ISLAMIC CAPITAL:
ETHICAL FOUNDATIONS OF AN EQUITABLE ECONOMIC SYSTEM

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IsDB Prize Laureate Lecture 2022
Islamic Development Bank Group
Jeddah, Saudi Arabia

12 December 2022
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1. Introduction

Recognizing the dire economic, social and environmental issues facing the humanity, the United Nations launched the Sustainable Development Goals (SDGs) in 2015 as an agenda of action for people, planet and prosperity. While the people aspect calls for tackling poverty and inequalities and the planet part involves introducing environmentally friendly production processes and consumption patterns, prosperity relates to balance economic growth that includes taking care of people and planet. Thus, SDGs calls for changing the development path to one that is sustainable and produces shared prosperity. Although there was some progress made in the some of the SDGs, the targets of 2030 Agenda have taken a hit in many countries due to the onslaught of COVID-19 (Sachs et al. 2022). On the people front, poverty (SDG1) and inequalities of income (SDG 10) are persistent and have gotten worse in the aftermath of the pandemic. For example, the share of global income going to labour, a broad indicator of inequality, decreased from 54.1% in 2014 to 52.6% in 2019 (UN 2022: 47). While the wealth of billionaires grew by US$4.4 trillion during 2020-2021, 100 million additional people fell below poverty line (Stiglitz 2022).

The co-existence of immense wealth and persistent poverty and inequalities raises questions on the underlying causes that create the disparities. A prevalent explanation is that the structural features of the capitalist system cause inequalities of incomes and wealth. This view can be seen in the discourses on capitalism starting with Karl Marx in the 19th century to more recent empirical literature by Thomas Piketty. Historically, capitalism has evolved from industrial capitalism to financial capitalism and more recently to informational or digital capitalism. Whatever the form, capitalism is based on private property, freedom of contracts, economic rationality of maximizing profit and utilities and allocation of resources through competitive markets (Bassiry and Jones 1993, Jahan and Mahmud 2015). There is a general believe that capitalism has been successful to promote economic growth but has failed to prevent perpetuation of income and wealth inequalities and environmental degradation. Critics blame capitalism for having destructive forces with its unabated urge for profit and accumulation that creates inequalities and environmental degradation (Chertkovskaya and Paulsson 2021). The failure of capitalism to resolve the problem of inequalities and poverty has led to continuous debates and search for an appropriate form of economic system that is more equitable.\(^1\)

Islamic economics was presented in the 1970s as an alternative vision that could resolve the problems of growth and equity in a balanced manner. Islamic economists asserted that an economic system based on values and principles derived from the Quran and Sunnah would be human-centric. As in the case of capitalism, Islamic economics also recognises private property rights and market mechanisms to allocate resources. However, key differences between the two systems lie in the legal principles and ethical values governing economies. In its basic form, an Islamic economy governed by legal principles of paying Zakāt and not dealing with Ribā is expected to produce an economy that would produce equitable growth.

Beyond legal rules, a key distinguishing feature of an Islamic economic system is that it integrates ethics in economics. The ethical dimensions of an Islamic economy can be viewed in different ways. First, the values and virtues such as integrity, honesty, compassion, etc. would change the nature of economic agents to *homo islamicus* from self-seeking *homo economicus*.

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\(^1\) For a discussion on alternative forms of capitalism see Bowles (2012), Bardhan and Roemer (1992).
Second, the *Maqāṣid al-Sharīʿah* perspective views actions and transactions in terms of goodness in outcomes or consequences. Islamic economists argued that Islamic legal principles and ethical values would bring about equitable growth and enhance welfare for all.

While Islamic economic system envisaged by the proponents of Islamic economics does not exist in reality, most OIC member countries have adopted some variant of the capitalist economic system. However, many Muslim countries, including those in the Middle East and North Africa (MENA) region, practice some elements of Islamic economic principles and values. It is reasonable to expect that a section of the people in the MENA region are likely to have some values of *homo islamicus*, pay Zakāt and be reluctant to engage with Ribā based transactions. One would expect that practicing some of the Islamic economic principles would have positive impact on the distribution of income and wealth.

Data on income and wealth distributions, however, shows that the MENA region has one of the most unequal income and wealth distributions. Chart 1 shows that the national income going to the top 10% of the population is 58.2% for the MENA which is the highest compared to other regions in the economy. Similarly, the concentration of wealth among the top 10% of the population in MENA (75.3%) is below Latin America (77.3%) but higher than all other regions. Interestingly, the regions that represent origins and bastions of capitalist systems (i.e., European Union and North America) have the lowest concentrations of income and wealth compared to the other regions. It should be noted that wealth inequality is more acute that income inequality in all regions.

![Chart 1: Income and Wealth Concentration (Top 10% Share) 2020](https://wid.world)

It is puzzling why the MENA region with some remnants of Islamic economic values shows relatively high levels of inequalities of income and wealth. The data on income and wealth distribution raises a fundamental question on what creates inequalities in Muslim economies even though they have some traces of Islamic economic practices. One way to answer this question would be to seek answers in the features of contemporary capitalist systems which most countries of the region have adopted. A fundamental feature of capitalism is ‘capital’ which forms ‘the starting point as well as the finishing point’ of the system and represents ‘all-dominating economic power of bourgeois society’ (Marx 1973: 107). Thus, a key factor that can explain how inequalities arise in contemporary economies is the notion of ‘capital’ which is not only a means of production but also defines the production relationships and processes in capitalist economies. In particular, a traditional explanation of inequalities in capitalist economies is that
capital exploits labour by expropriating labour surplus in the production process. Some recent studies have presented other perspectives on the role of capital in explaining increased inequalities in capitalist economies (Piketty 2014, de Soto 2010, Haskel and Westlake 2018 and Pistor 2019).

Given the vital role that capital has in capitalist economies, there is a plethora of literature on it. The discussions recognise the changing role of capital from the industrial capitalism to financial capitalism to the current state of capitalism with intangible informational or digital capital (Haskel and Westlake 2018). A key feature that determines the form of capitalism is not only the type of capital but the nature of financial institutions, capital markets and systems that mobilize and allocate capital (Carney 2010: xi, Gill and Law 1989).

While there is a large literature on capital and capitalism in conventional economics, the discussions on capital in an Islamic economy has not received much attention during contemporary times. Some have argued that the notion of capital existed in traditional Islamic societies long before the advent of industrial capitalism. Islamic capital was extensively linked to trade and commerce and governed by well recognized contracts and instruments since the 8th century CE (Labib 1969, Banaji 2007, Cizacka 2011). Although Islamic traditions recognised ‘commercial capital’, there has not been much discussion on the role of capital in the framework of ‘mode of production’ or industrial capitalism and the subsequent financial and informational capitalism.

Most of the discussions on Islamic economic system during recent times focus on the implications of *homo islamicus*, prohibition of *Ribā*, Islamic financing modes and *Zakāt* in the economy. A large literature discusses various aspects related to Islamic finance, but the role of capital as a means of production in the context of industrialization and economic systems has received little attention. It should be noted that the concept of finance and capital are different from an economic systems perspective. While financing is a general word implying provision of funds to different types of clients, capital is a term that has connotations of power that can affect production, value creation and income distribution.

Given the above, the aim of this paper is to explore and analyse the notion of ‘Islamic capital’ in an economy from the production perspective and discuss implications on growth and inequalities of income. While the focus of Islamic modes of financing has been on legal prohibitions, the paper asserts that the key distinguishing features of Islamic capital should also include ethical dimensions. The paper argues that without including Islamic ethics, the equitable impact of Islamic capital cannot be realised. The implication is that Islamic financial practices focussing on legal compliance only, without attention to underlying ethics, have the potential to propagate the same inequalities. It is necessary to have Islamic capital that inheres ethics to produce an economy that is just and equitable. At a practical level, ethical capital at the systems level can be promoted by a diversified financial sector beyond Islamic banks that includes non-bank financial institutions providing asset/equity-based financing and social finance.

The paper contributes to the literature on Islamic economics and finance in a couple of ways. First, the paper presents a conceptual framework of the notion of capital in an economic system from its role in production processes. The focus of most of the existing literature on Islamic economics has been on critiquing interest based financial systems and highlighting the role of Islamic modes of financing. However, the nature of Islamic capital and how it can impact growth and inequalities from an economic system perspective have received little attention.

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3- For a review of literature on definitions and debates capital see Cohen and Harcourt (2003) and Hodgson (2014).
Thus, the paper adds to the literature by classifying different types of Islamic capital in a production framework and elaborating on their features and role on growth and income distribution. Second, the paper critically examines the practice of Islamic finance sector to evaluate its impact on growth and income inequalities. In particular, the paper argues that the narrow focus on the legal compliance in Islamic finance practice would not be sufficient to promote growth and equity. It then provides a vision of Islamic capital formation by arguing that introducing ethics is necessary to promote both equity and growth. The ways in which this can be done at the levels of capital, institutions and individual behaviour are presented.

A couple of issues related to the scope of the paper need to be clarified. First, inequalities in societies arise from a complex process and determined by a variety of factors beyond capital. For example, Farooq (2018) discusses rent-seeking behaviours in economies beyond Ribā or interest-based financial sector that can create injustice and exploitation. While recognizing that multifarious factors determine poverty and inequalities, the focus of the paper is limited to examining the role of capital in affecting inequalities. Second, other than inequalities of income and wealth, contemporary economies also face many other serious issues that also include climate and environmental crisis. Although issues related to environmental degradation and sustainable development can also be examined from the perspective of capitalism too, the focus of the paper is on the role of capital in perpetuating inequalities.

The paper is organized as follows. Section 2 explains the notion of capital and its role in contemporary capitalist economies and Section 3 discusses how inequalities can arise in a capitalist system. While Section 4 presents the legal and ethical foundations of an Islamic economic system, Section 5 presents an evaluative framework of Islamic capital. Section 6 uses the framework to assess the current practice of Islamic financial system and its products and discusses the implications for growth and income inequalities. Section 7 presents the various policies that can introduce ethics in Islamic capital and promote an equitable economic system. The last section concludes the paper.

2. Capitalism, Capital, Law and Ethics: Literature Review

2.1. Capitalism: Types and Evolution

Although market-based capitalist system is attributed to Adam Smith, the term ‘capitalism’ was popularised by Karl Marx in the 19th century in his writings on the role of capital in creating value through production and using markets to acquire labour and exchange goods and services (Grewal 2017, Kapczynski 2020). Capitalism as a system is linked ideologically to neoliberalism that posits that ‘human well-being can be best advanced by maximization of entrepreneurial freedoms within an institutional framework characterized by private property rights, individual liberty, unencumbered markets, and free trade’ (Harvey 2007:22). The profit-maximizing feature of capitalism relates to ‘increasing the amount of surplus appropriated by capital on the basis of the private control over the means of production and circulation’ (Cohen 2019: 5). The surplus that capital can extract from the production process is determined by productivity levels which in turn depends on modes of technologies used (Castells 2010: 15).

The notions of capitalism have evolved over time. Varieties and features of capitalism depend on the level of development and institutional frameworks of the political economy (Hall and Soskice 2001). While the origin of capitalism is related to industrialisation (industrial capitalism) that focussed on physical capital, it evolved to financial capitalism and informational capitalism. The expansion of financial capital has increased financialization whereby finance has supremacy over real production (Mollo et al. 2022). Financial capitalism is discussed in terms of financialization of economies with financing playing an important role beyond the
productive real sector and expanding to the financial and household sectors. Financialization of capitalism has increased the financial flows within the financial sector and the role of financial institutions in the intermediation and circulation of funds has become prominent in the economy (Lapavitsas 2009, 2013). With the dominance of financial capitalism the size and role of the financial sector in the economy has increased significantly and has become progressively larger over time (Baragar and Chernomas 2012, Duman 2014). In some advanced economies the capital movement within the financial sector is larger than financing to the real economy. The transition from industrial capitalism to financial capitalism can be seen by the share of profits of the manufacturing and financial sectors. For example, while in the past financial sector’s profit was around 15% of all corporate profits, since 2000 the finance sector profit share has been exceeding the manufacturing sector’s share, except for 2008 (Peet 2011).

Furthermore, financial institutions also provide credit to households for different needs such as mortgages, education, health, consumption, etc. which increased their debt levels significantly. The move in the use of capital from production to financing consumption changed the net lending positions of many households from positive to negative (Baragar and Chernomas 2012). The prominence of financialization of the household sector is evident from the expanding share of the global household debt which was 57.9% of GDP, with the corresponding figures for non-financial corporation debt and public debt being 98.4% and 99.4% respectively in 2020 (IMF 2022).

Capitalism has also evolved in terms of financing modes used. While until mid-19th century equity was the dominant form of providing capital, since then debt started taking more important role (Canderle 2021). In recent times, debt forms the dominant form of capital (Pistor 2019). The dominance of debt has converted contemporary financial capitalism into debt capitalism. A key difference between equity and interest-bearing debt is the return on the former is a share of the profit and the latter is ‘rent’ (Lapavitsas 2009). Rentiers avoid engaging in the productive process, but instead get rent or interest from scarce resources that include loanable funds.

More recently, capitalism has evolved into informational capitalism or capitalism with intangible capital. The Fourth Industrial revolution has unleashed technological and digital innovations and has fundamentally changed business models and forces of production. Introducing digital and informational capital in production and distribution has changed ways in which value is created and distributed (Preiffer 2021). The new inputs and modes of production resulting technological capitalism is termed variously as informational capitalism, knowledge capitalism, cognitive capitalism, platform capitalism, surveillance capitalism or iCapitalism (Sadowski 2019, Wei 2021). Introduction of digital technological changes the fundamental production modes and processes by diminishing the requirements of physical capital, enhancing the efficiencies in operations, increasing the capabilities of accessing and processing data and information, enabling access to wider markets and replacing human labour with robots. Informational capitalism which can be thought of ‘alignment of capitalism as a mode of production with informationalism as a mode of development (Cohen 2019: 5) can potentially produce more value efficiently and provide goods and services to consumers faster and at lower cost.

### 2.2. Capital

Capital is used in production to generate potential surplus value under uncertainty. Capital thus becomes a ‘central tool of the economic calculations by profit-oriented enterprises’ (Braun 2017: 306). It is important to understand what capital is not and distinguish it from the concepts of commodity and assets (wealth). Whereas commodities are goods that are consumed or sold for profit in a certain time period, assets are durable things that generate income or rent over time (Greene 2022). Wealth includes all forms of assets such as money,
land, real estate, fixed assets, crypto assets and intellectual property. While wealth represents accumulated assets from the past savings and is static or passive stock concept, capital is linked to the capacity to generate future cash flows and expectations (Levy 2017). A key difference between assets and capital is the nature of returns. The return on capital is in the form of profit that is the residual value in a production process. Assets generate rent which equals value in excess of its opportunity cost and is linked to ownership and control of a scarce resource. Debt is a form of asset that can be used in productive or non-productive sectors and earns interest that is not contingent on performance of businesses. Other assets such as land can be used as collateral to get credit that can be used as capital.

Although wealth and capital are different conceptually, they are closely linked as wealth can be converted into capital by using it in productive activity. Some assets such as money can be capitalised by assigning them a pecuniary value that is linked to its expected capacity to yield a likely future income or profit (Levy 2017: 494). Similarly, the profits generated from capital can be converted into assets which become a part of wealth. The value of wealth can increase in an economy due to increase in asset prices or rents even when capital or output produced is constant or decreasing (Stiglitz 2016). Thus, income from assets or wealth can continue to grow while an economy is in a recession.

While capital forms a key building block of capitalism, it is defined in different ways and has variety of meanings. Hodgson (2014) discusses how the meanings of capital evolved and widened in application over time. The word capitale was first used in Italy in 1211 to mean ‘capital assets of a trading firm’ and later on as ‘money capital of a firm or of a merchant’ (Hodgson 2014: 1064). Capital continued to mean money that the shareholders used to establish a business until Adam Smith changed the meaning of capital to represent material or physical things used in production to generate profit. Karl Marx viewed capital as ‘definite relation of production’ or ‘means of production’ and was not only concerned with its role in production, but also distribution of surplus. Eugen von Bohm-Bawerk defined capital as ‘a complex of produced means of production’ and Fisher regarded capital as any ‘material entity that produces a flow of income over time’ (Hodgson 2014: 1066-1067). Capital was later used to define anything that helped production such as human capital, natural capital, social capital, etc.

A key issue that is debated in literature on capitalism is what constitutes capital and the difference between productive and fictitious capital. While production requires factors such as land, labour and physical capital such as machines and tools, financial capital used by the business sector in the production process can be identified as productive capital. The providers of financial capital make decisions to invest after making calculations of expected profit in an uncertain environment. It should be noted that valuation of capital depends on the prospective future returns which are uncertain. While the notion of fictitious capital goes back to Marx (1972), it is interpreted differently in literature. Marx viewed interest bearing debt as fictitious capital since it is not directly linked to physical capital used in production and interest payments is not associated with surplus generated in the business (Marx 1991, Mello and Sabadini 2019). In other words, the return from fictitious capital is fictitious profit which ‘do not correspond to a fraction of the surplus value generated in the productive process’ (Mello and Sabadini 2019: 155).

While some contemporary scholars consider all credit to be fictitious capital, others argue that credit used in production should be excluded (Mollo et al. 2022). The latter view would imply that all debt not used in production that includes loans provided to household and financial sectors would be considered fictitious capital. Thus, it can be argued that increased financial-

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4 For a discussion see Hudson (2010), Mollo et al. (2022) and Mello and Sabadini (2019).
ization under financial capitalism leads to expansion of fictitious capital with smaller shares of financing going to the real sector as productive capital. For example, in the US only 15% of the financing from financial institutions goes to the real sector with the remaining used for facilitating trading and speculation (Hardoon and Shigiya 2017).

Since returns on fictitious capital is not linked to real economy and production, it can grow without limits. One of the reasons of the exponential growth of fictitious capital is the fall of the overall rate of profits generated from productive investments (Duman 2014). A significant form of fictitious capital that is responsible for extensive financialization and not directly linked to production is derivatives. Derivatives are fictitious capital as their value depends on claims of other financial assets such as debt and abstract assets such as indices, exchange rates, interest rates, risks, etc. (Mello and Sabadini 2019: 150). While a very small percentage of derivatives are used for hedging purposes, the bulk is used for speculation. The extent of financialization in the derivatives markets is reflected by the size of their notional value which is much larger than the global GDP. The notional amount of OTC derivatives was valued at US$ 600 trillion in December 2021 which is more than six times the global GDP which was US$ 96.1 trillion in 2020.5

While the expansion of the financial sector and financialization is linked to financial capital, the extensive use of digital technology is increasing datafication and expanding the digital or informational capital. The digital era resulted in extensive use of information, data and computer coding in production and exchange. Digital technologies such as internet of things, big data, online platforms, etc. enable data extraction that can be used to enhance efficiency and profitability. While data and information are sometimes referred to as commodity, it can be more aptly defined as capital (Sadowski 2019).6 During the digital era, intangible capital such as data, information and codes are considered as ‘new sources of value and tools of accumulation’ (Sadowski 2019: 5) and play a key role in production and exchange (Kapczynski 2020).

### 2.3. Capital is Legally Constructed

Beyond a socioeconomic system, a central feature of capitalism relates to political and legal order that recognises private ownership of property and its exchange. Thus, a key issue in capitalism is the remit of the state in an economy. In a laissez faire economy, the markets are allowed to operate freely without any political control or interference of the state (Kapczynski 2020). The role of the state is to provide a legal regime that protects private property and enables exchanges in the markets. Capitalism can also be viewed as a juridical regime (Grewal 2017). Max Weber maintained that rational law and rule of law were fundamental to the development of capitalism in Europe (Habermas 1986, Trubek 1972). Not only property and contract laws form the foundations of a market economy (Kapczynski 2020), but capital and its features are defined by law (Pistor 2019).

One way to understand variety of types and notions of capital in industrial, financial and informational capitalism is to view capital from a legal perspective. Many economists and legal scholars assert that capital is legally constructed and law defines, recognizes and supports certain private property as capital. Levy (2017: 487) identifies capital to be ‘legal property assigned to a pecuniary value in expectation of a likely future pecuniary income’. In other words, capital can be viewed as legal rights of control and claims on its future income.

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5- For information on derivatives see BIS (2022) and GDP World Bank database.
6- Data capital is ‘discrete bits of information that are digitally recorded, machine processable, easily agglomerated, and highly mobile’ and ‘institutionalised in the information infrastructure of collecting, storing, and processing data; that is, the smart devices, online platforms, data analytics, network cables, and server farms’ (Sadowski 2019: 4).
Pistor (2019) provides a framework of the legal construction and code of capital. An asset is converted into capital by using legal codes by using different laws such as property rights law, contract law, collateral law, bankruptcy law, trust law and corporate law (Pistor 2019: 3). These laws are used to confer some important attributes to assets that converts them to capital. The legal per-spective of capital implies that laws are used to code capital which are backed and enforced by the state (Pistor 2019: 15).

Pistor (2019) identifies the attributes of capital as priority, durability, universality and convertibility. Priority ranks claims and rights over assets of debtor in case of bankruptcy (Pistor 2019: 13). Property rights, collateral and bankruptcy laws are used to secure priority of claims. Durability attribute of capital is ensured by legal codes that expand ‘life span of assets and asset pools’ by extending ‘the priority claims over time’ (Pistor 2019: 14). Universality feature relates to extending priority claims across space. Contract laws used to prioritise claims over assets are ensured by legal systems in different jurisdictions. Convertibility attribute allows claims on assets to be converted into cash and relates to the ability to transfer assets and gain liquidity.

The laws are used to infuse the attributes of capital on newer forms of asset and convert them to capital. For example, loan is coded to have the features of capital identified above. As a result, secured debt would have priority over other claims in bankruptcies. Debt is also durable over time and space (universality) as the claims of the creditor are recognised by courts and can be sold to others for cash (convertibility) (Pistor 2019: 77). Financial instruments such as mortgage-backed securities (MBS) are possible in conventional economies since debt can be legally owned as asset. Unlike interest-bearing debt capital, fictitious capital in the form of derivatives does not possess value in itself but is a ‘legal title which assumes an expectation of future income streams from variations in the prices of financial assets themselves’ (Mello and Sabadini 2019: 154).

In digital economies, control and production of data is also determined legally (Kapczynski 2020: 1499). Converting information and digital assets into capital would require legal coding to instil them with the features of property and attributes of capital. In most jurisdictions, patents, trademarks, copyrights, etc. are recognised as private property that can create value and are protected by intellectual property or copyrights laws. Laws have expanded the scope and duration of intellectual property rights during recent times (Cohen 2019: 16-18). Intangible digital and informational assets are recognized as property and capital under the framework of intellectual property rights.

2.4. Capitalism, Ethics and Justice

The laissez faire economy advocated by Adam Smith reflected the values and worldview of the Enlightenment era and modernity prevalent in Europe whereby religion was made a private and social matter and removed from political and economic realms (Griswold, Jr. 1999). Influenced by enlightenment, capitalism evolved as a secular ideology that emphasised rationality and, as a result, ethics was marginalised from economic discourse (Chapra 2009, Elshurafa 2012). Rationality in a market-based capitalist economy assumes self-seeking individuals who engage in production and consumption to maximise their profits and utilities respectively.

Ethics in a capitalist system is viewed from perspectives of whether it can further the eco-

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7- In some cases, judges in the US have ruled that computer coding is treated as speech that is protected by the constitution (Kapczynski 2020: 1511).
onomic goals of efficiency and wealth maximization. The relevant ethics that contribute to the 
*laissez faire* market economy include prudence, temperance and self-command as these 
lead to the maximization of profit (Bruni and Sugden 2013, Haakonssen 2004). While con-
sumer sovereignty, individual choice and responsibility, material progress are considered as 
values driving capitalism, work ethics and virtues such as productivity and frugality promote 
growth and accumulation (Bassiry and Jones 1993). Sen (1999: 262) argues that functioning 
of capitalist economy depends on values and norms such as honesty, trust and transparency. 
While it is recognised that certain virtues such as trust, truth, restraint and obligation sustain 
successful operations of markets and business organizations, their role have diminished partly 
due to focus on self-interest (Graafand and Wells 2021). Lack of ethics in production, trade and 
consumption has led to unabated exploitation of resources to generate profit through market 
driven capitalism.

Although it is recognised that capital is needed for production and creating value, its role in 
inducing inequalities would require understanding its distributional features and discussing 
the notions of fairness and justice. The notions of justice vary and can be broadly classified as 
procedural or substantive on the one hand and commutative or distributional on the other hand. 
Procedural justice, also referred to as formal equality, is to ‘treat like cases as like’ which brings 
about ‘arithmetic equality’ (Stancil 2017: 1641). Procedural justice involves fair processes and 
mechanisms through which the exchange/allocation takes place and following due process 
to resolve disputes. While procedural justice focuses on fair legal *process* and upholding the 
rule of law, substantive justice emphasises on the correctness of *outcome* of individual cases 
(Barnett 1988: 598, Sadurski 1984: 346). Substantive justice would consider issues such as socio-
economic status that can put certain parties at a disadvantageous position relative to others.

Commutative justice is defined as ‘the performance that each party makes is equivalent in eco-
nomic value to the one that he receives’ (Gordley and Jiang 2020:741). Commutative justice re-
lates the notion of just price in exchanges which in a capitalist framework is usually discussed 
in terms of labour market (Gunnemann 1985). Whereas commutative justice relates to equiva-
ience of value in exchange, distributive justice concerns with fair allocation of resources, equi-
table outcomes and the fairness of the ultimate resolution in disputes (Fassin and Drover 2017: 
justice deals with the distribution of resources among participants of a political community and 
can also be understood in the context of contract law. A key ethical issue in financial contract-
ing is justice that is reflected in fair conditions in contracts and trading practices (Boatright 
2010, Heath 2010).

One perspective of ethics of distributive justice in contracts is the ‘fair distribution of costs and 
benefits among the parties’ (Fassin and Drover 2017: 651). In this regard, distributive justice in 
financial transactions can be related to the fair distribution of returns and risks among parties. 
The relationship of risk and compensation can also be viewed in commutative terms when it is 
viewed as performances that each party makes ‘are equivalent in economic value when each 
party is compensated for the risks that the contract places on him (Gordley and Jiang 2020: 
741). Kronman (1980) also discusses distributive justice in contacts by identifying the differ-
ences of bargaining powers whereby the stronger party can take advantage over the weaker 
party. A contemporary example would be large companies exploiting smaller consumers by 
providing them with one-sided contracts that cannot be altered.

### 3. Capitalism and Inequalities

While free market capitalism has been able to produce growth, inequality remains one of its
inherent and lingering drawbacks. Capitalist systems are efficient but creates inequalities resulting in concentration of economic resources and wealth in the hands of a tiny minority of individuals and firms (Bassiriy and Jones 1993). To understand the impact of capitalism on growth and equality it is important to examine how value is created and distributed in an economic system (Sahr 2022). The value created in businesses is the difference between the willingness of the buyers to pay the price of the product and the opportunity cost of the resources supplied by the suppliers that is used in the production process (Brandenburger and Stuart 1996). Value created within a firm is distributed among different stakeholders such as employees, management, capital providers and government (in form of taxes) (Lieberman et al. 2017, Garcia-Castro and Aguilera 2015).

Since capital plays a key role in organising production and value creation, there is a need to understand how the income and wealth inequalities can be explained through the lens of capital. The traditional Marxist perspective is that the owners of capital control the production process and surplus value created by labour is extracted by the capital owners. While production generates growth, the exploitation of labour by the capitalists leads to inequalities of income and wealth. This traditional view assumes that all capital used in production comes in the form of equity, as Marx considered debt capital to be fictitious. During contemporary times, however, bulk of the financing comes from the financial sector in form of debt. Thus, value created in production process is distributed to pay for the inputs that includes labour, interest on debt capital and the residual profit goes to the equity holders. The amount extracted by the financial sector is greater the higher the interest rate charged, and the interest and debt payments must be made irrespective of the amount of value created in the production process. The more value expropriated by the financial sector as interest earnings, the less profit is left for the equity holders.

Beyond expropriation of value in the production process, the financial sector contributes to inequalities in a couple of ways when dealing with micro and small enterprises (MSEs). Whereas most of the microenterprises are financially excluded involuntarily and do not have access to credit that can enhance their production and income due to acute asymmetric information problems and lack of acceptable collateral, the larger companies and richer households do not face this constraint. Thus, lack of productive capital availability for MSEs due to financial exclusion is a key source of income and wealth inequality (Stiglitz 2016: 40). Second, the risk-based model used to price products translates to ‘poverty premium’ which is “the extra cost that households on low incomes incur when purchasing the same goods and services as households on higher incomes” (Tipping et al 2019: 16, Corfe and Keohane 2018: 5). The implication is that the financial sector appropriates relatively more from poorer households compared to their richer counterparts in terms of interest payments. Since the richer sections of the population get better terms and conditions including lower prices on financial products than relatively poorer households, poverty premium further acerbates inequalities (Hardoon and Shigiya 2017).

Beyond exploitation of labour in the production process, financial exclusion and poverty premium paid by MSEs, financialization also contributes to income inequalities. As indicated, fictitious capital provided to the household and financial sector derives income without participating in production of goods and services. Thus, excessive financialization and expansion of fictitious capital have negative impact on equality and concentration of income (Roberts and Kwon 2017). A difference between financing the household and business sectors is that the

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8- For example, Corfe and Keohane (2018: 14) estimate the average poverty premium for poorer households in the United Kingdom to be GBP 490.
interest and debt payments in case of the former does not come from profit generated in a production process (Lapavitsas 2013). Instead, interest paid by the households to banks comes from their wages and represents financial expropriation by financial institutions (Baragar and Chernomas 2012, Lapavitsas 2009). Thus, providing debt to the poorer households for consumption purposes also introduces a poverty premium as interest payments transferred to the financial sector increases the costs of goods and services and worsens their budgets.

Similarly, excessive financialization and growth of the financial sector leads to the generating fictitious profits without adding anything to real economy (Duman 2014). Assa (2012) shows that financialization has adverse impact on equality and growth in OECD countries. Overall, financialization enables the financial sector to extract interest from the household and financial sectors and this figure increases with the expansion of debt. For example, the total global debt stood at US$ 303 trillion in 2021, while the global GDP was US$ 96.1 trillion. An estimated 4% interest rate on debt implies that interest payments transferred around 12% of the global GDP from debtors to creditors.

At a macro level Piketty (2014) documents historical trends of the evolution of income and wealth (which is used interchangeably with capital) and finds that the return on capital \( r \) has always been higher than the GDP growth rate \( g \). The relationship \( r > g \) means that wealth grows faster than income which implies that owners of capital appropriate a larger share of output growth compared to those without capital. With the disparity of growth rates \( r > g \) compounding over time, the wealth held by owners of capital increases far more rapidly than other kinds of earnings such as wages. This inherent difference in growth rates implies that the growth rate of labour wages is less than the growth rate of capital returns which leads to concentration of wealth and amplifies the inequalities over time.

Piketty’s findings indicates that inequalities can arise due to uneven distribution of high-yielding capital in economy. Thus, financial exclusion in terms of lack of investment opportunities can cause inequalities as it prevents poorer households to invest in investment products that gives higher returns. Unlike well-off households who can invest in relatively high yielding capital, most of the low income and middle-income households end up investing in savings accounts in banks that pay very low interest rates. The result of investing in saving accounts that pay interest rates that are usually lower than the inflation rates is that the value of savings go down over time which worsens the wealth distribution.

3.1. **Capital and Inequalities: Legal and Ethical Perspectives**

Piketty’s empirical analysis points out to the feature of capital extracting a higher share of output growth in the economy that produces inequalities. Since capital is legally constructed, its role in increasing income and wealth inequalities can be viewed from legal and ethical perspectives. First, there is a need to have an enabling legal system that can support capital formation. De Soto (2001 and 2001b) asserts that in many developing countries the legal systems are not conducive to enable the capitalisation of the existing wealth which keeps them underdeveloped. He argues that while developing and emerging economies have a huge amount of assets and wealth, these cannot be transformed into capital due to lack of formal property laws and legal institutions that convert these assets into capital. In particular, due to lack of proper documentations, land and real estate cannot be used as collateral to get credit that can be used in

9- See Masterson (2022) for debt information and World Bank database (https://data.worldbank.org/indicator/NY.GDP.MKTP.CD) for GDP figure.

10 - Piketty (2014) estimated that the historical average rate of return on capital is between 4-5%.
productive activities. As such, most people cannot generate income and remain poor.

A key feature of capitalism, however, is that law is applied in a rationalist way and ethics is excluded in legal discourse. As indicated, Max Weber asserted that positive and rational law, as opposed to religious law was key to development of capitalism in Europe (Habermas 1986, Trubek 1972). Law is viewed as rational, and rule of law demands that laws be implemented through a legally institutionalized procedure without any moral considerations (Habermas 1986). The capitalist system adopted positive laws and legal systems that focus on procedural justice. Since the focus in capitalist economies on efficiency and wealth maximization, the discussions on the ethics of distribution marginalized (Britton-Purdy et al. 2020: 1797).

However, commutative and distributive justice are relevant to understanding inequalities. Contracts can be unfair due to inequalities in resources, bargaining powers, information availability and processing abilities (Boatright 2007). Unfair contracts can lead to outcomes that are unjust to one of the parties of the contract which can cause inequalities. Inequality can result from transactions that are exploitative resulting from asymmetric positions and unfair social relations (Vayrynen 2005). Gundlach and Murphy (1993: 42) identify equity as an ethical dimension in contractual relationships and link it to the notions of fairness and distributive justice.

Financial markets are different from goods markets in one significant way. While the price of a commodity is the same for all customers with little variations, the prices of financial products vary widely across types of customers and different prices can be charged to different clients. As indicated, the use of risk-based pricing leads to higher prices paid by MSEs compared to the larger companies. Lack of commutative justice in financial transactions can lead to usurious and exploitative practices. In situations when outcomes are unjust, legal rules governing contract that regulate terms of the contact can impact distributive justice by constraining elements of private exchange (Bagchi 2014). For example, Kronman (1980) suggested using contract law as an instrument of redistribution and cites the example of usury law that prohibits charging exorbitant interest rates in loan contracts.

Kolb (2011) identifies the ethical issues that can arise in risk bearing and transfer in financial contacts. In some cases, parties would agree to voluntarily take on certain risks due to the nature of a transaction. For example, an investor takes on risks of investments in stocks in hope of getting a financial return. However, ethical issues related to distributive justice arise when risk transfer occurs involuntarily due to asymmetric information, deception or undue exercise of power (Kolb 2011). In financial capital unethical risk transfer occurs when investors unduly transfer risks and costs of failure to the entrepreneurs due to their superior bargaining power.

Lack of ethical values can lead to outcomes or situations in which capital is coded in ways that serve the interest of capital holders and can produce unjust outcomes that produce inequalities. As indicated, capital is legally constructed and asset holders use different types of laws such as private law, of contracts, property rights, trust law, corporate law and bankruptcy law to instil the attributes of capital (i.e., priority, durability, universality and convertibility) (Pistor 2019). The code of capital has created protection for the dominant form of debt capital in capitalist economies. While returns to equity capital is linked to the uncertain future profits, debt capital is structured in a way that continues to earn returns during downturns and transfers the risks to debtors. In particular, while a loan contract supported by collateral can protect the creditor against negative shocks, the borrowers absorb all the losses arising from a downturn. The result is that debt capital holders maintain or increase their net-worth and the wealth of debtors decreases during downturns exacerbating the distribution of income and wealth.

Some ethical issues also arise in digital or informational capitalism which can worsen income
and wealth inequalities. Informational capital is legally protected by intellectual property and patent laws which creates monopoly power and enables digital firms to extract more value and increase inequalities (Kurz 2017). Many first movers in the digital world such as Facebook and Amazon dominate the markets that gives them enormous powers to collect information and data which can be used to extract value or sold at profit (Kapczynski 2020). Under information capitalism, ‘market actors use knowledge, culture, and networked information technologies as means of extracting and appropriating surplus value, including consumer surplus’ (Cohen 2019: 6). By nature, the value of networked technology assets grows exponentially with the size of the network. By absorbing other smaller networks into it or creating linked networks super networks are created. Furthermore, contractual and trade secrecy laws are used to exclusively control the data and information they collect (Cohen 2019: 63). While the information can be used to come up with products and services that benefit consumers, it can also be misused to discriminate among customers and extract surplus value.

To summarise, capital affects income growth and inequalities in the following ways. First, capital can be broadly classified as productive and fictitious with the former going to the business sector and enabling production and growth. Fictitious capital increases financialization and goes to household and financial sectors without affecting production directly. Increase in financialization implies that fictitious capital extracts income from non-productive sectors which worsens income and wealth inequalities. Second, financial exclusion deprives MSEs from capital that is necessary for production. Availability of capital for larger firms and not for smaller and micro enterprises increases the income and wealth gaps. Third, financial products and capital are priced in ways that adds poverty premium and is unjust towards the MSEs and poorer households. The terms and conditions of financing and investments for micro-entreprises and poorer households are less favourable than their richer counterparts, which implies relatively higher levels of income transfers from the former group to capital providers. Finally, capital is coded in a way that is unjust in terms of risk-rewards distribution. Bulk of the capital in capitalist economies is the form of debt which protects interest of capital providers. While the businesses and household sectors experience losses or lower income during economic down-turns, the return of debt is protected through interest based legal contacts which can worsen income inequalities.

### 4. Islamic Economic System: Legal and Ethical Foundations

Islamic teachings provide the legal rules and ethical values that govern human behaviour and economic activities and provide the foundations of an economic system. Before discussing the features of an Islamic economic system, a brief overview of the sources and methodologies of Islamic knowledge and legal and ethical principles related to economics and finance are presented.

#### 4.1. Islamic Knowledge, Sources and Methodologies

The foundational sources of Islamic knowledge are Sharīʿah texts of Quran and Sunnah. Islamic teachings can be broadly classified as ’Aqīdah (faith and belief), Akhlāq (ethics) and Fiqh (laws and jurisprudence) (Laldin 2020). While elements of Islamic teachings are given in the Sharīʿah texts, laws and ethics can also be derived through the process of ijtihād. Over the centuries, scholars have come up with Islamic methodological frameworks to derive rules and ethical values based on Quran and sunnah.

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11 Some scholars use Shariah instead of fiqh (for example Laldin 2020). Shariah, however, would have other connotations. At a broader level, Shariah would include all teachings of Islamic and would include aqidah, fiqh and akhlaq. It can also mean the teachings and guidance from the key religious texts of Quran and sunnah.
The three broad methodological frameworks include *Uṣūl al-Fiqh* (Islamic legal methodology), *Maqāṣid al-Sharīʿah* (objectives of Sharīʿah), *Qawāʿid al-Fiqh* (Islamic legal maxims).

*Uṣūl al-Fiqh* forms the dominant Islamic legal methodology of deriving rulings from Sharīʿah texts by using principles of interpretations, reasoning and deduction (Masud 1995: 20, Musa 2014: 327). Various methods are used to derive laws with the two common tools being consensus (*Ijmāʿ*) and analogy (*Qiyās*). While *Ijmāʿ* (consensus) is the agreement of the Islamic scholars on a particular matter, *Qiyās* (analogy) links new rules to the revealed texts through analogical deductions. Beyond the agreed upon methods of consensus (*Ijmāʿ*) and analogy (*Qiyās*), other methods used by different jurisprudential schools include juristic preference (*Istiḥsān*), unrestricted interest (*Maṣlaḥah Mursalah*), *Istiṣlāḥ* (consideration of public interest), *Sadd al-Dharāʿiʿ* (blocking the means), *ʿUrf* (custom) and *al-Istiṣḥāb* (presumption of continuity).

*Maqāṣid al-Sharīʿah* signifies the aims, objectives or ends of Sharīʿah (Laldin 2020: 26). *Maqāṣid* reflect the underlying normative wisdom of Islamic law and represent the permanent and universal goals of Sharīʿah (Kamali 2006, 2011). Some scholars identify the underlying guiding principle governing Sharīʿah to be ‘enhance welfare (*Maṣlaḥah*) and minimize harm (*Mafsadah*) (Dien 2004:3, Heinrichs 2002: 372, Kamali 2008: 32, 35). *Maqāṣid al-Sharīʿah* are the essentials elements that can achieve the best interests of humans and promote good life (Ibn Ashur 2006, Landin 2020). *Maqāṣid* is related to the consequences of acts and neglecting them can lead to rules that deviate from Sharīʿah’s intent of enjoining good. *Maqāṣid* perspective asserts that Sharīʿah ordains doing certain acts as they secure the welfare of the community and forbids evil because it is against the public welfare (Abdel-Wahab 1962-63). Given the framework of *Maṣlaḥah* as the purpose of Sharīʿah, it its sometimes used interchangeably with *Maqāṣid* (Kamali 1988, 2011, Opwis 2005). Since, *Maṣlaḥah* and *Maqāṣid* are concerned with the welfare outcomes, they form the teleological ethical foundations of Sharīʿah.

Legal maxims (*Qawāʿid al-Fiqh*) form another important genre of Islamic methodological tool. The maxims are based on and derived from Sharīʿah texts reflecting the spirit or essence of Islamic law (Dien 2004:3, Kamali 2011).13 Legal maxims can be used as guide in law making as they embody universal rules that can be applied to particular cases (Rabb 2010, Musa 2014). While some legal maxims have legal connotations, others as having ethical overtures. For example, the maxims of ‘if permissibility and prohibition coincide, prohibition prevails’ and ‘what is prohibited to take is also prohibited to give’ (Laldin et al. 2013: 188, 194) fall under the legal category. Maxims with ethical undertones include ‘the fundamental requirement in every contact is justice’ (Laldin et al. 2013: 22). It should be noted that many principles governing *Maṣlaḥah/Maqāṣid* are reflected in the legal maxims. Maxims related to *Maṣlaḥah* include ‘averting harm takes precedence over achieving benefit’ and ‘harm is to be eliminated’ (Laldin et al. 2013: 110, 117).

### 4.2. Legal Framework of Islamic Economies

Sharīʿah provides legal guidelines that govern economic activities. *Zakāt* is one of the five pillars of Islam and considered among the essential elements of worship. It is an obligatory levy that all Muslims who have wealth beyond a threshold level pay to, among others, the poor and needy. *Zakāt* is paid annually at the rate of 2.5% on various forms of assets that constitute

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13- Given the importance of legal maxims in Islamic law, *Majjalah* the first codified document of Islamic commercial law produced in the Muslim world in the 19th century lists 99 maxims before presenting specific rules related to different transactions. See (Majjalah 2001).
items such as cash, gold, silver, inventories, etc. Zakāt is a levy on the wealth and considered an essential tool of redistribution of wealth and income in an economic system.

Beyond Zakāt, the legal framework of commercial and economic activities is governed by the principle of permissibility which asserts that all acts are permissible unless they are prohibited by Sharīʿah texts. (Kamali 2000: 66). Other than forbidding some goods and activities such as wine, pork and gambling, two broad categories of prohibitions in economic transactions are Ribā and gharar. Ribā (literally meaning increase or growth) is prohibited by Sharīʿah. Although it is common to associate Ribā to interest, it has much wider implications which can take different forms. The common premise is that Ribā arises from unequal trade of values in exchange (Siddiqi 2004). Other than interest-based loans, selling of debt at a discount is also prohibited as it is considered Ribā. While gharar is usually referred to mean excessive uncertainty it also signifies deception, ignorance, gambling and fraud (Al-Zuhayli 2003: 82, ElGamal 2001: 32). Gharar relates to asymmetric information problem arising in the object or terms of the contract. While gharar in the object of sale exists when it is not clearly identified, does not exist or is not deliverable, gharar in the terms of the contact relates to the ambiguity in the stipulations and conditions that can lead to disputes.

Since interest-based loans are deemed to be Ribā and prohibited, different types of permissible contracts are used to structure Islamic financial products. Islamic modes of financing can be broadly classified into equity, debt and asset-based instruments. Equity instruments are partnership contracts (Muḍārabah and Mushārakah) in which parties contribute capital and labour in a venture. In these contracts while the profit is shared according to an agreed upon ratio, loss is distributed according to the ratio of capital contribution on a pro-rata basis. Debt instruments arise from sale transactions in which one of the counter-values of the transaction is postponed to a future date. These fixed income financing instruments include cost-plus or mark-up sale (Murābaḥah), credit sale (Bayʿ Muʿajjal) and object deferred sale or pre-paid sale (Istiṣnāʿ/Salam). Asset based instrument are leasing (Ijārah) contracts in which a durable asset is leased out for a period of time in return for rental payments. Organised Tawarruq is used in some jurisdictions to provide cash to clients by undertaking buying and selling commodities to replicate the substance of an interest-based loan. This product is controversial as a ruling of the International Islamic Fiqh Academy declared organised Tawarruq prohibited as it has elements of Ribā. The difference between Murābaḥah and Tawarruq is that the former is a genuine sale contract and the good is used by the client and in the later it is not.

### 4.3. Islamic Ethics: Framework and Values

Ethics in Islamic economics and finance is discussed from different perspectives and come from different sources. The key sources of Islamic ethics are the Quran and Sunnah (Al-Dagistani 2008, Laldin 2020). There are many Quranic verses and Ahādīth that provide ethical and moral teachings related to various issues. Derived form of Sharīʿah ethical values and legal principles are encapsulated as Maqāṣid al-Sharīʿah and legal maxims. Key objectives (Maqāṣid) of Sharīʿah include the protection and enhancement of property or wealth (mal) and ensuring justice. Similarly, the broad ethical principle guiding Sharīʿah is to maximize welfare (Maṣlaḥah) and minimize harm (Mafsadah). Maṣlaḥah and Maqāṣid provide teleological ethical perspectives as they related to the consequences of acts in terms of Sharīʿah’s goals of achieving good. Many maxims provide ethical guidance including some maxims that

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14- The principle of permissibility is derived from maxims such as ‘permissibility is the original rule of things’ or ‘the norm in transactions is that of permissibility’ (Laldin et.al. 2013:10).
15- For a discussion on these modes of financing see Ayub (2007), Kahf and Khan (1992) and Usmani (1999).
support ِMaṣlaḥah. Given the above, Islamic ethics related to economics can be presented in following four perspectives.

1. **Basic Axioms Governing the Economic System:** At a broad economic system wide level, Islamic economists have discussed the moral foundations by examining the worldview of an Islamic economy. Contrary to the capitalist system that has origins in enlightenment and modernity and is independent of normative or religious orientations, Islamic economic system is based on the Quranic worldview and embeds Sharīʿah values and principles related to economics (Haneef and Furqani 2009, Neinhaus 2000). The proponents of Islamic economics identified the key foundational principles or axioms of the system which included, among others, unity of God (tawhid), vicegerency (khalifah), free will (Ikhtiār), purification and growth (Tazkiyah) justice and benevolence (ʿAdl wa-Iḥsān) and Maqāṣid al-Sharīʿah (objectives of Sharīʿah).

2. **Ethical Principles Guiding Human Behaviour:** The ethical axioms provide the ontological foundations and derive the moral values that guide human behaviour and actions in an Islamic economy (Iqbal and Mirakhor 2020). The Islamic worldview and ethics change the nature of human behaviour form *homo economicus* to *homo islamicus* (Asutay 2007, Haneef and Furqani 2009). Instead of maximizing utility, the objective of Muslims is to achieve Falāḥ which is success in this world and the hereafter. Thus, *homo islamicus* will be imbued with behavioural ethics such as respect for property rights, trust, honesty, transparency, cooperation, compassion, benevolence, etc., prescribed by Sharīʿah (Ahmad 1992, Asutay 2007, Aydin 2018). A Muslim with means will engage in charitable acts beyond Zakāt such as ʿṢadaqah and create waqf.

In a financialized economy, ethical guidelines related to dealing with debt is also relevant. While debt is permissible, Islamic teachings discourage engaging with debt unless necessary (Ahmed 2011). Prophetic sayings support this view as he sought refuge from being in debt and also refused to pray funeral prayers of people who were in debt that was not paid off (see Box 1). It should be noted that the debt mentioned in the Aḥādīth is most likely personal debt in the form of Qarḍ Ḥasan that does not add additional amounts beyond the corpus of loan.

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Box 1: Hadith on Debt

Narrated ‘Aisha: Allah’s Apostle used to invoke Allah in the prayer saying, “O Allah, I seek refuge with you from all sins, and from being in debt.” Someone said, O Allah’s Apostle! (I see you) very often you seek refuge with Allah from being in debt. He replied, “If a person is in debt, he tells lies when he speaks, and breaks his promises when he promises.” (Bukhari, Volume 3, Book 41, Number 582)

Narrated Salama bin Al-Akwa: Once, while we were sitting in the company of Prophet, a dead man was brought. The Prophet was requested to lead the funeral prayer for the deceased. He said, “Is he in debt?” The people replied in the negative. He said, “Has he left any wealth?” They said, “No.” So, he led his funeral prayer. Another dead man was brought and the people said, “O Allah’s Apostle! Lead his funeral prayer.” The Prophet said, “Is he in debt?” They said, “Yes.” He said, “Has he left any wealth?” They said, “Three Dinars.” So, he led the prayer. Then a third dead man was brought and the people said (to the Prophet), Please lead his funeral prayer.” He said, “Has he left any wealth?” They said, “No.” He asked, “Is he in debt?” They said, (“Yes! He has to pay) three Dinars’, He (refused to pray and) said, “Then pray for your (dead) companion.” Abu Qatada said, “O Allah’s Apostle! Lead his funeral prayer, and I will pay his debt.” So, he led the prayer. (Bukhari, Book 37, Hadith 488)

3. **Teleological Ethics (Maṣlaḥah and Maqāṣid):** Since both Maṣlaḥah and Maqāṣid represent the goodness of outcomes and consequences, they provide the teleological ethical perspectives of Sharī‘ah. While the legal approach focusses on means (contracts) only, the Maqāṣid perspective also considers the ends of contracts. Maqāṣid is related to the desired outcomes and scholars identify these as the protection and enhancement of faith, self, intellect, posterity, and wealth (Chapra 2008, Hallaq 2004, Kamali 2003, Laldin 2020). The Maqāṣid al-Sharī‘ah provides the teleological ethical perspectives that will apply to all economic notions of an Islamic economic system. Maqāṣid implies guaranteeing a good quality of life by securing the religion, intellect and dignity of individuals and ensuring a minimum level of income or wealth for all in the society and protecting the interests of the future generations. Thus, implementing Maqāṣid would produce an inclusive economy and financial system.

Ibn Ashur (2006: 285) identifies the Maqāṣid specific to economic transactions and activities as marketability, transparency, preservation, durability and equity or justice. Circulation or marketability is defined as “the fair circulation of wealth in the hands of as many people as possible” (Ibn Ashur 2006: 286). Preservation of property and wealth is among the primary Maqāṣid al-Sharī‘ah and ‘is one of the fundamental and universal principles of the Sharī‘ah’ (Ibn Ashur 2006: 286). Persistence or durability implies that an owner of a property has the exclusive right to property that is earned lawfully and this right is not subject to any kind of delay. Transparency in wealth and property is aimed to ‘avoid harm and disputes as much as possible, for which reason pledges and documentation have been prescribed’ (Ibn Ashur 2006: 295). Justice means that ‘wealth and property should not be acquired wrongfully or unjustly’ (Ibn Ashur 2006: 298-99). Justice also implies equality of countervalues in exchange transactions and has distributive dimension in terms of pro-
viding equal access and opportunities to various economic activities and markets to all segments of the population.

Justice is ordained by Quran and the Sunnah as an overriding objective of Islam and permeate all aspects of social and economic relations (Kamali 2002: 108). Kamali (2011) asserts that all Islamic nominate contracts are structured in a way to fulfil the Maqāṣid of contracts. The Maqṣad of justice is the hallmark of Islamic teachings and inherent in all contracts. Justice from an Islamic perspective means ‘establishing the right (Ḥaqq) in its (due) place’ (Smirnov 1996: 343). Two key notions of justice related to transactions can be identified as justice in exchange and distributive justice. As indicated, justice in exchange relates to just or fair prices in markets and distributive justice concerns with equitable distribution of resources and outcomes.

Hassan (2002) identifies the rules and doctrines underlying Islamic contracts that ensure commutative justice. These would include transferring price and object of a sale between parties upon conclusion of a contract and avoiding unfair exploitation. Recognizing that commutative justice requires equality of countervalues, Hassan (2002) asserts that Ribā and gharar violate the principle of equality and as such are prohibited in contracts. Quran prohibits Ribā and argues that it is unjust, destined to destruction and demeans individuals engaged in it (Siddiqi 2004: 36). Siddiqi (2004) also asserts that Ribā is prohibited because it improperly appropriates other people’s property, corrupts society and leads to negative growth. Interest being a form of Ribā is prohibited and is considered as a key instrument of injustice. Gharar can be viewed in terms of ethics of information and information disclosure (Iqbal and Mirakhor 2020). Iqbal and Mirakhor (2020) identify asymmetric information problems of adverse selection and moral hazard as ethical problems of honesty and not disclosing all the relevant information related to a transaction.

While the focus of commutative justice from Islamic perspective is on Ribā and gharar, a key issue of justice in financial transactions relates to just prices. Some scholars distinguish between price and value. While price (Thaman) of an object is determined by the parties in the context of a contract, value (Qīmah) is the price determined in a competitive market which is considered to be just price (Al-Zuhayli 2003: 54). Commutative justice in terms of equality in exchange would require that the price paid reflects the just price. Contracts in which price is fixed higher than market price (value) due to unequal bargaining power and status would be unjust as one party gets undue value or benefits at the cost of other party.

4. Ethical Principles from Maxims: Several legal maxims (Qawāʿid al-Fiqh) provide ethical guidance related to transactions. For example, a key maxim governing economic transactions that states ‘The fundamental requirement in every contract in justice’ (Laldin et.al. 2013: 22). Similarly, a relevant maxim related to transactions is ‘substance over form’ that states that ‘in contracts, greater attention is given to intention and meaning than words and form’ (Laldin et.al. 2013: 46). There are couple of maxims that dealing with distributive justice in contracts in terms of risks and returns. Maxims linking returns to risk taking are ‘benefits goes with liability’ (al-Kharāj bi-al-Ḍamān) and ‘liability accompanies gain’ (al-Ghunm bi-al-Ghurm) (Laldin et.al. 2013: 156 & 161). These maxims assert that the entitlement to profit generated from an asset should be associated with the risks of its ownership or possession (Kahf and Khan 1988, Vogel and Hayes 1998). These principles would prescribe earning return without bearing the risks of investments as this would be considered

17- Iqbal and Mirakhor (2020:5) identify another notion of justice from an Islamic perspective as equality of liberty and opportunity for using natural resources in addition to justice in exchange and distributive justice.
18- Verses on riba in the Quran include 2: 275-80; 3: 130; 4: 160-161; 30: 39.
unjust. Iqbal and Mirakhor (2020) identify benefits of risk-sharing financing as promoting growth, equitable distribution, shared prosperity and making financial systems more stable.

While *Basic Axioms Governing the Economic System* provide the values related to the overall economic system, *Ethical Principles Guiding Human Behaviour* are ethics applicable to individuals acting as economic agents in an economy. The *Teleological Ethics* (*Maslāḥah* and *Maqāṣid*) and *Ethical Principles from Maxims* concern ethics related to financial transactions and also apply to capital formation and calls for an inclusive and just financial system.

### 4.4. Islamic Economics and Finance: An Overview

Islamic economics was formally introduced in the 1970s as an attempt to decolonise the discipline from the existing economic ideologies and systems and provide an alternative to capitalism and socialism. A key theme in the discourse was that while capitalism could generate growth, it created inequalities and socialism resolved the problem of equity but was unable to generate growth. Islamic economics was presented as an alternative that could resolve the problems of growth and equity in a balanced manner. It was argued that using Islamic legal and ethical principles would produce an economic system that will promote growth in an equitable manner.

Islamic economic worldview recognises free will, private property rights and markets for exchanging goods and services. Two broad perspectives exist in literature on Islamic economic system. First, some scholars discuss the concept of Islamic capitalism by arguing that capitalism is compatible with Islam. For example, Rodinson (1973) maintains that the basic Islamic principles such as private ownership, seeking trade and profit, wage-labour employment, etc. are compatible with capitalism. Similarly, Cizakca (2011) asserts that Islamic economic system was capitalistic even before the advent of Western capitalism. He argues that Islam began as capitalist by accepting property rights, free trade, market economy, entrepreneurship, private ownership of the factors of production and viewed profit and wealth accumulation positively. Cizakca along with some other scholars such as Koehler (2014) argue that capitalism in Europe emerged from the know-how and replication of some Islamic institutions of free markets, commerce and trade.

The second perspective adopted by many contemporary Islamic economists present Islamic economic system as distinct from both capitalism and socialism (Ahmad 2003, Chapra 1992, Naqvi 1981). Criticising capitalism of being devoid of ethics and producing inequalities, they argued that an economy guided by Islamic values and principles would produce an economic system that would promote equitable growth. Since a significant part of the capital used in contemporary economies is provided by the financial system, Islamic financial sector would play an important role in an Islamic economic system.

While recognizing that capital plays an important role in contemporary production processes, its impact on inequality depends on its type and features. Islamic economists assert that *Ribā* or interest-based financing is a key instrument that perpetuates inequalities. For example, Siddiqi (2014: 110) asserts that interest-based financing ensures a fixed return to capital providers in a world that is uncertain and risky thereby perpetuating inequalities. Similarly, Chapra (2003, 2014) argues that interest-based financing is unjust and has an adverse impact on growth, inequality and stability. Using an agent-based simulation model, Al Suwailem (2008) shows that interest-based financing leads to wealth inequalities. Marasli (2019), shows empirically that both real interest rates and interest payments exacerbates income inequalities measured by
Gini coefficient and income share going to Top 10% of the population. The conclusion is that interest free financing has the potential to improve the distribution of income (Ali et al. 2013).

The origins of contemporary Islamic finance practice can be found in the partnership-based Mit Ghamar Savings Bank in Lower Egypt in 1963 established under the leadership of Ahmed al-Najjar. The savings/investment houses provided financing on profit-loss sharing basis to small entrepreneurs and poor farmers. However, the Mit Ghamr experiment lasted a few years and the savings bank merged with Nasr Social Bank in 1972. The first Islamic bank was formed in 1975 and became the dominant institution of Islamic finance industry. Islamic banks, however, used the organizational formats of debt-based conventional banks and replicated their products in an attempt to provide Islamic alternatives of interest-based banking products.

The practice of Islamic finance is criticised for adopting conventional forms business models and products (Hefner 2006). Driven by market pressures and seeking to maximise profits, Islamic capital forms mimic their conventional counterparts by using legal stratagems (hila). The replication of conventional products was done by legal and financial engineering by focussing on legal forms and not the substance (Hefner 2006, Mansour et al 2015, Neinhaus 2011). The result is a lack of application of ethical values and principles in Islamic finance practice (Aribi and Arun 2015, Asutay 2012, Dusuki and Mokhtar 2010, Mansour et. al. 2015, Kamla and Rammal 2013, Maali et. al 2006). The use of legal tricks and stratagems (hiyal) can distort or dilute the Maqāṣid of contracts affecting their ethical propriety and justice (ElGamal 2006 & 2008, He-gazy 2007, Kamali 2011: 622, Neinhaus 2011).

5. Legal and Ethical Foundations of Islamic Capital: An Evaluative Framework

The role of capital in a capitalist economy can be summarized as follows. Capital is employed to facilitate the production of goods of services under uncertain environments with anticipation of profit in the future. Growth in an economy occurs when assets are converted into productive capital that can facilitate production of goods and services and generation of income stream. Capital is legally constructed with attributes of priority, durability, universality and convertibility to protect the rights and claims of capital providers (Pistor 2019). In a capitalist economy, the attributes of capital are not guided by ethical values. With freedom of contract parties can determine the nature of the attributes while coding capital. Capital can be coded in ways that serve the interests of capital owners which can lead to inequalities of income.

An Islamic economic system is guided by Islamic legal and ethical principles. Islamic teachings give priority to ethics and justice and restricts absolute freedom of contracts to achieve them. At the transactions level, teleological ethics (Maṣlaḥah and Maqāṣid) and ethical principles from maxims are relevant. Thus, the ethical features of Islamic capital can be introduced by introducing Maqāṣid and the relevant supporting maxims. As indicated, Ibn Ashur (2006: 285) identifies the Maqāṣid specific to economic transactions and activities as marketability (circulation), transparency, preservation, durability and equity or justice. Interestingly, Maqāṣid of circulation, preservation and persistence are related to Pistor’s convertibility, durability and universality and attributes of capital. However, the additional Maqāṣid of transparency and justice are not covered by the capital attributes. Thus, Islamic ethical capital will have the four attributes of capital common to capital in capitalist economies and also include additional Maqāṣid features of transparency and justice.

19- While mal is a common word for property or wealth (Ibn Ashur 2006: 279), the terms used for asset and capital would be asl and ras al mal.
Transparency relates to informational ethics and relates to mitigating asymmetric information problems in contracting such as adverse selection and moral hazard problems. From an Islamic perspective, transparency also relates to informational ethics and implies accuracy in measurements and weights and mitigating gharar in transactions (Kamali 2011). Other than unclear terms and conditions, gharar in financial contracting would also include unclear or unknown risk-return features of different capital types. Lack of transparency would make the unjust outcomes and also lead to disputes. During contemporary times complexity of products adds to the opaqueness of the capital structures. Thus, the terms and conditions and the risk-return features of Islamic debt, equity and asset-based capital should be transparent.

Justice is a fundamental feature of an Islamic economic system. Two key institutions that have direct relevance to distributive justice in an Islamic economy are Zakāt and waqf (religious endowments). However, in case of capital, justice can be viewed in two ways. First, commutative justice would mean equality in exchange that requires sale takes place at just price. In fact, the legal prohibitions of Ribā and gharar are introduced to achieve the Maqṣad of justice. Thus, in sale and Ijārah contracts the price of goods or usufruct should be reflect market prices. Second, the distributive justice would require fulfilling the maxims linking returns to risk in all transactions. The ethical principle reflected in the maxims of ‘returns linked to risks’ underlies all Islamic financial contracts and cannot be violated. Delinking returns from risks of ownership and transferring risks of ownership to other parties distort the distribution of risks and returns and would be considered unjust.

It should be noted that Islamic debt capital has some constraints in terms of the durability and liquidity attributes. The Islamic legal and ethical principles impose restrictions on adjusting the profit rate due to changes in benchmark rates, selling debt and adding further profit for extension of time and rolling over financing facility beyond the contract period. These restrictions make Islamic debt weak in terms of both attributes of capital and Maqṣad of circulation. Islamic financial institutions, however, try to resolve these limitations by legal engineering and using ruses (hila) by focussing on form, rather than substance of contracts.

5.1. Islamic Capital Types, Growth and Inequalities

Islamic capital is usually classified as equity, asset-based and debt. Equity-based products generate profits that is linked to business risk and as such is variable. Asset-based capital generates rent which can be either fixed or tied to a benchmark rate. Debt instruments are sale based and generate profit from trading and the profit rate is fixed when signing the contract and cannot be changed. Returns on Tawarruq based debt financing are fictitious trading profits since the sale of commodities is not for use by clients but to get cash.

To understand the impact of capital on growth and equality, Islamic capital is classified into four types: productive, quasi-productive, quasi-fictitious and fictitious. Productive capital is equity-based capital (such as Muḍārabah and Mushārakah) used in production that gets return as business profit. Quasi-productive capital and its return can take different forms: asset-based capital (Ijārah) used in the business earning rent, debt created by selling inputs (Murābahah) used in production receiving a fixed trading profit and debt created by Tawarruq getting fictitious trading profits. Quasi-fictitious capital is equity or asset-based financing (diminishing Mushārakah or Ijārah wa-Iqtinā`) provided to the household sector. Note that equity-based financing to the household sector is not productive venture generating profits, but represents joint ownership of an underlying asset that generates rent. Since the household sector is not engaged in production, the equity and asset-based capital is categorised as quasi-fictitious capital as it is used to acquire durable assets that generate implicit rent. Fictitious capital constitutes
debt-based capital provided to the household and financial sectors that generate trading profit for sale-based modes such as Murābahah and fictitious trading profit for Tawarruq.

Table 1: Capital Types and Features

<table>
<thead>
<tr>
<th>Capital Type</th>
<th>Contract</th>
<th>Sector</th>
<th>Sources of Income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Productive</strong></td>
<td>Equity</td>
<td>Business</td>
<td>Business Profit</td>
</tr>
<tr>
<td><strong>Quasi-productive</strong></td>
<td>Asset based</td>
<td>Business</td>
<td>Rent</td>
</tr>
<tr>
<td></td>
<td>Debt</td>
<td></td>
<td>Trading Profit</td>
</tr>
<tr>
<td></td>
<td>Debt (Tawarruq)</td>
<td></td>
<td>Fictitious trading profit</td>
</tr>
<tr>
<td><strong>Quasi-fictitious</strong></td>
<td>Asset/Equity</td>
<td>Household</td>
<td>Rent</td>
</tr>
<tr>
<td><strong>Fictitious</strong></td>
<td>Debt</td>
<td>Household</td>
<td>Trading profit</td>
</tr>
<tr>
<td></td>
<td>Debt (Tawarruq)</td>
<td>Financial</td>
<td>Fictitious trading profit</td>
</tr>
</tbody>
</table>

Given the different types of capital, the following propositions related to the impact of capital on growth and equality are developed.

**Capital and Growth**

*PG1: Growth depends on distribution of productive and fictitious capital in an economy*

While productive capital used in the business sector increases production and enhances growth, fictitious financing to the household and financial sectors do not directly contribute to growth. Specifically, productive capital and quasi-productive capital used in businesses to produce goods and services has a positive impact on growth. Quasi-fictitious and fictitious capital provided to household and financial sectors through asset/equity-based and debt financing does not contribute directly to production process and has no impact on economic growth. Thus, the growth rate will be reduced when a larger percentage of the capital goes to fictitious capital rather than productive capital. This is likely to happen with the financialization of economies.

*PG2: Growth is below potential due to non-availability of productive capital*

Another way in which growth can be below the potential is the lack of availability of productive capital for certain types of firms due to financial exclusion. The segments affected by financial exclusion include the MSEs who do not have access to capital from traditional banks and financial institutions and also entrepreneurs who lack risk-capital to start new innovative enterprises that drive growth in economies by producing novel goods and services.

**Capital and Equality**

*PE1: Equality depends on the distribution of value within a firm*

Distributive justice within a firm depends on how the value created in production is distributed among key stakeholders (labour, financial sector and equity holders). The typical Marxian view of creating inequalities is that a smaller share of the surplus value goes to labour and a larger share going to capital providers. From a commutative justice point of view, fairer wages paid
to workers would improve the distribution of income.

**PE2: Availability of productive capital to MSEs determines income inequalities**

A supply side distributive justice issue relates to distribution of capital. Since capital plays an important role in production processes, lack of capital for MSEs due to financial exclusion is another way in which the financial sector can increase inequalities. Some Islamic economists have highlighted that the current financial system perpetuates inequalities by pooling resources from all segments of the population including the poor, and financing only the relatively well-off segments (Chapra 2014: vii, Naqvi 1994: 28). Since debt financing is structured in a way that people who have valuable marketable assets that can serve as collateral get financing, only the relatively richer sections of the population are qualified for financing while the poor are excluded. This essentially translates to resources flowing from the poor to the rich (Naqvi 1994).

**PE3: Inequality increases due to fictitious and debt capital**

Even though debt is permissible, Islamic ethics on debt calls for keeping personal debt to a minimum level and using it only when it is necessary. At the firm level, excessive debt can increase fragility and increase the probability of default in case of negative shocks. Furthermore, returns on debt-based capital is not linked to the performance of the economy. The debt has to be paid off irrespective of the profitability of the firms or incomes of households. In some cases of negative shock that decreases the income levels, firms or households may not be able to repay back their dues. The financial institutions would recover the debt liquidating the collateral. While the financial institutions are able to recover their dues, firms or households face loss of assets and at times would become bankrupt. Thus, debt-based capital contributes inequalities with each negative shock by transferring resources from the debtors to the capital providers.

**PE4: Inequality results from commutative injustice related to price of capital**

Within the capital used in the production process, commutative justice in terms of prices of capital provided by financial institutions will determine the distribution of value among equity and non-equity (debt and asset-based) capital. In particular, the cost of financing for MSEs can be exorbitant which leads to unjust transfer of value from the businesses to the capital providers. Poverty premium in terms of higher rental rate of external asset/equity-based financing or profit-rate on debt-based financing provided by financial institutions imply extracting a relatively higher percentage of surplus from businesses by the financial sector. Similarly, for households a relatively higher rent/price charged for fictitious capital implies larger expropriation of funds from them to the financial institutions.

**PE5: Distributive justice related to risk-return distribution is important determinant of equality**

As indicated, distributive justice also relates to the distribution of returns and risks. Maxims of returns linked to risks assure that risks be borne by owners of capital. If asset/equity-based financing are implemented according to Sharīʿah principles, then distributive justice requires that in case of default the risks (losses) will be shared according to the shares of ownership. However, this may not be the case if these contracts are engineered to have debt like features in substance by using *hila*. Then as in the case of PE3, there will be adverse impact on the distribution of risks and income of businesses and households during downturns. Using ruses to manipulate the features of Islamic capital in terms of risk-return maxims have adverse impact on income inequalities.

**PE6: Equality depends on the distribution of ownership of productive capital**

Another feature of financial exclusion that distorts the distribution of capital and income is the
lack of investment opportunities for the low- and middle-income groups to take part in productive capital. As Piketty (2014) asserts, the return of capital is higher than income growth rates which tilts income distribution towards capital owners over time leading to increased inequalities. Thus, one way in which equality can be enhanced to have wider distribution of productive capital. Increasing investment opportunities for the relatively lower income groups would enable them to increase their capital ownership and get a share of higher returns on capital.

6. Islamic Capital: Status and Implications for Growth and Inequality

While respecting individual property rights and being a market-based system would promote growth, Islamic economists assert that implementing the broader goals of Maqāṣid al-Sharīʿah in an Islamic economy would resolve the problems of distribution of income and wealth. However, the approach of Islamic finance to replicate conventional finance reflects the dominance of the capitalistic paradigm not only in terms of the banking model and products used, but also the use of positive laws and ignoring ethics. At a broader level, taking a legalistic perspective would imply that an Islamic economy would be similar to a conventional economy, with additional features of implementing Zakāt and Islamic inheritance laws on the one hand, and excluding certain sectors such as pork and gambling and prohibiting of Ribā and gharar in exchanges on the other hand.

A legalistic approach devoid of ethics, however, is likely to fail to realize the goals of an Islamic economy that promotes equitable growth. Inequalities of income and wealth are essentially issues of justice which are related the ethical foundations of Islamic finance. While certain forms of capital can be Sharīʿah compliant from a legal perspective, the ethical issues determine the ultimate outcomes of inequalities in economies. For example, a car financed by using Murābaḥah at exorbitant profit rate is Sharīʿah compliant from a legal viewpoint, but would violate the principles of commutative justice. The result will be that the financial institution will appropriate more value from the customer than the case in which financing is provided at the market price. Thus, inequalities can result for not applying ethical values even when the contracts are legally Sharīʿah compliant.

In this section, some of the features of Islamic capital used in practice and its implications on growth and inequality are examined in light of the framework developed in the previous section.

6.1. Productive and Fictitious Capital

The relevant propositions related to productive and fictitious capital are PG1 (Growth depends on distribution of productive and fictitious capital in an economy) and PE3 (Inequality increases due to fictitious and debt capital). While productive capital support production in the business sector and contributes to growth, fictitious capital does not contribute to growth as the funding goes to non-productive household and financial sectors. The size of the latter type of capital gives an indication of financialization of the economy contributed by Islamic financial institutions.

Chart 2 shows the average asset composition of Islamic banks in ten sample countries. The bulk of the assets are financing (65.1%) and investments in sukuk and other Islamic securities (10.7%). The interbank financing is small with 3% of the assets. Chart 3 shows the breakdown of financing by Islamic banks to key economic sectors and activities. Almost one

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20- The countries included in the sample include Bahrain, Bangladesh, Indonesia, Jordan, Kuwait, Malaysia, Oman, Saudi Arabia, Sudan and United Arab Emirates. The countries were chosen based on the data availability of relevant variables and represent markets with significant presence of Islamic finance.
third (31.5%) of the financing goes to households, followed by 12.9% going for real estate financing. Financing of productive sector includes 10.3% for manufacturing and 5% for construction. While 9.2% of the financing goes to trade financing (wholesale and retail), the financing of other financial sectors is 3.9%.

![Chart 2: Asset Composition of Islamic Banks (Q1 2022)](chart2)

Source: IFSB Prudential and Structural Islamic Financial Indicators (PSIFIs)
Note: The countries included in the sample include Bahrain, Bangladesh, Indonesia, Jordan, Kuwait, Malaysia, Oman, Pakistan, Saudi Arabia, Sudan and United Arab Emirates.

![Chart 3: Average Percentage Financing by Key Sectors and Activities by Islamic Banks (Q1 2022)](chart3)

Source: IFSB Prudential and Structural Islamic Financial Indicators (PSIFIs)
Note: The countries included in the sample include Bahrain, Bangladesh, Indonesia, Jordan, Malaysia, Oman, Saudi Arabia, Sudan and United Arab Emirates.

21- Financing the household sector for some banks is much higher than the figures in Chart 3 indicates. For example for Bank Islam Malaysia Berhad the total financing going to the consumers was 75.1%, followed by 12.1% going to the corporate, 9.2% going to commercial and 3.7% going to SMEs (BIMB 2021: 79)
The data on assets and financing of Islamic banks in sample countries shows that their contribution to productive capital is relatively small with 10.3% going to manufacturing sector and 5% going to construction. The implication is that the bulk of Islamic bank financing constitutes fictitious capital that is unproductive. Thus, the contribution of Islamic financial sector towards growth is expected to be minimal (PG1).

While the financialization in terms of financing the financial sector is relatively small (3% interbank financing and 3.9% financing of other financial institutions), Islamic banks are contributing to the financialization of the household sector. Other than 31.5% of total financing going to the households, most of the financing of real estate (12.9%) is also used by the households to finance homes. As indicated, financing the household sector implies extracting returns from the households without adding to production which can exacerbate the income distribution in downturns (PE3).

6.2. Islamic Capital Types and Risk Return Distribution

The relevant propositions related to risk return distribution include PE3 (Inequality increases due to fictitious and debt capital) and PE5 (Distributive justice related to risk-return distribution is important determinant of equality). Capital in the form of debt has adverse distributive issues as it protects capital providers who do not share the losses during downturns (PE3). While the business sector is likely to incur losses during recessions and crisis periods, the debt liabilities remain the same. This disparity in sharing risks can add to income and wealth inequalities. Islamic financial institutions use legal stratagems to replicate the substance of interest-based loans to earn income beyond the contract period when financing is rolled over. One way this is done is to use a new Tawarruq on maturing debt and add extra profit reflecting additional returns for the extended time.22 However, this practice of refinancing an existing debt with a higher return is a replication of Ribā al-Jāhiliyyah which is prohibited as it causes injustice. Due to this reason, using Tawarruq to refinance existing nonperforming debt is prohibited by AAOIFI Standard 59 which again makes Islamic debt weaker form of capital.

Chart 4 shows that 73% of the financing by Islamic banks is debt-based with 58% being Murābahah, 10% Tawarruq, 4% salam and 1% Istiṣnā’.23 A significant part of the debt is likely owed by the household sector (as shown in Chart 3). As indicated, Islamic ethics discourages taking debt unless it is necessary (PE3). Financialisation of household transfers resources from households to Islamic banks in terms of additional profit added to price of asset or commodity sold. Since debt of households do not contribute to production and growth directly, the transfer adds to concentration of income and wealth in the financial sector providing the fictitious capital (PG1 and PE3).

Other than the large size of debt, ethical issues related to the violations of legal maxims of ‘substance over form’ and ‘returns linked to risks’ also arise in structuring of Islamic capital (PE5). Ruses are use to violate these maxims and risks are not borne by capital pro-

22- For a discussion, see https://www.dentons.com/en/insights/articles/2021/may/2/murabaha-financings-post-aaoifi-standard-59

23- It should be noted that the distinction between Murābahah and tawarruq is not clear in reporting modes of financing in many jurisdictions. Even if the bulk of the financing is done by using tawarruq, it is reported as Murābahah. The use of tawarruq in some individual Islamic banks is very high. For example, 90.3% of financing of Bank Islam Malaysia in 2021 was tawarruq based (BIMB 2021: 78).
providers by transferring them to others. An example of using ruses is organised Tawarruq which is the dominant mode of financing in many jurisdictions. While it is structured through sales of commodities, the substance of the outcome is similar to an interest-based loan. Thus, organised Tawarruq has all the harmful and unjust effects of Ribā based transactions. As indicated, the stratagems to protect capital holders’ fixed returns goes beyond Islamic debt. Legal engineering is also used to protect the interests of the capital providers even in assets/equity modes of financing in violation of the maxims linking returns to risks.

For example, in structuring diminishing Mushārakah product the maxim of returns related to risks is violated. Diminishing Mushārakah (DM) stipulates that the asset is owned by the client and bank according to their capital contributions. The monthly instalments paid by client cover the rent on the banks share and also purchase of some of the bank’s share. Once all the shares of the bank are transferred to client by the end of the contract period, the ownership is transferred to the client. If, however, the client defaults during the contract period, then DM stipulates that the asset should be sold and the proceeds distributed between the bank and client at a pro rata basis. The maxim of returns linked to risks requires that if the asset price is lower than the initial price then the losses should be shared by the parties according to their shares in the asset. In most of the cases, however, the bank does not share losses. DM product has a purchase undertaking that stipulates that in case of default the client would purchase all the remaining shares of the bank at a price that covers the amount due to the bank. In case of a default the purchase undertaking becomes effective and the equity of the bank in the asset is effectively converted into debt that ensures that no losses are borne by the bank. When the house is sold, the client pays off the debt of the bank and absorbs all the losses arising from a lower price of asset. Thus, violation of the maxim of returns linked to risks exacerbates the income distribution in favour of the capital providers.

The use of stratagems to replicate the substance of interest-based loans is likely to have the same, if not more, detrimental impact on distributive justice and income distribution as in the case of conventional finance. This is affirmed by Ibn Taymiyyah who asserted that the effective cause of Ribā is found in Tawarruq and concludes that Tawarruq is worse than financing with Ribā as the former entails more costs than the latter (Al Zuhayli 2009: 9, Alhadid 2009:4). As discussed in the next section, in most cases stratagems can lead to higher costs of Islamic finance which are transferred to clients and can further worsen the distribution of income and wealth (PE4).

Chart 4: Modes of Financing of Islamic Banks (Q1 2022)
6.3. Commutative Justice and Pricing of Capital

The proposition related to commutative justice is PE4 (Inequality results from commutative injustice related to price of capital). A key feature of commutative justice relates to just price which is the competitive market price. A price higher than the market price can be exploitative and transfer funds from the party paying the price to the receiver unjustly. Muslims clients often are willing to pay higher prices to get halal products to avoid violating religious rules. In a survey of 5071 Muslim adults from five countries, Demirguc-Kunt et al (2013) find that 45% of the respondents would prefer Islamic financial products even if they have to pay a higher price. While many Muslims are willing to a premium to get halal products, this has implications for income inequalities if similar products are sold at lower prices in the market. However, the issue of piety premium becomes a factor for some people in not using Islamic finance when they feel that they are paying higher prices for products that are mimicking conventional products. This is revealed in a survey of people who do not use Islamic finance as they thought that while there is no difference in Islamic and conventional financial products, they felt that the former is more expensive than the latter (Jaffar and Musab 2014).

In most jurisdictions, Islamic banking products seem to be more expensive than their conventional counterparts. Azmat et al. (2020) find that the now defunct Islamic Interbank Benchmark Rate (IIBR) was consistently higher than the London Interbank Offer Rate (LIBOR) implying piety or religious premium. However, the higher prices of Islamic financial products cannot be explained by IIBR since not all Islamic banks used it. Islamic banks charge higher prices due to other operational reasons that include complex legal documents that requires Shari'ah approval and also small size of Islamic banks (Amin 2017). Pricing differences can be ascertained by net interest margins (NIM) which is the ‘difference between interest income and interest expenses as a proportion of total earning asset’ (Azmat et al. 2020: 284). Azmat et al. (2020) find that Islamic banks charge a piety premium with the average NIM for Islamic banks being 3% compared to 1% for conventional banks. However, the piety premium decreases with competition.

The implications of a relatively higher price for Islamic financial products relative to a conventional product on the distribution of income can be seen in a hypothetical example of mortgage financing. If a Muslim client takes mortgage financing for a house worth $300,000 at 4% profit rate, she has to pay a total of $515,880 for it over 30 years. If the conventional banks provide the same loan at 3%, she will end up paying $455,400 for the same period. In other words, a Muslim client using an Islamic bank will pay approximately $60,500 more for the house compared to one who takes loan at 3%. This large excessive transfer implies the Muslim client will be relatively worse off than the one taking a loan from a conventional bank. Muslims have to pay a piety or religious premium and transfer larger amounts of money to Islamic financial institutions compared to their conventional counterparts to the benefit of shareholders of Islamic banks which adversely affects the income inequalities.

Another element of pricing of capital that further increases the disparity of income and wealth relates to ‘poverty premium’ which makes the terms and conditions of financing for micro-enterprises and poorer households more expensive that their richer counterparts. This implies relatively higher levels of value or income is appropriated from the former group by capital providers adversely impacting income distribution (PE4). Though no information on the price
structures of Islamic microfinance is available, poverty premium is likely to exist in Islamic finance too as generally its pricing is higher than conventional finance.

6.4. Financial Exclusion

The propositions relevant for financial exclusion are PG2 (Growth is below potential due to non-availability of productive capital), PE2 (Availability of productive capital to MSEs determines income inequalities) and PE6 (Equality depends on the distribution of ownership of productive capital). While in general, financial exclusion is involuntary as financial institutions do not provide capital to the poor and MSEs due to economic and social reasons, some Muslims do not engage with the financial sector voluntarily due to religious reasons. Voluntary financial exclusion would mean that a larger percentage of Muslims would not avail conventional financial services even if it is available. For example, in a survey of 66,484 respondents in 64 countries Demerguc-Kunt et al. (2013) find that 24% of Muslims and 44% of non-Muslims have an account with a formal financial institution. Six percent of those who do not have accounts (both Muslims and non-Muslims) indicate religion as being a reason for not having an account. Demirguc-Kunt et al. (2013) also report that out of 5071 Muslim adults from five countries only 2% of them use Sharīʿah compliant products. Thus, increasing financial inclusion in Muslim countries would need expanding the provision of Sharīʿah compliant capital.

Financial exclusion deprives micro and small business from capital that is necessary for production. While larger firms can increase their capital and production levels over time, MSEs cannot do so due to lack of financing. In particular, Islamic capital for many MSEs is not available which adversely impacts their production and growth (PG2). Though recent data on Islamic microfinance is not available, a survey carried out in 2008 shows that only 0.5% of the total microfinance was Islamic (Karim et al. 2008). Similarly, financing small and medium enterprises (SMEs) as a percentage of total private sector lending for Islamic banks was 2.4% compared to around 12% for conventional banks (IFC 2014). Thus, lack of Sharīʿah compliant microfinance for MSEs would lead to further disparity in the production and income levels. Availability of productive capital for larger firms and not for MSEs contributes to the persistence of poverty and increases the income and wealth gaps (PE2).

Financial exclusion also affects inequalities due to non-availability of Sharīʿah compliant investment products that enable low- and middle-income households to own capital (PE6). As confirmed by Piketty (2014), the return on capital is higher than the growth of income implying that capital owners get a higher share of the output growth compared to non-capital holders. Concentration of capital ownership in a few hands, thus, leads to concentration of wealth over time. Ownership of capital can be expanded across income groups if robust capital markets exist and opportunities for investments are available to majority of the people. However, capital markets in most Muslims countries are relatively small and the size of global Islamic funds in 2021 was US$ 154.6 billion only (constituting 5.1% of the total Islamic financial assets (IFSB 2022).

Owning capital and assets that can earn a higher return is even more important for Muslims as other than inflation that dilutes savings, Muslims have to pay 2.5% Zakāt on their wealth. Without opportunities of investment products that can generate returns than cover the inflation and Zakāt payments, the value of wealth of the low- and middle-income households will decrease compared to high-income households who can invest in high earning capital products.

6.5. Islamic Capital, Growth and Inequalities: Concluding Remarks

The above discussions indicate that the contribution of the Islamic financial sector to provide
productive capital is relatively small and the bulk of financing by Islamic banks go to non-productive household sector in form of fictitious capital. Empirical evidence of contribution of Islamic finance to growth is mixed. While some papers find no relationship between Islamic banking/finance with GDP or GDP growth rates, others find positive correlation between them. However, the direction of causality is not evident (Johnson 2013, Abduh and Omar 2012, Furqani and Mulyany 2009).

Bulk of Islamic financing is in the form of debt capital which is costlier than conventional loans. Higher prices of Islamic financial products raise questions of lack of commutative justice as more funds are expropriated by financial institutions from their clients compared to their conventional counterparts. Furthermore, debt capital increases inequalities with each episode of negative shocks collateral is sold to recover the debt obligations for firms and households unable to pay their dues. Even the asset and equity-based capital are structured in ways that make them similar to debt-based financing in substance thereby diluting their risk-return distribution features. Given the lack of consideration of ethics in terms of commutative and distributive justice, the result of using Islamic capital in its current forms is likely to increase inequalities. This is confirmed in a study done by Izhar and Munkin (2021) who empirically find that Islamic finance increases the income inequalities.

7. The Way Forward

While the proponents of Islamic economics envisaged an economy applying both legal and ethical values, the approach taken by Islamic finance has been to focus on legal compliance. The practice of Islamic finance is criticised for replicating conventional finance by using stratagems that focus on forms, rather than substance. At a system level this approach is akin to the capitalist framework that focusses on application of positive law devoid of ethics. An Islamic economy based on the narrow legalistic perspectives would be a prohibition driven economy (exclude certain forbidden products and activities such as pork, alcoholic beverages and gambling and prohibit Ribā and gharar in exchanges) and implement Zakāt and Islamic inheritance laws. As shown above, the legalistic practice of Islamic finance that ignores the ethical norms of Sharīʿah is likely to perpetuate the problems of inequalities that exist in capitalist system.

Resolving the disparity of income and wealth in an Islamic economic system would require introducing ethics of Maqāṣid al-Sharīʿah and legal maxims in economic activities and transactions. In particular, transparency and justice must be embedded in capital formation along with the other legal attributes of capital. The implementation of Islamic ethical capital would require discussing its formation and types, identifying the appropriate supporting institutions and personal characteristics (homo islamicus). The specific recommendations in which the ethical features of Islamic capital can be enhanced to promote equitable growth are presented under these three broad categories below.

7.1. Capital Formation and Types

RC1: Establish Supporting Legal Ecosystem to Enable Capitalisation of Assets

The legal construction of capital implies that it cannot be formed in economies lacking the appropriate laws, legal institutions and frameworks. As argued by De Soto (2001a, 2001b), legal systems of many developing countries do not support capitalisation of the existing assets which keeps the poorer households unproductive and impoverished. Development of appropriate property laws and legal institutions can enable conversion of these assets into capital which can promote growth. The implication is that poverty can be mitigated by establishing appropriate laws and institutions that can help confer the legal attributes of capital to dormant
assets. The idea of converting assets into productive capital is consistent with Islamic teachings as can be seen in the hadith presented in Box 2.

The framing of Islamic capital in contemporary economies, however, raises a couple of issues. First, in many jurisdictions the legal formation of Islamic capital is being done at the level of Islamic financial institutions with the guidance from Sharīʿah Supervisory Boards (SSBs). The emphasis on formal legal compliance of Islamic financial contracts approved by the SSBs at the organizational level focus on form and are devoid of ethics in many cases. Propositions PE4 and PE5 imply that ignoring commutative and distributive justice can lead to further inequalities even if the contracts are Sharīʿah compliant. Thus, there is a need to introduce ethical values in contracts to decrease inequalities. One way in which this can be done is to have national level Sharīʿah board that considers ethical and Maqāṣid perspectives in its decision making.

Second, the laws and legal system of a country must recognise and support attributes of Islamic capital used in the economy. While Islamic financial contracts are approved at the bank level, the national laws and legal system determine their status in case of disputes. There is a need to have an enabling legal framework that support the attributes of Islamic capital. Furthermore, the national level laws, regulations and guidelines for Islamic finance should incorporate both ethical and legal attributes of capital to produce a just and equitable financial and economic system. A good example of the latter is the Value-based Intermediation framework introduced by Bank Negara Malaysia (BNM 2018).

RC2: Enhance Capital Formation in MSEs and Entrepreneurial Firms

Financial exclusion adversely impacts growth and inequalities as it deters MSEs to use capital in productive activities (PG2 and PE2). Financial exclusion increases inequalities as the larger firms can get the necessary capital to produce optimal levels of outputs but MSEs cannot benefit from capital that can enhance production and growth. Given the Islamic social and ethical values of Maqāṣid, there is a need to fulfil the basic financial needs of all firms, including the MSEs. Providing productive capital to MSEs and entrepreneurial firms can enhance both growth and improve income and wealth distribution. Beyond the systemic reasons that exclude the poorer sections of the population from financial services, many Muslims voluntarily exclude themselves from interest-based finance due to religious convictions. Thus, a key issue to promote growth would be to provide Sharīʿah compliant financing to MSEs. There is also need to provide risk-capital to new enterprising entrepreneurial firms to promote growth.
Box 2: Hadith on Converting Assets to Capital

Narrated from Anas bin Malik that: A man from among the Ansar came to the Prophet (PBUH) and begged from him. He said, “Do you have anything in your house?” He said: “Yes, a blanket, part of which we cover ourselves with and part we spread beneath us, and a bowl from which we drink water.” He said: “Give them to me.” So he brought them to him, and the Messenger of Allah (PBUH) took them in his hand and said, “Who will by these two things?” A man said: “I will by them for one Dirham.” He said: “Who will offer more than a Dirham?” two or three times. A man said: “I will buy them for two Dirham.” So he gave them to him and took the two Dirham, which he gave to the Ansari and said: “Buy food with one of them and give it to your family, and buy an ax with the other and bring it to me.” So he did that, and the Messenger of Allah (PBUH) took it and fixed a handle to it, and said: “Go and gather firewood, and I do not want to see you for fifteen days.” So he went and gathered firewood and sold it, then he came back, and he had earned ten Dirham.

The Prophet (PBUH) said: “Buy food with some of it and clothes with some.” Then he said: “This is better for you than coming with begging (appearing) as a spot on your face on the Day of Resurrection. Begging is only appropriate for one who is extremely poor or who is in severe debt, or one who must pay painful blood money.”


RC3: Introduce Commutative Justice in Contracts

Inequalities are caused at the micro-level through unjust contracts (PE4 and PE5). Specifically, if the prices of financial products are higher than market prices, then the financial sector expropriates more value from the firms and households. There is a need to have fair prices for Islamic capital in general and MSEs in particular. The current model of risk-based pricing makes the pricing of financial products unfavourable for the MSEs and poorer households. Since the MSEs and poorer households are considered to have higher risks, they pay a ‘poverty premium’ when using financial services which can be exploitative and worsen income distribution. This problem requires a rethinking of ways in which financial services can be provided. One option may be to introduce blended finance that provides subsidies to the poorer sections from Islamic social finance (see Recommendation RI3 below).

Furthermore, customers using Islamic finance also pay a ‘piety premium’ in terms of higher prices relative to conventional finance. There is a need to come up with efficient business models to reduce the piety premium. One way to do this is to use digital technology to reduce costs of operations and delivery of products (see Recommendation RI2 below).

RC4: Introduce Distributive Justice in Contracts

Another way in which Islamic capital can contribute to inequality of income is by diluting the distributive justice related to risk-return features of contracts. Key maxims related to distributive justice assert that returns are linked to risks of ownership of capital. However, the practice devoid of ethics uses legal engineering to make the risk-return features similar to debt-based contracts. This practice transforms assets and equity-based capital to have features of debt. The
result is that capital owners are favoured during times of distress and have detrimental impacts on income and wealth of the finance. Thus, to reduce inequalities would require implementing the maxims linking returns to risks in different Islamic financial products. The practice of not employing the distributive ethics in contracts that are approved by SSBs at the financial institutions imply that there may be a need for national level Sharīʿah boards to ensure that risk-return payoffs are fair.

**RC5: Increase Share of Productive Capital and Decrease Financialization**

The proportion of Islamic capital going to productive business sector is small implying that the contribution of Islamic finance to growth is modest. In contrast, a large part of financing of Islamic banks goes to the financialization of the household which is not directly related to production. As shown in Chart 3, only 10.3% of the financing from Islamic banks goes to the manufacturing sector and 31.5% is going to the household sector. Increasing the role and impact of Islamic finance to enhance economic growth require providing more productive capital to the businesses (PG1). As indicated above in RC3, there is a need to increase productive capital for the MSEs sector through initiatives of financial inclusion.

High level of household debt is not only contrary to Islamic ethics, but also a mechanism of expropriating resources from households which can create further inequalities. Given the ethics of personal debt discussed above, financing of the household sector should be limited to financing durable assets such as houses and automobiles and not consumption items such as financing food or holidays.

**RC6: Increase Proportion of Nondebt Capital**

The negative impact of conventional debt-based financing on income inequalities is also relevant for Islamic debt. As indicated, debt financing to businesses constitutes quasi-productive capital as interest payments are not directly linked to the business performance and grow independent of the economy. Thus, debt repayments must be made even in economic downturns which can add to distress in businesses and may require rolling over and rescheduling the debt. Furthermore, attributes of Islamic debt are weak in terms of durability when the borrower defaults and also lack the convertibility or liquidity attribute of capital. In particular, rescheduling debt for additional returns cannot be done for Islamic capital as it constitutes Ribā. However, Islamic banks reschedule debt with additional returns by using controversial products such as Tawarruq (which is contrary to AAOIFI Standard 59). The practice of rolling over debt for a higher price would constitute Ribā which is unjust. The above features not only make Islamic debt an inferior form of capital, but also contribute to inequalities in economies.

Thus, to mitigate the adverse impact on income inequalities and have a more equitable and just economy, there is a need to use Islamic nondebt capital that comply with both the legal principles and ethical values of Sharīʿah. This would imply that an Islamic economy should use a larger share of equity and asset-based capital (productive and quasi-productive capital for the business sector and quasi-fictitious capital for the household sector) that are transparent and fulfils the maxims linking returns to risks (RC4).

**RC7: Increase the distribution of productive capital and increase the number of capital owners**

A key source of inequality is the concentration of wealth among few in the society (PE2 and PE6). The *Maqāṣid* perspective calls for an inclusive financial system that provides opportunities for all in a society including the poorer sections of the population. Since equity capital gives a higher return than debt capital, there is a need to increase the ownership of the former among more diverse segments of the population. This can be done in a few ways. First, people
from low and middle-income households should have the opportunity to invest productive equity capital. Currently most of them do not have these opportunities and place their savings in low return bank deposits that pay returns that are often lower than inflation rate. Another option to reduce inequality would be to have employees own a part of the ownership of equity capital. This will not only create incentives for employees to work hard for the success of the firms but will also counter the argument of exploitation of labour and contribute to equality. Finally, Zakāt can be used as an instrument of distribution of capital (see RI4 below).

7.2. Institutional Changes and Developments

RI1: Islamic Finance Beyond Islamic Banking

One of the reasons Islamic banks are not able to increase productive non-debt-based capital is because the sector has adopted the conventional banking model and are regulated accordingly. The organisational model of banks and the regulatory remiges make it difficult for Islamic banks to finance MSEs and provide productive equity and assets-based capital. There is a need to develop nonbank financial institutions (NBFIs) that can provide Islamic nondebt capital to different segments of the society. The ethical and social goals of Sharīʿah can be best realised by NBFIs than Islamic banks. For example, venture capital and private equity firms can provide nondebt entrepreneurial finance, leasing companies can provide asset-based financing and specialised microfinance institutions can provide productive capital to MSEs. Looking forward, the growth of Islamic finance should come from increasing different types of NBFIs that can provide products and services reflecting Islamic values and principles and also contribute to overall growth in an equitable manner.

RI2: Expand Fintechs

A key form of NBFIs that can promote equitable growth is fintechs. Fintechs use digital and informational capital in innovative ways to provide different types of financial services to all segments of the population more efficiently and effectively. For example, key constraints that traditional financial institutions face in providing microfinance relates to economics of finance which include high transactions costs of delivering small amounts of financing, acute asymmetric information problems and high risks of prospective clients. Using digital technologies including gathering information from different sources (big data) and using artificial intelligence to process it allow fintechs to address some issues related to asymmetric information and risk assessments. Furthermore, the services can be delivered to clients at much lower costs through digital channels.

Capital can also be raised through crowd-funding platforms for different productive ventures. Another area in which fintechs can enhance participation in capital formation and reduce inequalities is to increase opportunities for investments on the supply side. This can be done not only by investing in crowd funding platforms, but also having robo-advisors and investment platforms that can be used by ordinary people to invest in productive high-income generating capital (RC7). Moving forward, there is a need to provide an enabling ecosystem and Islamic risk capital that can support the growth of Islamic fintechs.

RI3: Increase the Number of Islamic Social Capital Institutions

While market-based profit seeking financing models can promote growth, their contribution to equality may be insignificant. Capital seeking profit would either not be employed in MSEs sector or if invested would engage in risk-based pricing whereby the poorer sections of the population end up paying exorbitant prices for capital. The poverty premium increases ap-
propriation of surplus from MSEs and poor households and perpetuates inequalities. There is, thus, a need for social capital beyond profit-seeking capital to reduce inequalities. In this regard, operational models of charity (Ṣadaqah) can be introduced to provide social capital. One option is to provide social capital to the poorer sections of the population as Qard Ḥasan (interest free loans). The experience of Akhuwat in Pakistan is a good example of how social finance has been very successful in alleviating poverty by increasing the productivity of the microenterprises by providing interest-free capital.

Furthermore, the institution of waqf can also be used to provide productive social capital for enhancing social and economic welfare and reducing inequalities. Historically various generations of Muslims have created awqāf over time to serve various social purposes. Estimated value of global waqf assets range from US$ 410 billion to US$ 3 trillion (Tok et al. 2022). A 5% return on US$ 1 trillion of waqf assets would yield US$ 50 billion annually that can be used for different social welfare purposes including providing capital to microenterprises. While the accumulated waqf assets is large in many Muslim countries, much of the assets are under-developed and not producing the potential output and impact. Increasing the role of waqf in contributing to equitable development would require increasing the capacities of existing waqf and also creating new waqf. While the capacities of existing waqf can be enhanced by investing in them, new waqf can be enlarged by creating productive Islamic social capital that serves the needs of the poor and improves income and wealth distribution.

RI4: Use Zakāt to Redistribute Wealth and Capital

Most of the redistributive schemes such as taxes and social security programs are based on redistributing income that can raise certain issues. First, as can be seen in Chart 1 wealth distribution is more acute than income distribution. However, in most of the countries the taxation on wealth is very small that limits the size and impact of redistribution policies (Kuypers et al. 2021). Second, the poor are more vulnerable to negative shocks with income redistributive policies compared to wealth redistribution. For example, if there is a loss of income due to unemployment, household with wealth will be able to sustain livelihoods better than those without wealth (OECD 2019: 162). Thus, poverty can be tackled more effectively by building the wealth of the poor along with redistributing income. Part of the wealth can be converted to capital that can increase the income generating capabilities and can reduce income inequalities. Thus, redistribution of wealth can have a higher impact in improving productivity and reduce income and wealth inequalities than redistribution of income (Bowles 2012, Kuypers et al. 2021, OECD 2019).

Zakāt is a redistributive instrument to create balance in income and wealth in a society. With estimates of potential global Zakāt collection ranging from US$ 200 billion to US$ 1 trillion (Tok et. al 2022), it can be used as a powerful tool for redistributing wealth in societies (RC7). Interestingly, Piketty (2014) found that on the average the difference between the rate of return on capital r and income growth g is around 2%. A redistribution of 2.5% of wealth is likely to remove Piketty’s r>g disparity gap in capital and income growth rates that perpetuates income and wealth inequalities and bring a balance in wealth distribution in the society. While the estimates of potential global Zakāt collection of more than $200 billion, it is not being used effectively to make an impact.

Other than problems related to collection of Zakāt, a key issue may relate to the way Zakāt is redistributed. While Zakāt is levied on wealth, in many cases Zakāt is used as instruments of income distribution. To have a larger redistributive impact Zakāt should be used to redistribute wealth and capital. This is in line with distribution of Zakāt on traditional forms of assets such
as cattle on which a certain number of cattle is given as Zakāt. Distribution of Zakāt in terms of wealth and building capital for the poorer sections of the population will likely have a positive impact income and wealth redistribution. However, using Zakāt to redistribute wealth during contemporary times will require a re-thinking of Zakāt policy.

7.3. Personal Changes and Development

RP1: Increase Capital Enhancing Ethical Behaviour

Contrary to the assumptions of self-seeking individuals in a capitalism economy, *homo islam-icus* is expected to have ethical virtues of compassion and benevolence. As indicated, inequalities cannot be reduced by only profit-seeking capital and requires social capital that promotes social goals (*RI3*). Since social capital formation depends on compassion, benevolence and being charitable, these ethical traits must be practiced by *homo islamicus* to produce an equitable economy. Another ethical value at the personal level relates to debt. As indicated above, the Islamic ethics of debt implies that debt should be used only in case of necessity and should be kept to a minimum. This attitude will help reduce the financialization of the households and encourage the use of capital in more productive activities.

Another important aspect of behaviour of Muslims relating to capital concerns risk-return preferences which can be applied to savings and investment. This relates to aligning the preferences of risk-returns features with the maxims linking returns to risks. There are a couple of issues relevant for Muslim capital owners and investors. First, the notion of rationality for Muslims would be to generate profit or income within the bounds of Islamic legal principles and ethical values. Thus, ethical considerations will guide economic decisions including those related to capital investments. In line with the maxims linking returns to risks Muslim investors should be willing to take measured risks on their investments to earn returns. Second, Muslims are required to pay 2.5% Zakāt on their wealth and savings/investment accounts in banks pay return that is usually lower than the inflation rate. Thus, saving in banks that pay low returns implies that the real value of the savings decreases over time due to inflation and Zakāt payments. Given that protection of *mal* or wealth is one of the *Maqṣad* of Shāri‘ah, Muslim investors should invest in relatively higher expected return assets to protect the value of their wealth.

As noted by Piketty (2014), the rate of return on capital has been historically higher than income growth rate (r>g). However, only a small percentage of population own capital that pays higher returns. To protect the real value of wealth from inflation and paying Zakāt over time, Muslims should invest in capital that pays higher returns. A key constraint that many Muslims from low- and middle-income groups face is the lack of investment opportunities and products that yield higher expected returns. There is a need to develop Islamic capital markets and come up with investment products that give opportunities to Muslim investors from all income groups to invest. In this regard, fintechs can play an important role to create opportunities for investors to diversify investments in capital markets instruments in the form of equity mutual funds and asset-based sukuk (*RI2*). This will help increase ownership of capital among a larger number of people and promote a more equitable distribution of income and wealth. Thus, the ethics of risk-returns of Muslims (*homo islamicus*) should induce them to move a large part of their low risk-low return debt-like savings products to investments that yield relatively higher returns.

RP2: Enhance Islamic Financial Literacy

Financial literacy is an important demand side issue for enhancing financial inclusion and economic wellbeing (Ramakrishnan 2012). Literacy across income levels helps households to access finance and make them better users of finance (Grohmann et al. 2018). Providing financial
services to poorer households who are not financially literate can lead to detrimental outcomes. For example, many farmers in India have taken loans that they did not have the capacity to repay which resulted in debt problems and in some cases suicides (Ramakrishnan 2012).

Financial literacy in Islamic finance would require another an additional layer of knowledge beyond the numerical literacy. Literacy of basic Islamic financial concepts is essential for Muslims to lead a religious life beyond doing the rituals of worship. For example, clients need to understand the nature of the Islamic financial contracts and the implied risk-return features to make appropriate decisions. People should also be aware that Ribā is one of the most strictest forms of prohibitions.24 As indicated above, Muslims also have to consider additional issues such as paying Zakāt and take steps to protect the real value of their wealth. This will require developing appropriate contents for Islamic financial literacy programs and using them to increase knowledge and awareness on Islamic economic and financial concepts among people.

8. Conclusion

While the dominant capitalist system has produced economic growth, it is criticised for failing to resolve the problem of inequality. This paper attempts to explore growth and income inequalities from the perspective of capital that forms a dominant factor in shaping contemporary market-based economies. Rooted in the Enlightenment era thinking, the capitalist economy is supported by a positive and rational legal system that supports capitalistic formation and is devoid of ethical considerations. Contemporary capital is legally constructed and an enabling legal system provides legal tools and framework through which assets are coded into capital. Given the freedom of contracts, laws are used to bestow capital certain attributes that protects the interests and enhances income of capital owners. The focus on increasing shareholders value in free markets without any ethical considerations has led to unabated use of natural resources that not only has increased inequalities of income and wealth but also is destroying the environment.

Islamic economists have argued that an economic system applying the Sharīʿah values and principles will produce equitable growth. A key distinction between a capitalist system and Islamic economy is that the latter is guided by Sharīʿah that entails both legal rules and ethical values. The Islamic teleological ethics are guided by the fundamental maxim that the ultimate goal of Sharīʿah is maximising welfare (Maṣlaḥah) and minimizing harm (Mafsadah) and the achievement of Maqāṣid al-Sharīʿah (objectives of Sharīʿah). Other than using the legal rules to confer the attributes of priority, durability, universality and convertibility, Islamic capital also ensures informational ethics (transparency) and justice. Furthermore, economic transactions are guided by legal maxims that provide important ethical guidelines related to transactions.

The practice of Islamic finance, however, followed the positive legal approach of the capitalist systems and replicated many features of conventional deb-based capital by interpreting Sharīʿah in narrow formalistic legal terms. The removal of ethics from Islamic finance practice by focussing on legal compliance and mimicking conventional financial products are likely to produce the same economic effects of conventional capital in substance and contribute to income inequalities. The data shows that income and wealth inequality in Muslim countries of the MENA region that has some elements of an Islamic economy such as Zakāt and Islamic finance is worse than many capitalist economies of the West (Figure 1).

The paper suggests ways in which Islamic ethics can be introduced in capital formation to produce equitable economic growth. Other than having an enabling legal system under which Islamic capital can be coded, there is a need to increase proportion of productive capital and

24 In Quran (2:279) Allah SWT declares war on those dealing with riba.
nondesbt based financing. Reducing financialization and expanding inclusive financial services is essential to promote growth and mitigate income inequalities. Increasing the number of capital and investment products paying relatively higher rates of returns that is available to all segments of the population is necessary to improve income and wealth distribution.

While traditionally financial systems are categorised as bank-based or market-based, an Islamic financial system would ideally be dominated by NBFIs and Islamic social finance institutions since they can provide products and services that reflects Islamic values and principles. Specifically, Islamic NBFIs and fintechs can facilitate providing nondebt based financial services to a wider range of people. The paper argues that inequalities cannot be mitigated by market-based solutions only and there is a need to provide social capital to promote equitable growth. In this regard, the social sectors of Zakāt and waqf can play an important role in contributing to a just and equitable society. There is also a need to increase Islamic financial literacy among all stakeholders to enhance financial inclusion.

The climate crisis and environmental issues that affect global economies and humanity during contemporary times has generated a lot of interest on sustainable finance and investments lately. As in the case of conventional economics and finance, there is also research on sustainable finance from an Islamic perspective and some Islamic green finance initiatives such as issuance of green sukuk undertaken. This is a welcome move since it important to use capital to tackle the existential risks facing the planet arising from climate crisis.

While sustainable and green finance can deal the ‘planet’ related issues of SDGs, there is a need to also resolve a fundamental issue related to ‘people’ of reducing the persistent poverty and inequalities to achieve shared prosperity. There seems to be failure of Islamic capital of not being able to deal with the problem of increased income inequalities due to its adoption of positive legalistic approach. This paper shows that ethical attributes of Islamic capital reflecting the *Maqāṣid of Sharīʿah* and other ethical values related to justice are the foundations of an equitable and just economy. The key message of the paper is that without introducing the ethics and notions of justice, the current practice of Islamic economic and financial systems will not be able to tackle the problem of inequality. Beyond legal compliance, there is a need to embed Islamic ethics of transparency, fairness and justice to tame the harmful effects of capital in order to produce economies that are equitable and promote balanced growth.
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Published by:
Islamic Development Bank Institute (IsDBI)
[A Member of the Islamic Development Bank Group]
8111 King Khalid St. Al Nuzlah Al Yamania Dist.
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IsDB Prize Laureate Lecture ▶️ 2022