions of self-interested parties to a contract that lead to suboptimal results. A labor contract, for example, cannot include factors such as trust, honesty, or the level of effort that influences the actions of agents (employees), which in turn impact the interests of the principal (employer).

Another example of "impossible contracts" is as previously disucssed an interest rate based debt contract. It is "impossible" because, given the axiom of self-interest, the borrower has no incentive to repay the loan. Moreover, even if such contracts were "possible," they could not include provisions for truth-telling, gambling, speculative risk taking, malfeasance, and other behaviors that would affect the borrower's promise to repay the loan.[18] Such contracts lead to waste and misallocation of resources, aside from the fact that there is no incentive for creditors to provide loans in the first place because such a contract would be unenforceable. In a society in which risk transfer dominates the economy, to make an "impossible contract" possible, the society has to allocate an enormous amount of resources to make debt contracts enforceable. It has to use resources to fund a coercive force that include the activities of courts, lawyers, and law enforcement to make loan contracts possible. These costs are shifted to the tax payers. Additionally, private loan contracts have to incur transaction costs, collateral, and resources for (out of court) dispute resolutions, all of which has to be paid by the borrower. These costs, born by taxpayers and borrowers, are generally hidden from the view of the public that has to also bear the costs of governments' borrowing. All these costs, while making impossible debt contracts possible, are, in effect, free insurance to creditors at the

[18] It may be asked, as is done in conference or seminar presentations: What about interest-free loans like the commended "Qardh Hasan?" It is clear that these types of loans contradict the axiom of narrow self-interest.

expense of tax payers and borrowers. These are similar to the subsidies to banks in the form of deposit insurance, the costs of which are born by the taxpayers. These costs are necessary to create an incentive structure that forces an alignment of the interests of the borrower with those of the creditor.

A major contention of contract theory is that the principal–agent problem arises because, under the self-interest axiom, the incentive structure of contracts is not efficient to elicit the kind of behavior from participants that serves the interests of both parties. This idea gave birth to "incentive economics."[19] This field searches for conditions and designs of contracts in which both parties have sufficient incentives to achieve efficient outcomes to improve gains from exchange for both as compared to contracts without such incentives. The class of contracts that meet this criterion are referred to as incentive-compatible contracts. Perhaps ironically, many types of incentive-compatible contracts in finance, one way or another, modify the risk transfer nature of transactions by moving contracts toward risk sharing. Consider, for example, Basel III capital adequacy ratio (CAR). To make banks behave in way to align their interests with those of the public, their CAR has to be 10.5 percent by 2019. This means that, in effect, banks are forced to modify their risk transfer model to share more of the risk with the public by putting more of their own skin (more of their own capital) in the game than they were before the crisis. Hence, banks become more of a principal than they were before the crisis. Other examples of incentive-compatible contracts are those in the labor and credit markets where the agents become residual claimants, in effect, becoming property rights claimants, meaning that they now have their own "skin-in-the-game," thus becoming principals themselves.

An example of incentive-compatible contracts in the labor market are those that allow labor to share in the profit of the firm.[20]An example of incentive-compatible contracts in the credit market are risk-sharing contracts that allow risk and rewards of a given project undertaken jointly to be shared between the parties to the contract. The major advantage of these types of contracts is that because agents are residual claimants, have "skin-in-the-game," they elicit truth-telling, trust, cooperation, hard work, efficiency in management of resources, and other behavior that

[19] See, J. J. Leffont 2000. *Incentives and Political Economy*. Oxford: Oxford University Press.

[20] See, for example, Martin Weitzman 1984. *The Share Economy*. Cambridge: Harvard University Press.

enhance productivity. These factors could not be written into contracts or be enforced. Hence, these contracts attenuate coordination problems and improve efficiency of outcomes as well as save resources that would otherwise have to be devoted to transaction, monitoring, and enforcement costs involved in designing and implementing contracts. Productivity gains and output expansion in risk-sharing contracts originate from X-efficiency and allocative efficiency at the micro level and from total factor productivity at the macro level.[21] A risk transfer economy (debt economy) forgoes these efficiency gains.

Not only is a debt economy inefficient, it is also fragile and subject to frequent bouts with crises. Long before Reinhart and Rogoff's book (2009) that demonstrated this fragility from historical records, Keynes argued that a risk transfer capitalist economy on its own (without government intervention) faces price or economic growth instability. It will have either unemployment or inflation. This instability he considered as an "evil" of this type of capitalism. In arguing against the classical economists' notion that a capitalist economy will always lead to full employment equilibrium, Keynes focused his attention on the Say's Law that "supply creates its own demand." According to this Law, there is a circular flow in the economy such that what leaks out of the income stream in form of savings, returns back to the flow in form of investment, hence, the economy is always in equilibrium. Therefore, unemployment or inflation would be only temporary phenomena. A major argument of Keynes was that such results would require perfect coordination between savers and investors. This, he argued, is not possible. One reason was that savers and investors are not necessarily the same people and save and invest for different reasons. Therefore, it is not likely that their independent actions can be coordinated. Another reason, he argued, is the existence of what he called "the rentier class" that would not release loanable funds into investment flows unless they collect "rent" on the funds in form of interests and transferred the risk of these funds to the borrowers. This behavior exacerbates the coordination problem. He further argued that such a system suffered from "two evils." One, that, left on its own, it could not generate full employment equilibrium and, another, that it would generate massive income and wealth inequalities. But the real "villain of the piece," he argued, was the existence of the interest rate mechanism that

[21] See, Michael Perelman 2011. "X-Efficiency," *Journal of Economic Perspectives*, Vol. 25, No. 4; and Diego Comin 2008. "Total Factor Productivity," in the *New Palgrave Dictionary of Economics*, edited by Steven N. Durlauf and L. E. Blume. New York: Palgrave Macmillan.

created instability.[22] When his book, the General Theory, was translated into German in 1936, he wrote a preface to the book praising the German policy of nonreliance on interest rate mechanisms in designing fiscal and monetary policies.[23]

Keynes was not the first to have noted the instability of risk transfer capitalism. However, he was the first to have so succinctly analyzed the causes as emerging from the financial sector. A brilliant follower of Keynes, Hyman Minsky, went much further in detailing how the risk transfer finance creates inherent instability and fragility in a capitalist system. Debt-leverage drives the cyclical evolution of the economy as its firms move from being "robust units," as they have little or no debt, to become "hedge units," as they assume ever larger debt but still able to service their debt, to "Ponzi finance units," where these firms can no longer service their debt. At this point the system is rendered fragile and, ultimately, leads to crisis.[24]

Another gifted follower of Keynes, James Tobin, Nobel Prize winner in economics, 1981, had a different explanation of the inherent instability of risk transfer capitalism. In a short, concise and forceful article in *Lloyds Bank Review*, July, 1984, he warned that the risk transfer debt system with new financial techniques and securitization would lead a productive economy to morph into a speculative economy; what he called "a paper economy." By this he meant that finance, which was supposed to intermediate between the surplus and deficit finance units in order to serve the real economy, was in the process of decoupling from the real sector to have an independent life of its own in which most of its activities was trading in paper debt securities or trading in stocks that were already issued without creating additional and new capital stock. He argued that in these circumstances, the speculative paper economy would grow with finance outpacing the growth of the real economy. This process was later called "financialization."[25] His prediction saw its full validation before and during the 2007–2008 crisis. Even years after the crisis, Tobin's analysis has

[22] For a more detailed discussion of Keynes' arguments see, H. Askari et al. 2012. *Risk Sharing in Finance*. Singapore: John Wiley and Sons.

[23] See, Lynn Turgeon 1996. *Bastard Keynesianism: The Evolution of Economic thinking and Policy-Making Since WWII*. Westport, CT.: Praeger Publishers.

[24] For detail of Minsky's thoughts see, Hyman Minsky 1982. *Can it Happen Again?* New York: Routledge; and Hyman Minsky 1986. Stabilizing an Unstable Economy. New Haven: Yale University Press.

[25] For a good discussion of financialization, see, Thomas I. Palley 2013. *Financialization*. New York: Palgrave Macmillan; and, Rana Foroohar 2016. *Makers and Takers*. New York: Crown Publishing Company.

not lost its validity. In 2012, five years after the crisis, it was estimated that of the US$ 33 trillion trade in the New York Stock Exchange, only 0.2 percent found its way into new capital formation, the rest constituted speculation in “paper trade.”[26]

In addition to these problems, a risk transfer debt-economy faces other challenges. Its financial system is pro-cyclical and exacerbates the phases of the business cycle. It produces excess credit during the boom phase which, combined with leverage, create pressure on prices, strengthening inflation. In the down phase of the cycle, the system creates a credit crunch and adds additional force to the downward movement of aggregate demand. Moreover, the system creates massive opportunities for mismatches in the balance sheets of its banking system, which again serve to exacerbate cyclical phases. Finally, the risk transfer financial system is riddled with moral hazards and other elements of the principal–agent problem. Much of the moral hazard issues stem from the fact that the credit creation (central banks) and its allocation (private financial institutions, including banks) functions are separate. Central banks (monetary authorities) have a different objective function (price stability) than the private financial institutions (profits). This separation of creation and allocation of credit reduces the potency of monetary policy because the dissonance between the two objective functions makes it difficult for the monetary authorities to achieve their aim since the financial institutions are at the core of the transmission mechanism of monetary policy. This has been the experience of nearly all countries in the post-crisis period where monetary easing aimed at inducing higher private investment has not been very successful. Adding to the strength of the moral hazard issue is the deposit guarantee the banking sector of these economies need, ostensibly, to protect the economy’s payment system.

To summarize, a risk transfer debt-economy is inherently unstable and fragile. Balance sheet mismatches in the banking system combined with leverage operations in its firms and banks are major sources of fragility. It makes coordination between surplus and deficit financial units difficult if not impossible (Keynes). It limits the financial inclusion of small and medium size firms as well as that of lower income groups into the financial system difficult (credit rationing). Its financial system is prone to pro-cyclicality (high leverage in good times, credit crunch in bad). Moreover, the system is challenged by a variety of moral hazard issues

[26] See, John Boogle 2012. *The Clash of the Cultures: Investment vs. Speculation*. Hoboken, New Jersey: John Wiley and Sons.

that exacerbate the inherent fragility of the system. All this represents a market failure of sizable magnitude, as in choosing an interest-rate-based debt contract, creditors and debtors ignore higher payoffs to both of them as well as to the rest of the economy.

At this juncture a question arises: with all these problems, how does the risk transfer debt system continue to survive and dominate the world of finance? The answer lies in the myths that surround debt. The first myth is that of the two ways of financing, debt or equity, the former is the cheaper of the two. It has already been pointed out that a debt-based system has huge costs that are not considered because they are mostly hidden but do create misallocation of resources. Just consider the costs to the taxpayers not only from making impossible debt contracts possible—by establishing a huge institutional edifice for administrative, legal, and enforcement functions—but also from the loss of tax revenues to the government from the write-off of interest rate expense of corporations.

A second myth is that corporations prefer more debt than more equity when mobilizing resources because more equity erodes ownership. This myth ignores risk-shifting phenomenon due to the moral hazard of the separation of corporate management and ownership. At times, particularly during times of financial stress, management borrows rather than issues additional equity because it wishes to hide balance sheet vulnerabilities. While, ostensibly, ownership has not been eroded, the first call on corporate resources has expanded.

A third myth holds that public debt is not costly. However, governments borrow either externally or domestically. In the first case, they expose the economy to the "sudden stop" phenomenon in which external creditors, for variety of reasons, withdraw credit from a country even when its economic fundamentals are sound. This occurred during the Asian crisis.[27] Even when there is no sudden stop, resources leak out of the economy to service external debt. When governments borrow domestically, they usually issue debt securities (bonds) with very large denominations, which are then purchased by high net asset individuals or institutions. The servicing of the debt however is done through tax resources, generally paid by lower- and middle-income groups, creating an income redistribution from the latter groups to the rich. This exacerbates income and wealth concentration.

[27] For an excellent analysis of the Asian crisis and the lessons that were not learned from that experience see, Andrew Sheng 2009. *From Asian to Global Financial Crisis.* New York: Cambridge University Press.

A second reason why the debt system continues to thrive is the fact that governments themselves create incentive structures to promote debt contracts through administrative, legal, and policy means. In addition to tax incentives provided for debt, governments' fiscal and monetary policies are debt-based. A third reason is the lack of finance education among the public as well as the lack of general knowledge and understanding about risk and uncertainty that keeps the public at the mercy of those who benefit from the operations of the debt system. A fourth reason is an almost theological devotion to the interest rate mechanism within finance and economics professions. It is astounding that among all the books that have been published since the crisis about debt being a major source of instability, none has questioned the near-sanctity of the interest rate mechanism.[28]

6.3 Is Risk Sharing a Better Alternative?

To answer this question, two other essential questions need to be addressed first: what is risk and what is finance? Regarding the first of these two questions, when the term "risk" is used in day-to-day conversation, it refers to two different types of statements about future events. First, there is the risk of occurrence of an event that can be precisely defined and measured against historical records and the probabilities of its occurrence calculated. Insurance does this as there are a number of events whose occurrences have known probabilities. The second is a risk that cannot be defined or measured because it relates to an unknown and unknowable future. This conveys the notion of "constrained cognition," ignorance due to insufficient knowledge of the processes and mechanisms by which the future is generated out of the past. Technically, this is uncertainty. Complexities of the social-political-economic environment can convert uncertainty into "radical uncertainty," which makes accurate predictions of the future impossible.

Turning to the second question, it can be argued that finance exists because of radical uncertainty. The most important and original function of finance is to create a bridge between the present and a radically uncertain future, to intermediate between now and later as it intermediates between financial surplus and deficit financial units. The financial resources

[28] See, for example, Adair Turner 2016. *Between Debt and the Devil*. Princeton: Princeton University Press.

of a surplus unit come from delayed gratification, delayed consumption. Surplus units postpone present consumption for two reasons: (a) more consumption in the future; and/or (b) precautionary move to mitigate their idiosyncratic risks (risks that are unique to individuals, households, and firms for which there are no insurance markets). Deficit units bring their consumption forward in time to the present also for two reasons: (a) available investment opportunities; or (b) actualization of idiosyncratic risks. Both face radical uncertainty. The surplus units take a risk that they will have their principal plus some addition (either interest on loans they have extended or the return on their investments) in an environment that is radically uncertain. Deficit units take a risk that they can meet their obligations from a future income stream that is subject to radical uncertainty.[29] In other words, surplus units trade their presently available resources for more in a radically uncertain future while the deficit units are trading their uncertain future for the certainty of now while expecting that a radically uncertain future will allow them to repay the resources they are borrowing now. The function of finance is to manage these expectations; to manage the risks of transforming the present expectations of the surplus units and the risks of future repayment of the principal, with additions, by the deficit units. This is the process of "maturity transformation"; banks are, therefore, transformation engines.

If any further argument is needed to strengthen the position that the risk transfer debt-economy is unstable, fragile, and costly to human societies, one can point to the notion that it is nearly impossible to efficiently and effectively regulate risk transfer finance in an environment of radical uncertainty. Therefore, the system will, ultimately, shift all the risks of financial operation to the taxpayers. In a recent book, the former governor of the bank of England, Myrvin King,[30] eloquently explains that because of radical uncertainty there is no way one can use risk models to regulate behavior of financial institutions in order to create an efficient and effective regulatory structure. King's solution is to require a much larger CAR (more "skin-in-the-game" which in effect weakens risk transfer and brings in more risk sharing) and force banks to pledge their assets to the central

[29] For an interesting discussion of the relation between finance and radical uncertainty see, Mervyn King 2016. *The End of Alchemy: Money, Banking, and the Future of the Global Economy*. W. W. Norton & Company.

[30] See, Mervyn King 2016. See also, Umar Rafi et al. 2016. "Radical uncertainty, non-predictability, antifragility and risk-sharing Islamic finance." *PSL Quarterly Review*, Vol. 69, No. 279.

bank as collateral. Similarly, Nassim Nicholas Taleb argues that to make a fragile financial system not only stable but antifragile,[31] more "skin-in-the-game" is necessary, which means converting a risk transfer financial system into one where the risks of contracts are shared between participants.

6.4 How Does Risk Sharing Make a Financial System Antifragile?

The simple answer is because of four important characteristics: mutuality, commitment, horizontal governance, and common good objective. A risk sharing contract mutually commits the participants to share resources, risks, and rewards. Because everyone has "skin-in-the-game," the governance structure will, most likely, be horizontal rather than vertical providing agility, flexibility, and greater accountability in the management and operations of the venture subject of the contract. Moreover, all participants work to gain the most out of the operations of the contract since they all stand to gain from effective, efficient, and productive outcomes. Due to these characteristics, risk sharing resolves the issues of moral hazard associated with the principal–agent problem since the parties to the contract are functioning as both. As well, in a risk-sharing system where financing is being provided by shareholders, there is no incentive to withdraw financing when there may be potential downturn as there would be in a risk transfer system. Similarly, during the upside, financing would be available commensurate with increased productive activities only, unlike the risk transfer system that provides greater credit during the boom and withdraws credit during the bust phases of the business cycle.[32] Hence, risk sharing reduces or eliminates pro-cyclicality of finance. Also important is the fact that in the absence of a rentier class, risk-sharing finance improves income and wealth distribution thus reducing inequality.[33]

[31] See N. N. Taleb 2012. *Antifragile*. New York: Random House.

[32] See, Joseph E. Stiglitz 1988. "Why Financial Structure Matters". *Journal of Economic Perspectives*, Vol. 2, No. 4.

[33] For detailed discussions of the adverse impact of "rent" on income and wealth distribution, refer to the decade of painstaking work of Thomas Piketty and his colleagues in collecting and analyzing data showing this impact; see, Thomas Piketty 2014. *Capital in the Twenty-First Century*. Cambridge: Harvard University Press. This book may well be considered as the validation of Keynes' assertion that risk transfer capitalism skews income and wealth distribution in favor of the rentier class.

Risk sharing also reduces or eliminates the coordination problem since in a risk sharing contract savers and investors are both involved as owners. There is no rentier demanding a premium for providing financing. All parties involved work for the objective of greatest return to be shared by all. As mentioned earlier, risk sharing creates an opportunity for firms, at the micro level, and the economy, at the macro level, to experience X-efficiency and total factor productivity gains that increase output and growth.[34] Another major source of output growth due to risk sharing is that the focus of contracts shifts from creditor-borrower to investor-entrepreneur relations and from credit rating/collateral to the viability/profitability of the project subject of contract. Consequently, large number of projects that in a risk transfer financial system would be rationed out of the market due to lack of collateral or credit record would find funding in a risk-sharing system.

The answer to the question posed in the title of this section, therefore, is that, indeed, an economy based on risk-sharing finance would be a much better alternative to risk transfer debt-economy.

6.5 Conclusion

Risk sharing has the potential to enhance efficiency as each party to contracts has "skin-in-the-game," thus eliminating or minimizing the principal–agent problem. In doing so, it can minimize monitoring, supervisory, and disciplinary costs leading to efficiency gains. As a result, participants in a contract of an economic undertaking can choose higher risk–higher return projects and thus increase the efficiency and productivity of the system. Risk sharing finance provides two powerful additional sources of economic expansion and growth. First, through sharing contracts, micro and small enterprises that are normally credit-constrained can expand their operations or engage in innovative activities that otherwise would not be undertaken. Asset-poor participants become less risk-averse, allowing them to seek higher risk–higher reward ventures. Second, households can hedge against idiosyncratic

[34] See, Samuel Bowles 2012. *The New Economics of Inequality and Redistribution*. New York: Cambridge University Press; see also, Michael Lewis and Pat Conaty 2012. *The Resilience Imperative: Cooperative Transition to a Steady-State Economy*. Gabriola Island, Canada: New Society Publishers.

risk by becoming asset holders or shareholders, instead of depositors, and hence diversify their sources of income by investing in productive activities. This increases investment in projects that are typically rationed out of the market due to lack of collateral, no track record, no credit history, and a host of other adverse selection factors. Risk sharing can also create a reciprocal and trusting environment that strengthens social cohesion, promotes social mobility, and reduces income inequality without perverse incentive effects and resentments that would lead to resistance to changes in the status quo that marks income-based redistribution efforts and without creating a conflict with proposals to improvement in the state of "being" in a society (Rosanvallon 2013; Sen 1992).

While systematic risk cannot be eliminated, collective risk taking reduces the intensity of individual risk aversion to promote a more efficient mobilization of resources, and more equitable sharing of economic risks. The economic rationale behind equity investment is that in order to share prosperity, economic risks should be shared as well. The allocation of risk commensurate to the idiosyncratic abilities to bear losses is arguably more conducive to a socially inclusive financial system. Economic prosperity should be pursued through risk sharing rather than at the expense of others (Maghrebi and Mirakhor 2015). All the factors mentioned thus far represent the growth-promoting efficiency gains of risk sharing and perform analogous to the microeconomic concept of "X-efficiency" (Perelman 2011) and the macroeconomic concept of Total Factor Productivity (Comin 2008).

In addition to all the growth-enhancing benefits of risk sharing, there is an additional factor that buttresses the growth and prosperity expansion effects of risk-sharing Islamic finance: Barakah. Based on the Qur'an, this factor can be defined as a positive, nonlinear, and dynamic scalar that Allah (SWT) applies to virtuous (rule-compliant) individual behavior or contracts. The scalar can take on values from 10 to 18 to 700 and much more depending on the nature of the behavior.[35] Not only individuals experience the positive effect of this element of the expansive incentive structure that Islam has created for internalization of prescribed virtues, the economies of virtuous societies too will experience Blessings (*Barakah*) in terms of higher growth and prosperity as promised by Allah (SWT) in Verse 96 of Chapter 7.

[35] See, for example, Qur'an (Verse 160: Chapter 7; Verse 261: Chapter 2; Verse 245: Chapter 2; Verse 11: Chapter 57; Verse 17: Chapter 64; Verse 12: Chapter 5).

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CHAPTER 7

Ethical and Responsible Finance for Development

A reading of various documents presented to the Spring Meetings of the International Monetary Fund and the World Bank[1] (2017), as well as a number of empirical and theoretical books and published research,[2] point to a number of vulnerabilities and fragilities that have, collectively, led to the warning of the emergence of a perfect storm in the global economy. These vulnerabilities include the following: With few exceptions, economies across the world are stagnating; unemployment is widespread and growing; private investment is sluggish; productivity is declining; commodity prices are low and increasingly volatile; protectionist sentiments are growing; global trade is shrinking; there is large and growing liquidity in search of yield with no place to go; financialization of economies is proceeding unabated; global debt is large and growing; governments have resorted to financial repression to service their debt; income and wealth inequality across the world is large and growing; macroeconomic policies are impaired; international financial institutions have failed in their mandates to stabilize global finance and to reignite global growth; political uncertainties across the globe have intensified; and emerging market economies, that provided a cushion for the global economy during the last

[1] These include reports by the UN and its affiliated agencies, such as the IMF, World Bank, UNDP, ILO, as well as by various regional development banks and agencies.

[2] See the recent writings of Steve Keen, Mervyn King, Adair Turner, Nassim Nicholas Taleb, as well as articles in Project Syndicate and in Real-World Economic Review.

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Palgrave Studies in Islamic Banking, Finance, and Economics,
DOI 10.1007/978-3-319-66390-6_7

crisis, are themselves in search of stability and cannot provide support for the global economy should the risks of another worldwide crisis materialize. This list does not include a plethora of environmental and ecological risks on the horizon.

Growing disparity in income distribution despite healthy growth and deteriorating opportunities for lower segments of the society has raised awareness of the importance of ethical and responsible finance for sustainable development. With the failures of regulatory regimes to fully address the imbalances in financial markets and concerns of rising indebtedness in various countries, developmental agencies, policy-makers including G20, global financial regulatory bodies, civil society, and the private sector worldwide has recognized the need for ethical and responsible finance.

Whereas ethical finance calls for fundamental change in the prevailing thinking of approaches in development, responsible finance asks how financial services should be delivered to live up to the challenge of promoting sustainable development such that the work must incorporate social, developmental, and environmental dimensions. In other words, how a financial sector could be made responsible for the fair treatment of end-clients and in ways that protect clients' social and economic welfare.

Ethical and responsible finance could play an important role in economic development, poverty reduction, and sharing of prosperity. Research has demonstrated a strong relationship between stable and inclusive financial systems and economic development, and the link between economic development and poverty reduction. Generally, when financial systems are more responsible and equitable in allocating resources among all members of the population in a way that does not create economic imbalances, there is greater equity of opportunity for entrepreneurship, education, and quality of life.[3]

The value of economic growth and prosperity is not only reflected in the material improvements to a society but also shapes the social, political and, ultimately, the moral character of a people. Whereas traditional thinking has been that practice of moral and ethics foster economic growth, an argument could also be articulated that economic growth not only relies upon moral impetus, it also has positive moral consequences.[4] Similarly,

[3] IFC, CGAP, and BMZ (2011)., Advancing Responsible Finance for Greater Development Impact, International Finance Corporation (IFC), Washington, D.C., USA.

[4] Friedman (2006). The attitude of people toward themselves, toward their fellow citizens, and toward their society as a whole is different when their living standard is rising from when it is stagnant or falling. When the attitudes of the broad majority of citizens are shaped by a

the reverse could also happen when deteriorating economic conditions and bleak prospects of the future could lead to deteriorating morals. It is important to recognize that "laws and regulations are typically less effective when the desired behavior requires taking initiative or action, as opposed to refraining from unwanted action. Hard work, diligence, patience, discipline, and a sense of obligation to fulfill our commitments clearly make us more productive economically."[5] In other words, rules and laws alone are not sufficient, but internalization of morals, values, and ethics are key to achieving economic growth, which in turn could further enhance strengthening of moral behavior.

7.1 Need for New Perspective on Economic Development

Professor Thomas Piketty's influential 2013 book, *Capital in the Twenty-First Century,* highlighted the inequality in 20 countries during the last three centuries. Income distribution is worsening around the world, leading to widening inequality. Recent research on inequality and growth has provided strong evidence that inequality has damaging effects not only on economic development and growth but also on social mobility and the social contract. The drastic deterioration in the distribution of wealth and income between the very rich and the very poor in the world is evident considering that almost half the world's wealth is now owned by just 1 percent of the population[6] and the richest 10 percent of the population hold 86 percent of the world's wealth, and the top 1 percent alone account for 46 percent of global assets.[7]

An extensive literature review in a 2012 report by the European Commission (EC) finds that high inequality has adverse effects on household well-being, criminality, health, social capital, education, political participation, and female labor market participation. In the context of the discipline of finance, the recent literature also emphasizes how inequality intensifies

rising standard of living, over time that difference usually leads to the positive development of a society's moral character.

Friedman, Benjamin, M. (2006). "The Moral Consequences of Economic Growth," *Society*, January/February 2006.

[5] Friedman (2006).

[6] Working for the Few (2014).

[7] Credit Suisse (2013).

leverage, produces financial cycle, and precipitates a crisis.[8] Rajan's (2012) thesis is that the declining share of low-income households was compensated by ever-expanding credit facilities, which in turn increased fragilities in the economic system through high leverage ratios, creating systemic risk.

There is also a change in the economists' perception that there is always a trade-off between growth and inequality and their notion that redistributive policies are necessarily not conducive to growth (Ostry et al. 2014). A host of political-economic factors also comes into play through the power of the richer few (Stiglitz 2012). Rising inequality and ways to cope with this growing problem now top the agenda of multilateral development institutions and the policy-makers in both developed and developing countries who have repeatedly warned about the dire consequences of the increasing gap between the incomes of the very rich and the very poor. The World Bank and the UN has given the highest priority to poverty reduction and has listed poverty eradication as the first Sustainable Development Goal (SDG).[9]

Whereas growing inequality is a global trend, the situation is alarming in many of Muslim countries. Figure 7.1 shows the state of poverty in Organization of Islamic Cooperation (OIC) countries with respect to the non-OIC countries in the world.[10] It could be observed that both OIC and non-OIC countries have managed to reduce poverty levels in recent years however the OIC countries are lagging behind their non-OIC counterparts in reducing extreme poverty.

Figure 7.2, depicts and contrasts the state of OIC countries with the World with respect to income levels of the bottom 40 percent of the population.[11] In both categories of countries the per capita income has increased from 2007 to 2011 but the OIC countries are lagging behind

[8] Rajan (2012).

[9] http://www.un.org/sustainabledevelopment/poverty/

[10] Recently, the World Bank has increased its threshold for defining people living under extreme poverty from $1.25 ($2.0) to $1.9 ($3.1). The official goal of the World Bank and Sustainable Goals (SGD) is to reduce extreme poverty to 3 % (or less) by 2030.

[11] Forty percent cutoff line is determined by the World Bank to benchmark the bottom segment of the society, which must share in the prosperity to boast overall development of a country. The goal of enhancing shared prosperity aims not only to increase the economic resources of the countries, but also to maximize the share of those continuously increasing resources going to the bottom 40 percent of the income distribution. Hence, shared prosperity mainly relies on enforcing a social contract where all agents in society have a fair opportunity to realize their full potential, contribute to economic growth, and receive their fair share of income/wealth.

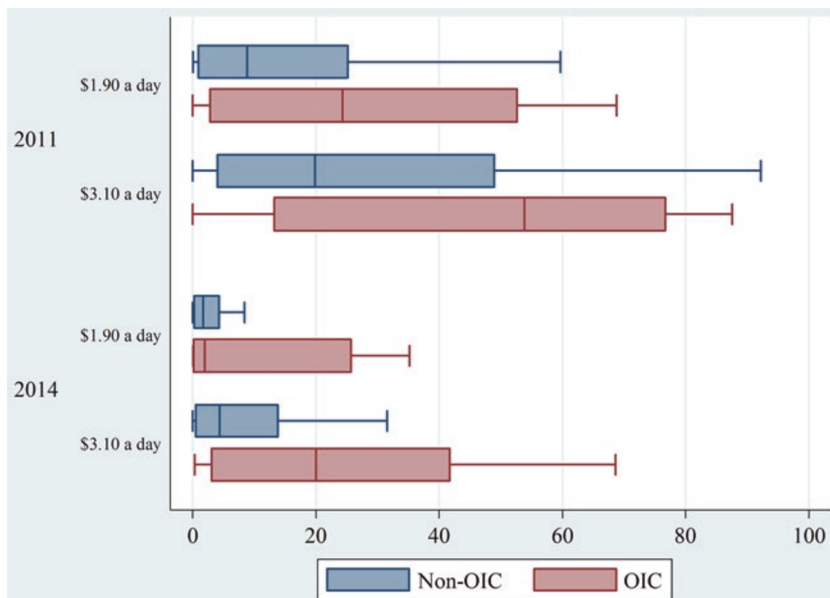

Fig. 7.1 Poverty headcount ratio at $1.90 and $3.10 a day (2011 PPP) (% of population)
Source: World development indicators. 2011 represents the averages of available values for the period from 2005 to 2011 while 2014 represents the average of the available values from 2012 to 2014

the World in both waves of survey periods (2007 and 2014). Figures 7.1 and 7.2 together suggest that the issue is grave in OIC countries, which should develop new policies in trying to catch-up with the rest of the world in terms of economic development and increasing the welfare of their citizens.

Providing access to finance to the lower segment of the society has also been identified as a catalyst for economic development.[12] Figure 7.3 shows the relative state of OIC countries with respect to non-OIC countries in different proxies that intend to capture the level of financial inclusion, such as account ownership, credit card ownership, and saving habits at a

[12] See the World Bank's initiative UAF2020 that aims for achieving universal financial access by 2020, which has been prioritized to be able to achieve its twin goals of eradicating poverty and enhancing shared prosperity.

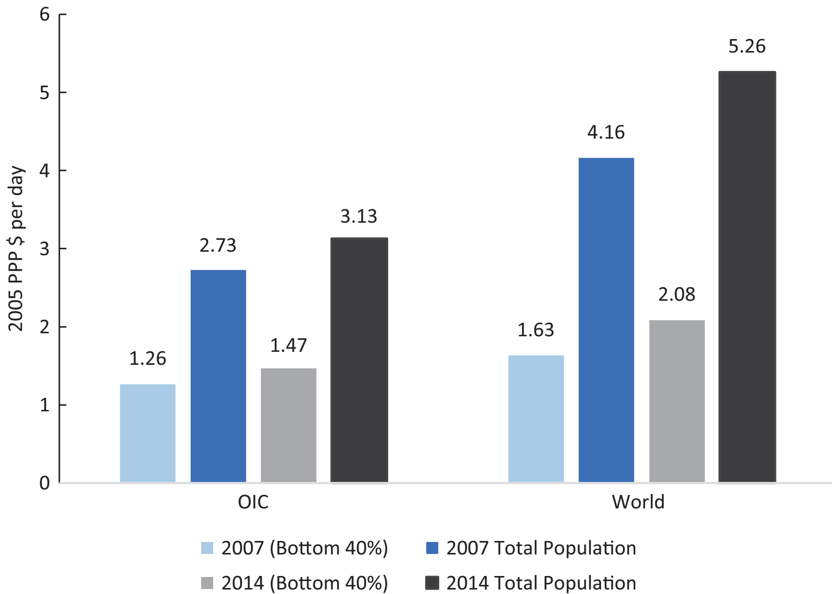

Fig. 7.2 Survey mean income per capita, bottom 40 percent and total population (2005 PPP $ per day)
Source: World development indicators

financial institution.[13] Using micro-level data, Demirguc-Kunt et al. (2014) find that, once relevant individual characteristics are accounted for, although Muslims are less likely to have an account or save in a formal financial institution, they are no less likely to borrow from one, and the greater observed religious self-exclusion of Muslims seems to arise particularly in sub-Saharan African countries. In Fig. 7.3, we see that the OIC countries are worse off than their non-OIC counterparts in all three metrics. In other two categories, i.e., saving in a financial institution and use of credit card, it is striking that the state of OIC countries has not improved at all between 2011 and 2014.

Given the strong evidence of the negative impact of inequality on economic growth, the social and economic costs associated with inequality,

[13] The users of financial services can be distinguished from nonusers, who either cannot access the financial system or opt out from the financial system voluntarily, i.e., due to nonavailability of finance compatible with their religious beliefs.

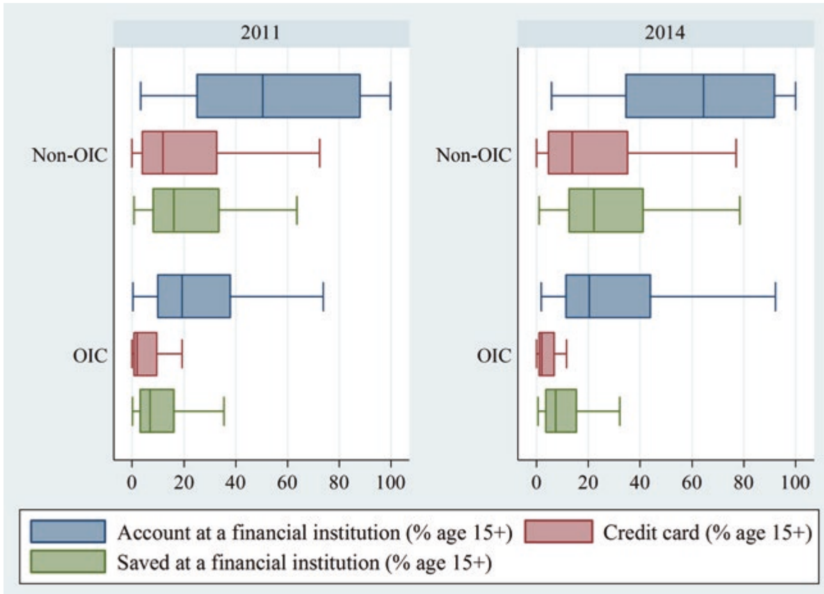

Fig. 7.3 Different proxies for comparing financial inclusion between OIC and non-OIC countries
Source: Findex database

and the risks high inequality poses to any economic system, it is difficult to argue that inequality in a society can be ignored. Inequality in a society not only damages the growth prospects of a country but also creates social unrest and has negative effects on mobility between different income groups. Furthermore, the alarming situation in the majority of countries, particularly in OIC countries, as demonstrated above, calls for new approaches and thinking on economic development.

7.2 Development Approaches: Conventional Versus Islamic

Thinking about development has evolved over many years producing a galaxy of definitions and meanings of the concept. Discourse regarding the various lines of thought and the empirical results of their application has become intense during the last three decades, and a consensus view of what “development” should mean and how to achieve it has yet to emerge.

The concept of economic development has progressed from a concern for social order, the role of civil society, culture, and state to development as material well-being, with ethics, freedom, development of the self, income equality, environmental preservation, and sustainability factored in. It should be stressed that Smith is the basis of Western thinking on development, but the author of *The Wealth of Nations*, stressing the self-interest motive that is the basis of utility and profit maximization for the individual consumer and producer at any cost to society, including the impoverishment and exploitation of fellow human beings, is very different from the author of *The Theory of Moral Sentiments*.

Before the Great Depression, much faith was placed in the unhindered workings of markets to achieve material development. After the Second World War, however, development thinking went through a fundamental change primarily influenced by the experience of the Great Depression. Markets were no longer trusted to automatically generate full employment of resources. This was particularly the case in policy prescriptions to developing countries. The basic idea was that the low-income countries could duplicate the material growth performance of rich countries. To do this, governments of these countries should take a leadership role in directing the development process. This period coincided with the ideological cold war period. The rich countries in the West undertook to help these governments through development aid provided that their politics would align with those of the West. The disappointing results of this model and the lower availability of development aid soon paved the way for development models in the 1980s and 1990s that focused on structural reform. Toward the end of the last century, development professionals had to admit that structural reforms had not fully succeeded in reducing the gap between the rich and the poor either internationally or internally in many developing countries. In fact, the gap had increased. Even in countries where the structural reform policies had achieved some measure of success, income and wealth distribution had worsened. Overall, poverty rates had grown at an alarming rate and the burden of debt of developing countries to the rich countries, and to their "international institutions," had increased dramatically threatening widespread default.

During the closing decades of the last century, development thinking went through another historic "twist and turn" as development specialists, intellectuals, and professionals began questioning the basic premise of the then dominant thinking that saw development as material growth and in the face of failure of the leading model to, at least, prevent poverty

from spreading. Professionals such as Mahbub ul Haq urged changing the focus to "human development."[14] These efforts culminated in the closing years of the twentieth century in the work of Amartya Sen on *Development as Freedom*, arguing that the focus of development should be expanding the capabilities of people to empower them to do things they value.[15] Concurrent with the efforts of Mahbub ul Haq, Amartya Sen, and others, the new institutional economics (NIE) came into prominence with policy implications for development.[16] The NIE argued that in order to make economic progress, developing countries had to reform their institutional structure, i.e., "the rules of the game." In short, high transactions costs—that is, search and information costs, bargaining and decision costs, contract negotiation and enforcement costs—render a market dysfunctional. Therefore, the collection of devices that organizes and supports transactions—channels for the flow of information; laws and regulations that define property rights and enforce contracts; and the informal rule, norms, and codes that help markets to self-regulate—must provide "a workable" market design that keeps transaction costs low.[17]

This conclusion was reached as a result of empirical enquiries addressed to the question of why countries differed so widely in their economic performance. While differences in capital per worker, investment in human capital and technology explain *some* differences in the level of per capita income among countries, none of these can be considered the fundamental reason for the underdevelopment of many countries, especially when capital and technology are mobile. The result of these studies confirmed that better performing economies had better institutions. The poor performing economies not only suffered from deficient institutions but also from a "path dependency" that created an inertia making change and reform difficult.

Systematic focus on economic issues of Islam, however, began in earnest in the 1950s with availability of Sayed Qutb's book, *Social Justice in Islam*.[18] The challenge of the two dominant systems—capitalism and

[14] Mahbub ul Haq 1995. *Reflections on Human Development*. New York: Oxford University Press.

[15] Amartya Sen 1999. *Development as Freedom*. New York: Anchor Books.

[16] See for instance, Douglas North 2005. *Understanding the Process of Economic Change*. Princeton, New Jersey: Princeton University Press.

[17] John McMillan 2002. *Reinventing the Bazaar: A Natural History of Markets*. New York: W.W. Norton & Company Inc.

[18] The book was first published in or about 1945 in Egypt but did not become available in the rest of the Muslim world until the 1950s. It was translated into English much later by John B. Hardie as *Social Justice in Islam* (Lahore: Islamic Book Services n.d.).

socialism—and their attraction for Muslim youth during the decades of 1950s, 1960s, and 1970s made the task of articulating an Islamic response ever more urgent. The first to respond to the challenge, positioning Islam's view on economic matters between capitalism and socialism, was Sayyid Abul A'La Mawdudi.[19] His writings became a major source of thought and the standard bearer of ideas in Islamic economics.

The 1960s represent a watershed in the progress to articulating a vision of the Islamic economic system firmly grounded on the Qur'an and the *Sunnah*. The publication of Shaheed M.B. al Sadr's book, *Iqtisaduna*[20] or *Our Economics*, initiated a new approach in articulating Islam's vision of an economy that serves society's needs.[21] The central focus of the book is to identify the architecture of the Islamic economic system and then to examine and understand the behavior of its constituent elements.[22] The renewal of Islamic economics stemmed from discussion of social justice and social issues, and many prominent scholars of Islamic economics focused their efforts on issues dealing with economic development. Islam's concepts of economic development were further articulated in seminal works by Chapra (1993, 2000, 2008).

The emphasis on the Islamic axiological principle of Unity forms the basis for the fundamental belief that Islam knows no distinction between the spiritual and temporal, between the sacred and the profane, or between the religious and the secular realms. Yet, only in the last three decades of the twentieth century did professionals look at broader conceptions of development than just growth of physical-material-producing capacity, as the preceding outline suggests. The idea that economic growth is only an element of the overall progress of human beings, and that humans should be the end rather than means of development is a relatively recent idea in mainstream development literature. Even in the most sophisticated of conceptions—that of Sen's development as

[19] For a recent rendition of Maulana Mawdudi's ideas on Islam and economics see Ahmad (2011).

[20] Al-Sadr (1961).

[21] It is noteworthy that *Iqtisaduna* was written after the Shaheed had already published *Falsafatuna* or Our Philosophy in 1960, a book that established the ethico-philosophical framework in which Iqtisaduna was later envisioned. M.B. Al Sadr, *Falsafatuna* (Beirut, Dar al Ta'aruf 1980). A study of *Falsafatuna* would provide a more complete understanding of *Iqtisaduna*.

[22] Monzer Kahf (2006). He suggests that the book Iqtisaduna became a shining beacon that began a new era in Islamic studies and ushered the birth of Islamic economics.

freedom—the imperative of self-development as a prerequisite for cognizance of the substantive meaning of freedom receives little attention.[23] If development should mean freedom and functioning, an exercise of capabilities, what guarantee is there that capabilities and functioning, doing what one values, will not lead to a fully self-centered, selfish outcome that has produced massive poverty and misery for a large part of humanity side-by-side with such astonishing opulence and colossal wealth accumulation for a few? Without a doubt some minimum level of income is necessary to avoid destitution and absolute poverty before one is able to think, reflect, and meditate upon one's action-decision choices. But beyond that, embarking on a phenomenological process of self-development becomes an imperative for humans to cognize the responsibilities of the human state from an Islamic point of view.

The Islamic concept of development therefore contains three organically interrelated dimensions:

(a) individual self-development;
(b) physical development of the earth; and
(c) development of the human collectivity, which includes both.[24]

The first dimension specifies a dynamic process of the growth of the human person toward the realization of *Allah*-given potentiality,[25] alluded to in previous chapters in the context of theological anthropology.[26] The second dimension specifies the utilization of natural resources to develop the earth to provide for the material needs of the human individual and collectivity. The third dimension refers to progress of the collectivity toward full integration and unity. Self-development is the all-important anchor, for without it, progress in the other two dimensions is not possible

[23] For example, Giri suggests that Sen's idea of development as freedom lacks a treatment of the self necessary for human freedom and well-being, and needs to be improved in several areas to make it a more complete view of freedom. Ananta Kumar Giri 2000. "Rethinking Human Well-being: A Dialogue with Amartya Sen," *Journal of International Development*, vol. 12, pp. 1003–1018.

[24] For a detailed analysis of each dimension, see Abbas Mirakhor and Idris Samawi Hamid, *Islam and Development*, chapter 4.

[25] One who is making progress on the path to perfection is called *rashīd*. The opposite of self-development is *ghayy*, meaning deep ignorance (Q 2:256).

[26] See Iqbal and Mirakhor (2011). Also, see especially the chapters by Seyyed Hossein Nasr and Ibrahim Kalin in the same volume.

in a balanced and appropriate manner; any forward movement in them without self-development leads to harmful distortions, such as the environmental crisis discussed in preceding chapters. All three dimensions must therefore proceed in tandem to achieve the desired balance, i.e., progress must be accompanied by justice both in its general (*'adl*) and interpersonal (*qist*) conceptions.

The most crucial and central to Islam's concept of development is the progress humans make in developing the self.[27] Without this, balanced and appropriate progress in the other two dimensions of development is not possible; any forward movement in them without self-development leads to harmful distortions. Compliance with the rules prescribed by the Law Giver prevents distortions. The rules constitute a network that regulates all dimensions of the human experience, individually and collectively, on this plane of existence.

The process of the physical development of the earth by humans who are aware of themselves, of the responsibilities of trusteeship-agency, and who are ever conscious of their Creator renders sacred all economic activities. With regard to the physical development of the earth, the Islamic view would suggest that the Almighty would not leave humans without sufficient resources to perform the duties expected of them. Indeed, the Qur'an makes it clear that the Creator has created sufficient resources to meet the needs of all humans at any time and He has done so dynamically, meaning that this sufficiency holds regardless of timeframe and population.[28] Consequently, the assumption that at a cosmic, universal, and general level humanity (macro) faces scarcity would be untenable. This, however, may not be the case at the micro level.[29] As one of the important tests of human experience on this plane of existence, individuals, and groups of humanity experience conditions of plenty as well as conditions of scarcity [15–18: 89; 37–42: 30; 34–36: 34]. The rules prescribed by the Cherisher Lord specify the appropriate response to these tests. The

[27] The process of self-development requires self-purification, which begins with self-awareness, the first sign that the self does not have an independent existence without its Creator and His Creation. This awareness starts an interactive process in which Allah (SWT) empowers the self along the path to perfection. Progress indicates further advancement in the recognition and knowledge of the Unity of the Creator and His Creation. For example, the degree of sensitivity the person experiences in feeling the pain and suffering of the "other" is an indication of the progress of purification.

[28] See Qur'an (49: 54; 8: 13; 3: 65; 21: 15).

[29] Zaman (2005), Barrera (2005), Marglin (1998).

wealthy and the opulent are those who are most susceptible to responding inappropriately. The Islamic view of scarcity is thus in contrast to conventional economics, where there is never enough to go around. According to Islam, there are sufficient resources at the global level as long as individuals share. With regard to exhaustible resources, Islam teaches that these are the heritage of all generations and current generations must preserve the right of future generations—for every individual in each generation to reap the same benefit.

The Islamic concept of development places great emphasis on the need to focus human energy on the achievement of social solidarity and unity. Islam's emphasis on the social dimension is so great that there is not one act of adoration and worship that is devoid of societal implications. The success of each human, on this plane of existence and beyond, is made dependent on patient and tolerant interaction and cooperation with other humans (Qur'an 20:3). The idea is that mutual support and social solidarity bring about a more tolerant and patient response to individual and collective difficulties. It is the interconnectedness of humanity that calls forth the order from the Supreme Creator for cooperation in good deeds (Qur'an 2:5).

The fundamental objective of creation is to create a society in which individuals become cognizant of all their capabilities, including the spiritual. When humans are able to actualize these capabilities, it makes possible a life the Qur'an refers to as *Hayat Tayyibah*, the good life, a life free of anxiety, fear, and regrets; a life of full awareness of the beauty of creation and Creator; a life of solidarity with other humans and the rest of creation; and a life lived in the full Grace of Allah (SWT). The final objective of such a society is to ensure the actualization of the capabilities of humans to progress along the path to perfection toward their Creator. This is the common objective of society as well as of individuals.

7.3 Ethics of Islamic Perspective of Development

Smith makes clear in his less cited book (*The Theory of Moral Sentiments*) that while compliance with the rules prescribed by the Creator is a must, compliance with the market, an instrument for achieving the greatest good, is also a necessity. Smith succinctly and clearly shares some of the foundational scaffolding of Islam: belief in the one and only Creator; belief in the accountability of the Day of Judgment; belief in the necessity of compliance with the rules prescribed by the Creator; and belief that

justice is achieved with full compliance with rules. To paraphrase Sen, no space need be made artificially for justice and fairness; it already exists in the rules prescribed by the Law Giver. Smith considers the internalization of rules (virtues)—being consciously aware of the ever-presence of the Creator and acting accordingly—as crucial to all human conduct, including economics. Economists have ignored this Smith and have focused on the champion of self-interest—the basis for utility and profit maximization for the individual consumer and producer, whatever the cost to society, even if it means the impoverishment and exploitation of fellow humans.

An important insight of the new institutional economics (NIE) is that rules reduce uncertainty and transaction costs, promote coordination, and make collective action possible, and that rule-compliance promotes social solidarity. Rules reduce uncertainty and transaction costs and promote coordination, making collective action possible and promoting social solidarity. All of these elements have been directly emphasized or strongly implied in Islam. Thus today, the Western concept of development is focused on efficient institutions; a political system that nurtures institutions and prohibits rent-seeking activities and the confiscation of legitimate wealth; and a social outlook that embraces human development, including education, healthcare, poverty eradication, a more even income distribution, sustainability, and freedom. This is akin to the Islamic view—with one big difference and one small one. Islamic teachings (not necessarily the practice in Muslim societies) embrace heavier doses of social and economic justice, morality, humanity, compassion, generosity, and charity; and Islam places more emphasis on rules (virtues) and rule compliance (internalization of virtues).

Islam's perspective on development has three distinct features that distinguish this perspective from the prevailing conventional one. Ethics are considered as the source of material as well as spiritual development. The Prophet's (SAAS) saying "Good ethics and being good to one's neighbors contributes to the prosperity of cities and increases development" sums up the nexus of ethics, development, and prosperity.[30] The set of virtues and the rules prescribed in Islam advocate ethical and responsible finance through (a) social and economic justice; (b) equitable and fair distribution; and (c) redistribution to enhance inclusion, as discussed below.

[30] Ali (2014) based on quote by Al-Mawardi who also reported the Prophet's (SAAS) saying that "He who displays bad ethics, his earnings will be severely curtailed."

7.3.1 Social and Economic Justice

As discussed in earlier chapters, economic and social justice is at the core of Islamic virtues. The central goals of Islam for the society are the welfare of all its members and socioeconomic justice. All members of an Islamic society must be given the same opportunities to advance; in other words, a level playing field, including access to the natural resources provided by Allah (SWT). For those for whom there is no work and for those that cannot work, society must afford the minimum required for a dignified life: shelter, food, healthcare, and education.[31] The rights of future generations must be preserved. Thus Islam advocates an environment where behavior is molded to support the goals of an Islamic society: societal welfare and socioeconomic justice, with the goal of making humankind one, confirming the Unity of Allah's (SWT) creation. If the rules prescribed by The Creator are followed, then the outcome will be a just and unified creation. It is with the Unity of Creation as the goal that the Qur'an advocates risk sharing as the foundation of finance.

The most important economic institution that operationalizes the objective of achieving social justice in Islam is that of the distribution-redistribution rule of the Islamic economic paradigm. Distribution takes place post-production and sale when all factors of production are given what is due to them commensurate with their contribution to production, exchange, and sale of goods and services. Redistribution refers to the post-distribution phase when the charge due to the less able are levied. These expenditures are essentially repatriation and redemption of the rights of others in one's income and wealth. Redeeming these rights is a manifestation of belief in the Oneness of the Creator and its corollary, the unity of the creation in general and of mankind in particular. It is the recognition and affirmation that Allah (SWT) has created the resources for all of mankind who must have unhindered access to them. Even the abilities that make access to resources possible are due to the Creator. This would mean that those who are less able or unable to use these resources are partners of the more able.

[31] Chapra (1983) concludes that a Muslim society that fails to provide welfare of its members is really not worthy of the name as the Prophet (SAAS) declared: "He is not a true Muslim who eats his fill when his next-door neighbor is hungry."

7.3.2 Equitable and Fair Distribution

Throughout the ages, one of the most important questions confronting humankind has been: What criterion should determine the distribution of economic resources? The answer depends on the underlying concept of justice and fairness, which, in turn, depends on the belief system. Islam considers justice an important attribute of the Creator manifested in His creation. The concept of justice for humans is simple and unambiguous: Justice is obtained when all things are placed where intended by the Creator. How are humans to know where the right (just) place is for everything? The answer is: Follow the rules prescribed by the Creator. Rule compliance assures justice. In turn, justice ensures balance for individuals and for their collectivity. Compliance with rules, however, does more than create balance; it guarantees that humans draw near to their ultimate objective, namely, their Creator. Morality is a result of just behavior. In contrast, non-theocentric thought considers justice “an important subclass of morality in general, a subclass which generally involves appeals to the overlapping notions of right, fairness, equality, and deserts.” These systems must find ways in which a consensual agreement is reached on the concept of justice and fairness according to which goods and services produced can be distributed. To do so, they must first devise moral theories that provide reason to justify a particular distributional system.

The Qur’an makes clear that all property belongs to the Creator who has made all the created resources available for humans to empower them to perform what their Creator expects of them. This ultimate ownership will remain preserved for the Creator, with all this implies for social justice. Humans are allowed to combine their physical labor with the created resources to produce the means of sustenance for themselves and others of mankind. This right of access to resources created by the Cherisher Lord belongs universally to all of mankind (Q 2:29). There are only two ways in which individuals can gain legitimate property rights in the limited sense of the previous two rules governing property. Individuals can gain property rights through a combination of their own creative labor and other resources or through transfer—via exchange, contracts, grants, or inheritance—from others who have gained property right title to an asset through their own labor. Fundamentally, therefore, work is the basis of acquiring rights to property. Work is considered a duty; its importance is reflected in the fact that it is mentioned in a large number of verses in the Qur’an. Work is a foundation of “belief”: “Indeed there is nothing for the

human other than (what is achieved through) effort and that (the results of) his effort will be seen and then he will be repaid fullest payment" (Q 53:39–41). The next rule governing property forbids gaining instantaneous property rights claim without commensurate work. The exception is transfer via gifts from others who have gained legitimate property rights claim on the asset transferred. The prohibition covers theft, bribery, gambling, interest from money lent, or, generally, income from unlawful sources.

Resources are created for all of mankind; therefore, if a person is unable to access these resources, her/his claim to resources (as an extension of the invariant ownership of the Creator) cannot be violated. All individuals have a property right claim in resources even if they are unable to partake in the act of production. These rights must be redeemed, in kind or in monetary equivalence. In short, the Qur'an considers the more able as trustee-agents in using these resources on behalf of the less able. In this view, property is not a means of exclusion but inclusion in which the rights of those less able in the income and wealth of the more able are redeemed. The result would be a balanced economy without extremes of wealth and poverty. The operational mechanism for redeeming the right of the less able in the income and wealth of the more able are the network of mandatory and voluntary payments such as *zakāt* (2.5 percent on wealth), *khums* (20 percent of income), and payments referred to as *sadaqāt*. This is the foundation of the rule of sharing ordained by the Creator, who also threatens those who shirk in meeting this obligation and violate the rule of sharing (Q 24:33; 3:180; 4:36–37; 92:5–11).

The next rule governing property imposes limitations on disposing a property over which legitimate rights are claimed. Property owners have a severely mandated obligation not to waste, squander, or destroy (*itlāf* and *isrāf*), use property opulently (*itrāf*), or as means of attaining unlawful (*harām*) purposes. Once the rules governing property rights claims are observed and related obligations, including sharing, are discharged, property rights on the remaining part of income, wealth, and assets are held sacred and no one has the right to force appropriations or expropriation.

Finally, distribution takes place post-production and sale when all factors of production are given what is due to them commensurate with their contribution to production, exchange, and sale of goods and services. Redistribution refers to the post-distribution phase when the charge due to the less able are levied. Followers of all religions must remain fully conscious of their partnership with those who are less fortunate throughout

the process of wealth creation and the fact that they must redeem the rights of others in the created income and wealth. Being unable to access resources to which they have the right does not negate the share of the poor in income and wealth of the more able. Moreover, even after these rights are redeemed, the remaining wealth is not to be accumulated, since wealth is considered as the life blood of the economy. Accordingly, Islam incorporates other philanthropic institutions such as *awqāf*, or endowments, to play a key role in fostering all three dimensions of development—further discussed under redistribution.

These ideas on distributive justice afford a perspective on Islamic notions of just distribution. An important central difference between Islam's position and those discussed earlier is the role of the market. All these ideas apply to market economies. Markets also play a crucial role in Islam, but with one major difference. Epistemologically, the difference is one of the concept of the market as an ideology and the concept of the market as an instrument. This difference is profound. In societies known widely as market economies, market norms are central to social relations. In turn, market norms are determined by self-interest, which dictate "rational" behavior as maximizing what interests the self, narrowly labeled as satisfaction (utility or profit). Market norms, in turn, determine the pattern of preferences of individuals. As Gomberg argues, market norms and preference patterns are individualist, not communal. They have self-seeking orientations.

In Islam, by contrast, the market is an instrument. It is not an organism that determines the rules and norms of behavior, not even those of its own operation. Rules that shape the pattern of preferences of participants are determined outside the market. Participants internalize them before entering the market. The behavior of consumers, producers, and traders, informed by their preferences, are subject to rules determined outside the market. In a market where there is full rule compliance, the price that prevails for goods, services, and factors of production is considered just. The resulting incomes are considered justly earned. Therefore, the resulting distribution is just. However, participants will not be allowed to keep their full earnings simply because their income was justly earned. There are rights and entitlements of others in the resulting post-market distribution of income and wealth that must be redeemed. This is the function of post-market redistribution, which is governed by its own set of rules. Any remaining wealth that is accumulated is broken up at the end of the person's life and distributed among a large number of beneficiaries spanning

at least four generations, according to rules specified in the Qur'an to avoid the concentration of income and wealth in the hands of a few.

Of the two main approaches to redistribution, (a) income-based or (b) asset-based, Islamic finance provides a comprehensive approach to asset-based redistribution through risk sharing, which is at the core of Islamic finance. Whereas the income-based redistribution approach takes the current income distribution as given and aims at fairer distribution of future GDP, the asset-based redistribution is basically a risk sharing approach and converges to Islamic finance's contractual framework in terms of empowering equity participation by the lower income groups in the society. Analytically, by making the poor direct real-asset holders in the real sector of the economy, the approach reduces their empirically observed high risk aversion, it creates positive incentives for actualizations of behavioral factors that are productivity enhancing (such as trust, truth-telling, hard work, etc.) through design of contracts that reduce or eliminate the difference between principals and agents and are conducive to achievement of interests of all parties to a contract (Ng et al. 2015).

7.3.3 Redistribution (Inclusion)

Modern development theories analyzing the evolution of growth, relative income inequalities, and economic development offer two tracks of thinking. One track attributes imbalances in redistribution of wealth and income in the economy as an impediment to growth while the other track identifies financial market imperfections as the key obstacle.[32] Many poor families in the developing world have limited access to formal financial services, including credit, savings, and insurance. They instead rely on a variety of informal credit relationships with moneylenders, relatives, friends, or merchants. Traditionally, banks and other formal financial service providers including insurance companies have not considered the poor a viable market, and penetration rates for formal financial services in developing countries are extremely low. Increasing access to financial services holds the promise to help reduce poverty and improve development outcomes, by enabling the poor to smooth consumption, start or expand a business, cope with risk, and increase or diversify household income.

There is growing evidence identifying the linkage between the economic development and financial inclusion. Galor and Zeira (1993) and

[32] Demirguc-Kunt et al. (2007).

Banerjee and Newman (1993) imply that financial exclusion not only holds back investment, but results in persistent income inequality, as it adds to negative incentives to save and work and encourages repeated distribution in a society. Further evidence is supporting the significance of financial inclusion and economic development prompting multilateral institutions such as the World Bank to initiate Universal Financial Access (UFA) 2020 goals. Conventional finance has developed mechanisms such as microfinance, SME finance, and micro-insurance to enhance financial inclusion, but these interventions are not without challenges. Key challenges include (a) high rather than affordable interest rates that have led to distress for poor borrowers without conclusive evidence of alleviating poverty; (b) not every micro-borrower is an entrepreneur; (c) shortage of low-cost funding; and finally, (d) absence of market-driven funding due to high risk perceptions.[33]

Islam emphasizes financial inclusion more explicitly, but two distinct features of Islamic finance—the notions of risk sharing and redistribution of wealth—differentiate its path of development significantly from the conventional financial model. According to the Islamic perspective, risks are mitigated in various ways. First, the economic system is a rule-based system, which has provided rules of behavior and a taxonomy of decisions: actions and their commensurate payoffs based on the principles of risk sharing. Complying with these rules reduces uncertainty. Second, Islam has provided ways and means to mitigate uncertainty by sharing the risks by engaging in economic activities with fellow human beings through exchange. Sharing allows risk to be spread and thus lowered for individual participants. However, if a person is unable to use any of the market means of risk sharing because of poverty, Allah (SWT) has ordered a solution here as well: the rich are commanded to share the risks of the life of the poor by redeeming their rights derived from the Islamic principles of property rights (Mirakhor 1989; Iqbal and Mirakhor 2011). Islam ordains risk sharing through three main venues:

(a) contracts of exchange and risk-sharing instruments in the financial sector
(b) redistributive risk-sharing instruments through which the economically more able segment of the society share the risks facing the less able segment of the population

[33] Iqbal and Mirakhor (2013).

(c) inheritance rules specified in the Qur'an, through which the wealth of a person at the time of death is distributed among current and future generations of inheritors

The Islamic system advocates risk sharing in financial transactions, and a financial system based on risk sharing offers various advantages over the conventional system based on risk shifting. Use of risk-sharing instruments could encourage investors to invest in sectors such as micro, small, and medium enterprises (MSMEs), which are perceived as high-risk sectors. Given an enabling environment, investors with an appetite for taking on such higher risk will be attracted to providing capital for these sectors. This argument can be supported by growing the market for the private equity. If funds for these sectors become more available, financial inclusion in the system could be expected to increase.

The second set of instruments meant for redistribution are used to redeem the rights of the less able in the income and wealth of the more able. Rules of redistribution ensure that those unable to benefit by participating directly in production and consumption in the market, through a combination of their labor and their right of access to resources provided by the Supreme Creator for all humans, are redeemed their rights through *zakah*,[34] *khums*, *sadaqat*, *waqf*, and other redistributive mechanisms. Once these rights have been redeemed out of the income and wealth of the more economically able, the latter's property rights to the remaining income and wealth are held inviolable. These rights, however, expire at the point of passing of a person. At death, the person loses the right to allocate his/her wealth as he/she pleases except on one-third of income, which believers can use to make *waqf*, *sadaqat*, or other transfer contributions as the person wishes. The remainder is broken up and must be distributed among a large number of persons and categories according to strict rules of allocation specified in the Qur'an (see 4:1–13).

Contrary to common belief, these are not instruments of charity, altruism, or beneficence, but instruments of redemption of rights and repayment of obligations. The Qur'an considers the more able as trustee-agents

[34] Moheildin et al. (2011) estimate the resource shortfall to fill the poverty gap through *zakah* collection based on domestic and remittance contributions to determine whether the *zakah* collection is sufficient to cover the estimated shortfall. Using this estimation, they find supporting evidence that 20 out of 39 OIC countries can actually alleviate the economic hardships of the poorest, those living with income under $1.25 per day, out of the poverty line simply with adequate *zakah* collection and disbursements.

in using these resources on behalf of the less able. In this view, property is not a means of exclusion but inclusion, in which the rights of those less able to the income and wealth of the more able are redeemed. The result would be a balanced economy without extremes of wealth and poverty.

Instruments meant for redistribution are used to redeem the rights of the less able in the income and wealth of the more able. Contrary to common belief, these are not instruments of charity, altruism or beneficence but these are instruments of redemption of rights and repayment of obligations. In practical terms, the Qur'an makes clear that creating a balanced society that avoids extreme of wealth and poverty, a society in which all understand that wealth is a blessing provided by the Creator for the sole purpose of providing support for the lives of all of mankind is desirable. The Islamic view holds that it is not possible to have many rich and wealthy people who continue to focus all their efforts on accumulating wealth without simultaneously creating a mass of economically deprived and destitute. The rich consume opulently while the poor suffer from deprivation because their rights in the wealth of the rich and powerful is not redeemed. To avoid this, Islam prohibits wealth concentration, imposes limits on consumption through its rules prohibiting overspending (*israf*), waste (*itlaf*), ostentatious and opulent spending (*itraf*). It then ordains that the net surplus, after moderate spending necessary to maintain modest living standard, must be returned to the members of the society who, for a variety of reasons, are unable to work, hence the resources they could have used to produce income and wealth were utilized by the more able.

The third dimension—after risk sharing and redistributive instruments—of distributive justice in the institutional scaffolding of an Islamic society is the institution of inheritance crucial in the intergenerational justice framework envisioned by the Law Giver. Rules governing production, consumption, and distribution assure conservation of resources for the next generations. Rules of redistribution ensure that those unable to benefit by participating directly in production and consumption in the market, through the combination of their labor and their right of access to resources provided by the Supreme Creator for all humans, are redeemed their rights through *zakah*, *khums*, *sadaqat*, *waqf* and other redistributive mechanisms. Once these rights have been redeemed out of the income and wealth of the more economically able, the latter's property rights on the remaining income and wealth are held inviolable. These rights, however, cease at the point of passing of a person. At the time of passing, the person loses the right to allocate his/her wealth as he/she pleases except

on a third of income that believers can use to make *waqf*, *sadaqat*, or other transfer contributions as the person wishes. The remainder is broken up and has to be distributed among a large number of persons and categories according to strict rules of allocation specified in the Qur'an (see Verses 11–13, Chapter 4).

7.4 Conclusion

Thus, a true Islamic economic system is a market-based system, but with entrenched Islamic behavior and goals (objectives/rules/institutions) attributed to consumers, producers, and to government (authorities), and with institutions as outlined above. For economic analysis, some of these Islamic values and goals can be introduced into the conventional behavioral functions of consumers and producers and others can be added as constraints in the maximization of consumer utility and producer profit. Based on the Islamic vision elaborated in this paper, we expect the Islamic solution to differ in the following important ways from the conventional: greater degree of justice in all aspects of economic management, higher moral standard, honesty and trust exhibited in the marketplace and in all economic transactions, poverty eradication, a more even distribution of wealth and income, no hoarding of wealth, less opulence in consumption, no exploitive speculation, risk sharing as opposed to debt contracts, better social infrastructure and provision of social services, better treatment of workers, higher education expenditures relative to GDP, higher savings and investment rates, higher trade/GDP, higher foreign aid/GDP, higher degree of environmental preservation, and vigilantly supervised markets. It would be expected that these differences would be reflected in higher quantitative and qualitative economic growth if the Islamic rules and objectives were adopted. One would expect to achieve higher rate of growth because of higher investment rate, higher educational expenditures, higher social awareness, better functioning markets, higher level of trust, and institutions that have empirically been shown to be critical for growth.

Given the virtues governing property rights, work, production, exchange, markets, distribution, and redistribution, it is reasonable to conclude that in an Islamic society—a rule complying and Allah (SWT)-conscious society—absolute poverty could not exist. It can be argued that there is no topic more emphasized in Islam than poverty and the responsibility of individuals and society to eradicate it. The Prophet (SAWA) said that poverty is near disbelief and that poverty is worse than murder. It is

almost axiomatic that in any society in which there is poverty, Islamic rules are not being observed. It means that the rich and wealthy have not redeemed the rights of others to their income and wealth and that the state has failed to take corrective action.

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