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ZAKAT AND GROWTH

(A. Hasib, former Executive Director, Reserve Bank of India)

Zakat is one of the pillars of Islam. All Muslims who have a minimum prescribed amount of wealth for at least a year, in excess of their basic needs, are obliged to pay zakat to the poor and the needy. This does not mean that Islam discourages prosperity. On the other hand, it encourages its followers to earn a good livelihood, partake of the good things of life consistent with piety and be prosperous without being miserly or extravagant. At the same time it ordains its followers to share a portion of their wealth with the needy and the poor. Zakat has to be distinguished from charity. Charity is an act of giving money out of mercy. Zakat, on the other hand, is a RIGHT of the poor, their share in the wealth of the more fortunate. The rich will not give zakat with arrogance and the takers will not face any humiliation or obligation. In other words, Islam ensures prosperity with social justice.

Is there a contradiction in this approach? Will the obligation to share part of the wealth with others discourage investment of money, talent and labour in order to increase wealth? More specifically, is it wrong to impose a tax on wealth which is a means of creating income flows? Fiscal orthodoxy says ' Tax income if you like, but not wealth'. The basis of this view is that any tax is a disincentive. This short article submits that zakat promotes growth both of the wealth of a country and an individual.

Before we present the main argument, a couple of points should be clearly borne in mind.

First, Islamic laws are not determined on the basis of a man made discipline. For instance, in most works of Economics, it is assumed that man's behaviour is dictated by selfish profit seeking. Man, according to this view, is an economic being, unaffected by the consequence of his actions on his fellow beings. Wealth is an object, not a means. Islam takes a holistic view in which morality and ethics are as important, if not more important, than trying to increase wealth. Hence we cannot judge the laws of Islam by the standards of modern society. If we did, it would mean, for instance, that offering prayers is a waste of time and hence contrary to the object of growth, or that spending money for social purposes is uneconomic! Secondly, we must acknowledge that even some well-known economist scholars are questioning the assumptions of traditional Economics. Gunnar Myrdal, for instance, has forcefully shown that economic policies based on purely economic assumptions are inconsistent with social justice and the welfare of society. Even the assumption that all taxes irrespective of their level, have a disincentive effect, have been questioned. For instance, at one time it was an accepted wisdom that savings are interest elastic. Theoretical and empirical work has raised doubts on this assumption.

Coming to our main question, viz., whether zakat affects economic growth, meaning the growth in income, let us discuss the main determinants of growth. They are savings, investment and the human factor. The higher the investment in plant and machinery, schools, technology, roads irrigation etc the higher will be the growth rate. And the higher the increase in income the higher will be the savings to be used for further investment. This creates a virtuous movement, conducive to growth.

Human factor, has been recognised as a very significant element in this process. Thus, an educated, healthy, satisfied society will have its members who will be more efficient than ignorant, sick people. With the same amount of capital more can be produced by efficient labour and management, thus accelerating growth process. The question then boils down to this: does the payment of zakat, adversely affect investment and efficiency?

Contd. p.3

Experts say Islamic banking is viable in India

MUMBAI: Interest-free banking, based on Islamic principles which is in operation in more than 25 countries, has a strong potential in India like several non-Islamic countries, say Islamic scholars. Once the regulatory framework is in place, it could offer a viable alternative to the conventional banking system, they say.

Islamic scholars and former bankers debated the issue at a seminar organised by the Maharashtra chapter of Jamaat-e-Islami, with the RBI setting up a committee to look into the possibility of introducing interest-free banking in India.Islamic economist Shariq Nisar said Islamic products are offered not only in Islamic countries but also in many European countries including the UK, Switzerland and the US.

Globally, the Islamic finance market is estimated at $1,000bn, which includes products offered by not only Islamic banks, but also Islamic financial institutions and non-banking outfits, stock and bond market.

Islamic bonds, known as Sukuk bonds, are getting popular even among non-Islamic banks. Already MNC banks like Standard Chartered Bank, UBS, JP Morgan Chase and Merrill Lynch are offering such products, according to Mr Nisar. There are non-banking finance companies operating on Islamic principles in Mumbai and Bangalore, according to Islamic academic MI Bagsiraj, though there is no bank functioning on Islamic principles in the country, there have been many successful co-operatives in Surat, Gujarat, Andhra Pradesh, Tamil Nadu and Karnataka, which run on Islamic principles of banking.

As against the conventional banking practice of accepting deposits and using the proceeds to lend, Islamic banking does not entail paying of interest either to the depositor or collecting it from the borrower. Instead depositors share the profits out of lending that the bank makes.

Hence, the depositor does not earn a stable or fixed return unlike conventional banking. Interest-free banking is very pertinent especially in the context of huge interest burden that governments have to bear, experts speaking at the seminar said.

(Source: *The Economic Times*, September 27, 2005)

European Finance House

Qatar Islamic Bank is setting up the *"European Finance House"* in London with the aim to support investors placing their resources in the European market and to help non- Islamic European banks structure and market Sharia-compliant products in Europe, was said by the General Manager, Salah Mohamed Al-Jaidah according to Pratap John, Gulf Times on 23rd October. Editorial note: This entity is different from the European Islamic Investment Bank, which applied already for a banking license and is funded by other sources.

ABC looks at lending to European customers

Bahrain-based Arab Banking Corporation may introduce retail Islamic home finance in France, Germany and Italy in the coming years, revealed in a bank statement. ABC UK-based subsidiary Alburaq offers retail home lending products, and plans to launch Islamic savings products early next year.

RBI is looking for a key to unlock Islamic deposits

NEW DELHI: Banking could get sensitive to religious beliefs soon. A special committee of the Reserve Bank of India (RBI), appointed on the directions of the Government of India, is studying "instruments of Islamic banking." Islam prohibits interest, the fundamental instrument of modern banking. Offering financial products and services that conform to Islamic principles can lead to the unlocking of large financial capital that believers are unable to invest. In Kerala alone, thousands of crores earned in interest is kept in suspended accounts as believers do not claim it. "This money could be above Rs 40,000 crore," says sociologist Imtiaz Ahmad, formerly of JNU.

Formed in July, the committee headed by Anand Sinha, Chief General Manager in charge (Banking Operations and Development), RBI, has not fixed a deadline yet. "The present committee is only studying the possibilities of instruments of Islamic banking. I cannot say if it will lead to changes in banking regulations," an official said. However, trends worldwide show the change. Banks such as HSBC, Standard Chartered etc have Islamic banking divisions started in recent years, and Indian banking regulators are perhaps catching up. Instruments of Islamic banking are broadly based on the concept of sharing risk and profits rather than assured rates of interests. • For instance, murabaha is a mechanism of financing trading. Here, the contract will have cost and profit components, profit will be shared by the trader and the financier. • Mudaraba involves a sleeping partner who invests and the labour partner who does the work—the first gets his principal and share of profit; if the business fails his capital and the latter's labour sinks. • In musharaba, it is equivalent to a joint venture where banks get on board with equity and management partnership. • In muqarada, or Islamic bonds, investors share the profits of the cumulative investments. And the bank collects a service charge, where profit sharing is not involved. Jamaat-e Islami Hind, campaigning for Islamic banks for long, is excited about the RBI move. "There are many Muslims who are unwilling to deal with the existing banking system. And some are earning a lot of wealth too. If they have an opportunity to invest, on a profit-sharing basis, it is going to have a major impact on the economy," says Siddique Hassan, secretary. Abdur Raqeeb, Tamil Nadu state president of the Jamaat-e Islami, says interest-based banking can create havoc, as it happened in the case of farmers in AP. "Islamic banking is based more on sharing of responsibilities and is more compassionate," he says, adding it could make credit available for the weaker sections. But there is a lot of heated debate among ulemas on what is permissible and what's not and some scholars say it is all a farce. "It is all very good to talk about but I am not convinced of its viability," says Prof Imtiaz Ahmad. However, it may not be the moral or religious arguments, but the economic ones that got the concept moving across the globe and now in India—assets controlled by Muslims is estimated to be $1.5 trillion and growing at 15 per cent a year. Banks began to eye this—Islamic bonds collected $30 billion in 2004, $20 billion already this year. Malaysia, headquarters of Islamic Financial Services Board (IFSB), has emerged the hub of Islamic banking. As many as 265 Islamic banks across 40 countries have assets of $262 billion. Services offered by Islamic banks are a hit among non-Muslims too. More than 50 per cent business of HSBC's Islamic banking division started last year in Malaysia is with non-Muslims!

(*Source*: Varghese K George, *Sunday Express*, October 02, 2005)

New Books and Articles

Books:

1. CHAPRA, M. Umer, (Review Article), *Islam and Mammon: The Economic Predicaments of Islamism by Timur Kuran*, in: *Journal of Islamic Studies* (Oxford, UK), Vol.16, No.2, May 2005, pp.232-238.
2. ISLAMOGLU-INAN, Huri (ed.), 'Constituting Modernity: Private Property in the East and West (Islamic Mediterranean), London: I.B. Tauris, 2004, 335pp.
3. ISLAMOGLU-INAN, Huri (ed.), *Ottoman Empire and the World Economy*, Cambridge: Cambridge University Press, 2002, 439pp.
4. KAMALI, M.H., *Equity and Fairness in Islam*, Cambridge: Islamic Texts Society 2005, 144pp.
5. KHAN, M. Akram, *Islamic Economics and Finance*- A Glossary (2nd Edition) London and New York: Routlege, 2003, 195pp.
6. MUNAWAR Iqbal, & PHILIP, Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects*, Basingstoke, UK: Palgrave Macmillan, 2004, 190pp.

Articles:

1. CHOUDHURY Masudul Alam, HUSSAIN Md. Mostaque, "A paradigm of Islamic money and banking", *International Journal of Social Economics*, Mar 2005 Volume: 32, Issue 3, pp. 203 – 217.
2. GHANNADIAN, F. Farhad & GOSWAMI, Gautam, "Developing economy banking: the case of Islamic banks", *International Journal of Social Economics*, Aug 2004 Volume: 31 Issue: 8 Page: 740 – 752.
3. ISLAM, M. Mazhar, "Regulations and supervision of financial institutions in GCC countries", *Managerial Finance*, Aug 2003 Volume: 29 Issue: 7 pp. 17 – 42.
4. KHAN, Omar, "A Proposed Introduction of Islamic Banks in India", *International Journal of Islamic Financial Services*, Vol. 5 No.4.
5. MAKIYAN, Seyed Nezamaddin, "Role of rate of return on loans in the Islamic banking system of Iran", *Managerial Finance*, Aug 2003 Volume: 29 Issue: 7 Page: 62 – 69.
6. ROSLY Saiful Azhar, & BAKAR Mohd Afandi Abu, "Performance of Islamic and mainstream banks in Malaysia", *International Journal of Social Economics*, December 2003 Volume: 30 Issue: 12, pp. 1249 – 1265.
7. ZAMAN, Asad "Towards A New Paradigm for Economics", *JKAU: Islamic Econ.* Vol. 18, No. 2. pp. 30-49.

Contd. from p. 1

Zakat is a tiny proportion of accumulated wealth. The rate is 2.5% of defined wealth. It is not imposed on those who do not have zakatable assets. In addition, investment depends on demand, and demand depends on purchasing power. If there is a considerable part of population whose basic needs are not satisfied, the total purchasing power will be low, and investment will lose its momentum. One can argue that the lack of purchasing power among the poor will be compensated by increased purchasing power of the rich, the increased purchasing power being measured by the non-payment of zakat. This argument if flawed at least on two counts. First, the pattern of demand of the rich and the poor is different. The demand of the latter takes the shape of basic necessities of life, food, clothing, housing, education of children etc. while the former, having satisfied their demand for basic necessities resort to wasteful expenditure on cars, luxurious marriages, palatial houses and the like. It is a demand which is satiable. When that point is reached, accumulation of money becomes an object by itself. One is reminded of Gulliver Travels in which in a land inhabited by intelligent horses and greedy human beings, a horse asks Gulliver what was the use of amassing coloured pieces of glass (or money in modern world) which can neither satisfy hunger nor lead to decent living. That in fact depicts the modern world,. characterised by uneven distribution of wealth and income, in which rich are becoming richer and poor becoming poorer. Even when a part of increased wealth trickles down to the poor, the relative distance between the rich and the poor increases. This affects the level of efficiency and fruitful maintainable level of investment. It also affects social amity. In brief, if the payment of zakat reduces the level of poverty and destitution, the material and social effect will increase the overall growth through investment and enhanced level of efficiency. There is an additional point. Zakat is levied normally on idle wealth which does not contribute to the process of growth. Let us also not forget the effect of payment of zakat on Government finances. Ensuring the provision of basic necessities including food, education, health facilities is the accepted duty of every democratic civilised government. Payment of zakat helps the government in the implementation of the declared policies of the society.

In this brief article it will not be possible to do justice to all the points relevant to the question raised. However, it needs to be emphasised that priorities in the distribution of zakat are the relatives (parents and children are not eligible) the destitutes who may or may not disclose their needs, needy travelers and so on. If strictly adhered to, it will provide effective social insurance. This leads to another point. To get the maximum benefit out of the zakat system, should it be centralised or decentralised? Other papers will deal with this important topic. I would only submit that in order to be effective and consistent with objectives of zakat, a centralised system has to be really well organised and efficient, with updated data on the needy and continuous monitoring of the recipients. However, there will be a self-respecting strata of the needy, who will not like to be registered with the centralised system. They are known only to relatives and friends.

(Note: The paper was written for the Conference on Zakat organized by the Zakat Foundation of India)

Evolution and Origins of Islamic Banking in Pakistan

Primarily, the very origin of Islamic banking is rooted in the prohibition of interest (*Riba*) in Islam. A secondary issue relates to *Gharar* which signifies the underlying uncertainty about a transaction that can affect its transparency. In addition, there are social and ethical objectives such as an equitable distribution of income and wealth in society which an Islamic Banking system aims to promote and achieve. Consequently, all these factors together led to a strong demand to introduce a banking system in accordance with Islamic principles. Efforts to provide an alternative system to interest-based banking practically started in the early sixties in Egypt, but picked up momentum when countries like Malaysia and Bahrain entered this field. Seeing the potential growth in Islamic Banking, conventional banks also started to offer Islamic banking products.

In Pakistan, the demand for Islamic banking in its initial phase came about as an outcome of constitutional and judicial obligations rather than as a financial and economic phenomenon and efforts to implement it in its true spirit started only a few years back. Earlier attempts at Islamizing the banking system were made in 1979 when the Banking Control Department of the State Bank, under the guidance of the Ministry of Finance and in collaboration with the Council of Islamic Ideology and Pakistan Banking Council, issued directives to banks for the transformation of the conventional banking system into a non-interest based system. This process, which started in 1979, was finally completed in 1985 when all banking companies were asked to provide finance only under the identified interest free modes. A number of amendments in various laws were made during this period. From July 1 1985, no banking company was allowed to accept any interest bearing deposits. However these directives did not apply to foreign branches of Pakistani commercial banks and foreign currency deposits and loans. However, the procedure adopted by the banks to implement a banking system based on 'mark-up' was declared un-Islamic by the Federal Shariat Court (FSC) in November 1991.

On December 23 1999, the Supreme Court of Pakistan endorsed this verdict, with the directive that laws involving interest would cease to have effect by June 30, 2001. According to the Supreme Court, the financial system in the country had to be changed radically in order for it to be in conformity with the Shariah. On the Supreme Court's directives, a Commission for the Transformation of Financial System (CTFS) was set up by the Government along with two task forces to plan and implement the process of transformation. This directive also required specific measures to be taken in the associated legal framework.

The CTFS was formed in January 2000 in the State Bank, and constituted a committee for the Development of Financial Instruments and Standardized Documents to prepare model agreements and financial instruments for an Islamic banking system. In its two reports, the CTFS identified a number of prerequisites for an effective transformation of the financial system. As a result of these efforts, in 2001, an Islamic Banking Division was established in the Banking Policy Department at SBP, which was expanded to a full-fledged Islamic Banking Department (IBD) in 2003. This time around, concerted efforts are being made by SBP to undertake Islamic Banking in its pure form, learning from the experience of Bahrain, Malaysia and Saudi Arabia etc. in this area.

The Islamic Banking Department at SBP has formed a comprehensive regulatory framework aimed at the establishment and promotion of an Islamic banking system in line with best international practices. These measures are primarily demand-driven and provide an option to the customers to choose between the two banking systems in accordance with their preference.

As a first step, in December 2001, the State Bank issued detailed criteria for the establishment of Islamic banks in the private sector. A three-pronged strategy for the promotion of Islamic Banking in Pakistan was operationalized on January 1, 2003,7 which allowed financial institutions, to decide at their discretion, to establish either full-fledged Islamic banks in the private sector; or Islamic Banking subsidiaries or stand alone Islamic Banking branches of the existing commercial banks. This is in sharp contrast to the earlier attempt, when Islamic Banking was required to be implemented by all banks across the board.

(*Source: Pakistan: Financial Sector Assessment 2004, State Bank of Pakistan*)

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