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**GRADUATE SCHOOL OF DEVELOPMENT STUDIES**

*Justification by Works or by Faith*  
**The Islamization of Pakistan's Economy: 1979-2001**

*A research paper presented by*

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*"The Faith which you represent can still create a new world where the social rank of man is not determined by his caste or colour or the amount of dividend he earns, but by the kind of life he lives; where the poor tax the rich, where human society is founded not on the equality of stomachs but on the equality of spirits, where an untouchable can marry the daughter of a king, where private ownership is a trust and where capital cannot be allowed to accumulate so as to dominate the real producer of wealth. This superb idealism of your Faith, however, needs emancipation from the medieval fancies of theologians and legists. Spiritually we are living in a prison house of thoughts and emotions which during the course of centuries we have woven around ourselves...The whole community needs a complete overhauling of its present mentality in order that it may again become capable of feeling the urge of fresh desires and ideals."*

*Muhammad Iqbal*

Poet-Philosopher of Pakistan

(Presidential Address at the Annual Session of All-India Muslim Conference)

1932



*"I shall watch with keenness the work of your research organization in evolving banking practices compatible with Islamic ideas of social and economic life. The economic system of the West has created almost insoluble problems for humanity and to many of us it appears that only a miracle can save it from disaster that is now facing the world. It has failed to do justice between man and man and to eradicate friction from the international field. On the contrary, it was largely responsible for the two world wars in the last half-century. The Western world, in spite of its advantages of mechanization and industrialization is today in a worse mess than ever before in history. The adoption of Western economic theory and practice will not help us in achieving our goal of creating a happy and contented people. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice. We will thereby be fulfilling our mission as Muslims and giving to humanity the message of peace which alone can save it and secure the welfare, happiness and prosperity of mankind."*

*Quaid-i-Azam Muhammad Ali Jinnah*  
Founder and Governor General of Pakistan  
(Opening Ceremony of the State Bank of Pakistan)  
Karachi 1948

... ..

... ..

Dedication

**Mujtaba**

*My friend, guide, and philosopher*





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## Chapter 1

### **Research Introduced**

#### **Background**

Pakistan has become, according to the vision of its founder, a laboratory of Islam. All regimes in Pakistan regardless of their political ideology and democratic dispositions have relied on Islam as a legitimizing force. The military government under General Zia-ul-Haq, which assumed power in 1977 after displacing the civilian government of Zulfikar Ali Bhutto, adopted Islam as its sole legitimacy and set forth an all-inclusive overhaul of policies and systems according to the Islamic law – a process termed “Islamization”. While education policy, foreign policy, and media policy received special attention under Islamization, economic policy remains the classical case. Referring these economic reforms as the ‘Islamization of Pakistan’s Economy’, this essay discusses their underlying behavioural, political and socio-economic reasons and analyzes their outputs and outcomes.

The ‘Islamization of Pakistan’s Economy’ (IPE) seeks the (1) imposition of an Islamic tax called Zakat, (2) elimination of interest from financial institutions and (3) introduction of alternative modes of Islamic finance. It started in 1980 with the Zakat and Ushr Ordinance, which imposed an ‘Islamic wealth tax’ deducted annually from bank deposits and from farm produce. The Zakat and Ushr policy was adopted as an Islamic policy of income transfer and poverty alleviation. Thus Zakat – which has remained in the ambit of Muslim community throughout history except for its first half-century – was taken over by the Muslim state.

The critical component of IPE uproots one of the fundamentals of modern banking and finance by arguing for an interest-free regime. It started with interest-free counters in all the nationalised banks in 1981, while interest-based accounts continued to operate. In 1984, through the “Prohibition of Riba (Interest) Ordinance”, all nationalised and private banks were prohibited from accepting local currency deposits except on the basis of

sharing profit and loss. In the same ordinance, banks were allowed to open special counters for Islamic financing through permissible modes. The declared objectives of these measures were to (1) make all economic policy and practices compliant with the Shari'ah-Islamic law, (2) safeguard the interests of persons requiring loans for consumption and (3) ensure a just, fair and equitable system between trading partners when a loan is taken for production (GoP 1992:8).

### **Statement of the Problem**

Policy reform is a complex task that depends upon reform characteristics, resource mobilization, public support, and bureaucratic and political action. In a country like Pakistan, which constitutionally acknowledges the supremacy of religious texts over policy-making processes, the influence of religious elements should be treated as an important additional element. This influence is spread throughout the reform process from contents to public and bureaucratic support. However, like any other policy, Islamization has both intended and unintended consequences and its success or failure remains contested (Grindle and Thomas 1991:127).

The problem that IPE attempts to resolve is three-tier: behavioural, socio-economic and political (Ahmad 1998:13, Naqvi 1993). The behavioural problem for Islamic economics is the materialistic individualism of capitalistic system, which leads to exploitation of the needy or one of the trading partners (Maudoodi in Pal 1999:48 and Choudhury 2001). In terms of socio-economics, Islamization, on the one hand, seeks to mobilize the real productive sector over and above the monetary sector by eliminating interest (Choudhury 2001) and on the other hand, aims at poverty alleviation through Zakat. From the standpoint of socio-economics, the pivotal rationale of Islamic economics is social justice, as evident from the concepts and objectives of both Zakat and Islamic financial system (Chapter 3). The political problem, which governments-both elected and non-elected, though mostly latter- try to resolve through Islamization, is lack of legitimacy (Karim 1993:19). As IPE continued addressing this three-tier problem, it encountered many problems of its own during implementation. These were pertinent to (1) the level of simplicity or complication of the contents of policy reforms, (2) the capacity, skills and

willingness of implementers and (3) the degree of public support. These implementation problems have altered the course of IPE and undermined its effectiveness.

### **Research Questions**

The questions that guide the objectives and direction of the study are:

1. Why and when does Islamization occur in Pakistan?
2. What are the policy inputs and outputs of IPE?
3. Who are the stakeholders in IPE and what are their interests?
4. What has IPE delivered? What are its policy outcomes?

### **Hypotheses**

1. Introduction of a public policy as Islamic enhances its legitimacy in Pakistan.
2. Islamization occurs when policy reforms are simple, skill development is enhanced and bureaucratic and political support are present.
3. Zakat alleviates the poverty of its recipients in Pakistan.
4. Islamic financial instruments offer competitive rates of return in Pakistan.

### **Scope and Limitations**

Muslims seek guidance from religion in their public affairs more persistently and frequently than followers of other religions. Thus the results of religiously inspired public policies such as Islamization of the economy considerably signify their attachment with faith. Perhaps more than anywhere else, this is evident in Pakistan, which has taken lead in Islamization. However, studies in Islamization lean heavily towards theological and theoretical arguments and lack empirical analysis. While the importance of the former type of analysis is not being undermined here, this study focuses on outputs and outcomes of Islamization of the economy, which has been in practice for a significant period of two decades. Thus it would to an extent correct the deficiency of empirical analysis in this area of Islamization.

The major limitation of the study is that of IPE itself: Islamization intervenes only partially in the vast and complex web of socio-economic policy and its results are

affected by other components over which it does not claim any authority. The imposition of a pro-poor wealth tax and elimination of interest are selective reforms in social, fiscal and monetary policies. Any empirical analyses of IPE would be constrained by these extraneous factors. In sum, political reasons and political impacts receive greater attention than the economic and behavioural ones and this study becomes an inquiry into the politics of Islamization.

### **Methodology**

The research employs a number of qualitative and quantitative research methods and tools. At the outset, it is built on an eclectic conceptual framework drawn from various policy scientists. For the purposes of description, prescription and policy analysis, this model guides the use of data. Most of the data used in the research have been obtained from secondary sources including books, documents, periodicals, web-sites, and newspapers. Primary data sources comprise selective interviews conducted on a semi-structured pattern both in person and through email. The data are a combination of qualitative and quantitative data due to the nature of the hypotheses. The qualitative element derives from the theoretical background of the subject as various relevant arguments are evaluated and analysed at length. A considerable part of the research will be quantitative as some of the variables under study like poverty level and profitability of Islamic financial instruments can only be presented statistically.

### **Organization of Paper**

The paper starts with the background and statement of the problem, research questions, hypotheses and methodology in Chapter 1. It is followed by an eclectic conceptual framework in Chapter 2, which outlines the parameters of analysis. Chapter 3 introduces some of the important terminologies and concepts relevant to Islamization. Chapter 4 is the historical account of (1) the role of Islam in the struggle for independence for Muslims of South Asia, (2) the evolution of relationships between Islam and the state, and (3) the Islamization of economy in particular. It examines the hypothesis that Islamization enhances the legitimacy of public policy. Chapter 5 describes characteristics of policy reforms and identifies the stakeholders. It suggests the possible locations and intensity of reactions to the said policy reforms in terms of bureaucratic and public arena.



It tests the hypothesis that Islamization occurs when policy reforms are simple, skill development is enhanced, and political and bureaucratic support are present. Chapter 6 focuses on the issue of Zakat – Islamic tax – and its relationship with poverty alleviation and thus examines the hypothesis that Zakat policy alleviates poverty. It also presents some recommendations to improve the outcome of Zakat policy. Chapter 7 explores the relationships between Islamic alternative modes of financing and the level of profitability and evaluates the hypothesis that Islamic financial instruments offer competitive rates of return. It also offers some recommendations to make Islamic economics more competitive. The paper concludes in chapter 8, which reverts back to the three-tier problem that IPE has resolved to address and put forwards some policy implications of the study.



## Chapter 2

### **Concepts Framed**

As what you find depends on what you look for, the result of policy analysis depends upon your 'lens' or model. These models do not necessarily explain an event but they guide "where to look" and "what to look for" (Björkman 2000:1). An important consideration is whether the implementation of policy is being studied as an outcome or as a process. Studying implementation as process allows the analysts to take into account both intended and unintended consequences of implementation. It also encourages the policymakers to monitor the implementation process keenly instead of divorcing themselves from it. Selection of a model furthermore depends upon the political economy of a country as developing countries encounter peculiar problems owing to political instability, corruption and poverty.

This study needs multiple handles for analysis of data. To study the policy-making process and the role of stakeholders, the 'Grindle and Thomas Model' (1991) has been selected, which was developed after detailed cross-sectoral policy analyses in fourteen developing countries. For implementation analysis, which focuses on the politics of implementation, various works by Björkman (1994, 1994a, 2001) have been used. For retrospective analysis, the framework by Pollit (1995) is employed. These multiple models constitute an 'eclectic framework'.

#### **Grindle and Thomas Model**

Grindle and Thomas' 1991 analytical framework is built on two distinctive components: the perceptions of policy elites and the context of policy choice. Perceptions of policy elites are developed by their goals, ideological commitments, experience, training and political and institutional loyalties. The policy elite broadly represents various stakeholders and these two terms will be used interchangeably. These are the heads of states and ministers, the executive bureaucracy, legislators, political parties, and societal interests (business interests, religious elites, the military, organized labour, the media, and

(common) people who look elsewhere for influence). The context of policy choice is even broader as it entails societal pressures and interest groups as well as historical, political and economic circumstances. Thus policy makers and stakeholders have a 'policy space' vis-à-vis context, within which they can manoeuvre to achieve preferred outcomes (ibid:32).

A decision to undertake policy reforms is followed by an implementation stage. In fact implementation is a filter that often alters intended policy (ibid:6). Two models of implementing policy reforms have been proposed. The Linear Model assumes that once the proposed reform gets on the agenda, and a decision is made to implement it, only two outcomes are possible. Either the implementation is successful or it is unsuccessful. If the latter is the case, greater institutional capacity or stronger political will or both are suggested as remedial measures (ibid:122). However, this analysis signifies lack of detailed knowledge. The Interactive Model begins with the assumptions that a state of equilibrium surrounds an established policy set and that efforts to alter equilibrium will elicit some response or reaction from those affected. The nature, intensity, and location of the response or reaction, which can be either overt or covert, will determine the extent to which reform is implemented or sustained (ibid:126). The main problem with the Linear Model, which Interactive Model seeks to overcome, is that it tends to divorce policy makers from implementation with the assumption that once the decision has been taken, implementation is just an administrative issue. However, experience has shown that implementation is a political process as much as the decision making process itself. Thus examination of conflict and conflict resolution as well as development of strategic management capabilities is of vital importance (ibid:135).

Grindle and Thomas have proposed that policy characteristics determine whether the reaction to a policy reform is likely to occur in the public or bureaucratic arena. These characteristics are: degree of dispersion of costs, level of concentration of benefits, nature of technical content, extent of participation sought and length of duration required. If the costs of a reform are dispersed such that a large segment of the population or some of its politically important groups are likely to be affected, the reaction will occur in the public

arena. On the other hand, if these costs are concentrated in a particular government department, the public will not react at a significant scale and the policy reform shall instead be resisted by bureaucratic circles. Secondly, if the benefits of a policy reform appear to be concentrated only in the government, the public will not value them highly. Thirdly, if the reform is technically simple in nature, the public will readily understand and react while if it contains high technical content, the bureaucracy is likely to react as it would more likely understand and implement such a reform. Fourthly, if a policy reform seeks extensive participation, implementation becomes difficult and reaction from various quarters – especially from the public – intensifies and complicates. Finally, if the result of a policy reform is visible in a short span of time, reaction is likely to be stronger from the public than if it takes long duration to show the impacts. The nature of reaction could be positive or negative but we are concerned only about the location and intensity of reaction.

### **Björkman Model of Implementation**

The effectiveness of implementation is affected by the amount of change sought by a policy reform (Björkman 2001). Lack of implementation could be attributed to (1) a communication problem, (2) a capability problem, and (3) a dispositional problem. A communication problem can refer to either lack or excess of information and its solution lies in the nature of flow of information within or without an organization. Capability concerns the size and competence of staff, material resources, realism of schedules, and degree of hierarchical control of sub-unit decisions. Thus, obtaining material resources and training and skills development can enhance capacity. Dispositional problems include violation of actor's personal values, sense of self-interest, extra-organizational loyalty, and lack of legitimacy of issuing authority (ibid). Deterrence and corrective action for dispositional resistance consists of two activities: (1) surveillance, i.e. on-site visits, audits, and reports focusing on the output and (2) manipulation of inducements and sanctions including material incentives, normative appeals, solidarity incentives and coercion (ibid.)

To recapitulate this eclectic conceptual framework, policy elites can manoeuvre the policy process by using the 'policy space' available due to changing context. This manoeuvrability depends largely on the policy characteristics defined in terms of technical validity, level of spread and concentration of costs and benefits, length of time needed to see the impact, and degree of participation required. Implementation should be studied as a process to consider both intended and unintended consequences as it depends on an interactive set of processes between policy objectives and achievements. Implementation is a political process and its effectiveness depends upon communication, capacity and dispositional issues.

### Chapter 3

#### **Knowledge Recapitulated**

Literature on Islamization of economy is vast and abundant. Islamic scholars and economists have deliberated at length on “Islamic Economics”. This literature leans heavily towards theological and theoretical arguments and leaves a lot of ground for empirical studies. Performance analyses and impact assessment studies are rare. However, as the importance of a sound theory for implementation of a policy cannot be undermined, introduction of key concepts used in Islamization of economy is essential. This chapter introduces relevant concepts of Islamization, Islamic Economics, Riba (rent of interest), its Islamic alternatives and Zakat (Islamic tax). As this paper highlights the politics of Islamization, academic concepts are supplemented with political analysis.

#### **Islamization Process**

Esposito categorizes the concept of Islamization into ‘traditionalist’ and ‘reformist’ versions. For traditionalists, Islamization is “primarily the reintroduction of past institutions and practices with little substantive change, for example reinstituting traditional Islamic laws and punishments...and the ‘protected’ status for non-Muslims” (Esposito 1991:194). Islamization, for reformists, is a “twofold process of deriving laws and practices from Islamic sources and adopting and adapting ideas and institutions from foreign sources, provided they are not contrary to Islam” (ibid:195). This author brackets himself with the reformist version of Islamization and believes in individual reasoning known as *Ijtihad* in Islamic law as a legitimate source for rethinking and reinterpretation. Islamists – Muslims who believe in political action for implementation of an Islamic agenda (Piscatori 2001:2) – trail a modern agenda by fusing the spirit of religion and accomplishments of human knowledge. The secularization thesis, which displaces religion from the public sphere, becomes an invalid explanation of modernization and industrialization of post-colonial Muslim world (Hefner 2000:9). As Islamic nations continue to advance in social and scientific arenas, Islamization itself becomes a modernizing process.

The vitality of political action makes Islamization in essence a political process. But this politicization of Islamization harbors contradictions in the rank and file of Islamists, as democracy can be bypassed despite plans of modernization. Politics juxtaposes Islamists to power and they set their focus on assuming power through any means. When they are successful, they naturally cling to an Islamization agenda as their source of credibility and legitimacy. Interplay of various actors for authority and control in changing socio-economic context occupies central focus. Thus to understand Islamization, we must attend to its politics.

### **Islamic Economics**

Perceptions of Islamic economics vary from vision of a *de novo* discipline (Saleem 1995) to intelligible eclectics like “controlled capitalism” and “spiritual socialism” (Ahmad 1998: 14). Arguments in favour of an entirely new concept are based on the belief that “Divine Unity” is the epistemological basis of any Islamic social “science”, which modern economic thought does not recognize. Choudhury articulates this perspective by identifying five major tenets of Islamic economics as “(1) abolition of interest, (2) profit-sharing under economic cooperation between labour and capital, (3) joint ventures, principally though not wholly through equity participation, (4) the institution of charity, and (5) avoidance of wasteful use of resources” (Choudhury 2001). Islamic financial system also specifies the principles of (1) using money as ‘potential’ capital, (2) prohibition of speculative behaviour, (3) sanctity of contracts and (4) Shari’ah-approved activities (Iqbal 1997:2). Paradoxically, one expert argues that Islamic Economics is “happy mixture of selfless and selfish behaviour” (Naqvi 1993:111).

Islamic economics emphasizes monetary and fiscal measures stressing the elimination of *Riba* (interest) and introduction of Zakat (Pal 1999:23). Positive measures for Islamic modes of financing and investment are also proposed, which are presented as policy alternatives for modern interest-based instruments (Usmani 2000, Buckmaster 1996, Ahmad 1991). The central rationale of Islamic economics, both in the case of Zakat as a redistributive measure and elimination of *Riba*, is the need of social justice (Iqbal 1997:2 and GoP 1992: 8). In the case of loans for consumption, the main consideration is



“humane” because the poor could be exploited by giving loans on high returns to meet their urgent needs. This is analogous to the private money lending institution prevalent in especially the rural areas of Pakistan. If the loans are given for production and commercial purpose, which is practised through banks, Islamic economics argues that the “occurrence of profit or loss and their magnitudes cannot be fully determined in advance”. Therefore any transaction would be *unjust* from both lender’s and borrower’s perspectives (ibid).

Social justice is not the only premise of Islamic finance. Ideologically their boom coincides with the “Washington consensus”, which called for protection of private property, free enterprise, deregulation and the rule of law (Warde 2001). Hence the emergence of a private sector helped in the growth of Islamic finance. Moreover, the recent preoccupation with ethics in current business practices has helped in supporting the ethics-centered and socially justifiable practices of Islamic finance (ibid). The central argument of Islamic economics against interest is unwittingly supported by the decreasing influence of interest rate as an effective monetary treatment in highly advanced economies like the United States (*The Financial Times* 2001).

Islamic economics is an interplay between participation and ethics. Its emphasis on *sharing* profit and loss gives it the distinctive participatory character. Banks come out from their safe havens as financial intermediaries and assume the role of a business partner because otherwise they become more vulnerable to loss. The depositors also become exposed to the risk of failure of prospective projects, so their pressure on the banking system increases. At one point, they may be equally persuaded to avoid depositing their savings altogether. This is more likely where mutual trust is absent and hence the problem of ethics comes to the forefront. Ethical norms become as important as material resources because the rate of return would depend upon the reported outcome of the entrepreneur. In sum, Islamic economics demand high standards of participation and ethics.

## Riba

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The most controversial, contested and significant policy issue for Islamists is the definition, scope and application of interest in modern banking and financial structure. The interest rate is one of the most common and effective monetary instruments that central banks use to influence investment, saving, lending and overall rate of economic growth. For most of Islamic economists, this instrument is *haram* (absolutely forbidden) for both moral and economic reasons.

Maudoodi maintains that “*Riba* (interest) is that fixed and prearranged amount on the use of capital which is claimed by the lender” and that “there is no difference between the practice of money-lending that prevailed during *Jahiliyya* period and the modern banking system” (Pal 1999:48). Maudoodi’s definition is representative of mainstream Islamic thought on the subject. A critique of this definition is offered by Fazlur Rahman who defines *Riba* as “an exorbitant increment whereby capital sum is doubled several-fold against a fixed extension of the term of payment of debt” (ibid:53). In his opinion, interest rates in the modern economy should be treated as other prices, which are determined by market forces and should not be equated with pre-Islamic usury. Opinion also varies depending upon the nature of loans, which could be for consumption or for productive purposes.

Saleh (1992:11) does not confine *Riba* to the banking system and defines it more generally as an “unlawful advantage by way of excess or deferment”. He defines *Riba* as “an unlawful gain derived from the quantitative inequality of the counter-values in any transaction purporting to affect the exchange of two more species, which belong to the same genus and are governed by the same efficient cause” (ibid:16). The recent decision by the Supreme Court of Pakistan states “any amount, big or small, over the principal, in a contract of loan or debt is *Riba* prohibited by the *Holy Qur'an*, regardless of whether the loan is taken for the purpose of consumption or for some productive activity” (Usmani 2000:159).

Why Riba is absolutely prohibited? A World Bank's expert on the subject lists social justice, equality and property rights as main reasons for prohibition (Iqbal 1997). He argues that Islam encourages profits, determined *ex post*, as they 'symbolize successful entrepreneurship and creation of additional wealth whereas interest, determined *ex ante*, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses.' Social justice demands an equitable sharing of profits and losses between borrowers and lenders (ibid).

### Alternatives of Riba

What does Islam offer as an alternative to interest? The answers provided fall into basic two categories: ethical-spiritual and financial-legal (Ahmad 1998:13). The ethical answer is rooted in the historical fact that in the pre-Islamic Arab society, like some other societies, moneylenders used to exploit the need of poor people by giving them loans on exorbitant rates. Islam gradually eliminated this practice and encouraged the society to help the needy as a voluntary obligation by giving *qard-i-hasn* (interest-free loans) and, if possible, waive them. The main motivation for this act would be to seek the pleasure of Allah. Muslims are further encouraged to spend by paying *zakat*<sup>1</sup> and *sadaqat*<sup>2</sup> instead of earning through interest, because the former would increase in Allah's eyes and the latter would decrease<sup>3</sup> no matter if, in a material sense, the case is opposite. Thus the appeal is primarily ethical and spiritual.

Financially, Islam offers two alternatives to interest: *Qard-i-Hasn* (interest free loan) and financing on profit-and-loss sharing basis (Siddiqui:53). Various trade-related and investment-related modes have also been developed by Islamic banks and financial institutions on these principles. The most widely used instruments are *Murahaba* (mark-up, in which the bank buys equipment for the customer and sells it at *marked-up* price), *Mudaraba* (Project venture based on profit-and-loss sharing), and *Ijara* (revised form of leasing) (Usmani 2000). Historically, trade practices on the basis of sharing profit and

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<sup>1</sup> Compulsory annual spending on the wealth saved and produce every year over a specified limit.

<sup>2</sup> Voluntary spending

<sup>3</sup> 'That which you seek to increase by usury will not be blessed by God; but the alms you give for His sake shall be repaid to you many times over.' (*Qur'an* 30:39)

loss had existed in the Arab society and parts of Southern Europe long before Islam and were later adapted by Islamic law (Khan 1999:156).

Islamic finance, at least theoretically, is socially more just and economically more efficient than its capitalistic counterpart. The principle of sharing *both* profit and loss instead of only profit increases equity in business transactions. This principle also compels the banks as the source of financing to scrutinize project proposals and to avoid the political loans altogether because, in the case of a loss, the bank would have to bear it. It is financially stable and more efficient owing to elimination of debt-financing and complete backing of demand deposits by reserves (Iqbal: 1997).

### **Zakat and Ushr**

Islamic Economics lays equal stress on imposition of Zakat (literally to purify), one of the five pillars of Islam, to reduce poverty and economic inequity. Ushr is the tithe imposed on agricultural produce and livestock but, as Zakat includes Ushr, Zakat can serve for both. Unlike interest, Zakat is a relatively less controversial concept. However, differences exist on heads and rates of Zakat. It is levied annually after exclusion of a specific amount or quantity called *nisaab* that on wealth, for example, is equivalent to 612 grams silver. Means of production (e.g. tools, machinery etc.), personal items of daily use (e.g. house, car) and the *nisaab* are exempted from deduction of Zakat. Most would agree that it is levied on these rates: wealth (2.5%), produce (5-10%), livestock (number varies for different animals), minerals and precious metals (20%) (Saleem 1995:16). Heads of Zakat include: the poor and needy, employees of government, on those whose hearts are to be reconciled, to free slaves, on those who inflicted losses, in the way of Allah (defence and public works), and for the wayfarer (including highways and lodgings) (ibid: 19). Traditionally, Zakat has been primarily used for helping the destitute, orphans and widows in Muslim society.

Zakat is a distinctive feature of Islam for being the only pillar with a tangible material outcome, while the others are spiritual in nature<sup>4</sup>. Due to both its divine and financial importance, early Muslim rulers waged war on the newly converted Muslim tribes, who refused to pay Zakat. Payment of Zakat was equated with political allegiance and failure to do so provoked the rage of the state. With the exception of the first half century of Islamic history, however, when Zakat collection and disbursement was in the ambit of the state, it has become a community-based charity institution in the larger Muslim society and is run solely on voluntary basis without any coercive measures.

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<sup>4</sup> Five pillars of Islam are Faith in God, Prayer five-times daily, Annual Fasting for one month, Annual *Zakat*, and One-time Pilgrimage for those who can afford it.



## Chapter 4

### **History Revisited**

History is an inconclusive lesson for future (Arnold Toynbee) and a fallible premise for scientific predictions (Karl Popper). However, to avoid the trap of the 'attribution error' (Pollitt 1995), history must be visited and revisited. Causal relationships must be established and the variables constituting a particular context must be defined. This chapter, therefore, describes the geo-political, social and international context of Islamization process in Pakistan, which is dovetailed with the specific economic reforms. It argues that Islamization was undertaken due to the failure of capitalist and socialist models in Pakistan and was initially used as a source of legitimacy for a non-elected government.

#### **Historical Factors**

Pakistan, now independent for 54 years, owes its creation to a number of historical, political, religious, cultural and psychological factors (Aziz 1998:9). As Islamization superimposes a religious factor, we shall briefly review the history of Pakistan Movement and Pakistan itself accordingly. The issue of a separate Muslim identity, and subsequently separate life-world, was first articulated and advocated by Sir Sayyid Ahmad Khan (1817-1898) (ibid:19). He faithfully echoed the rationalism of his age, and did not exempt the religious sphere from scientific analysis (ibid:22). His liberal thinking won him many enemies but he successfully institutionalized his ideals in the form of a movement and a university, both known as Aligarh. A milestone in the political revival of Muslim community was the *Tahrik-i-Khilafat* (Caliphate Movement), which began as a reaction to the British-supported partition of Ottoman Empire, the last Islamic caliphate. Though the movement witnessed the unity of Hindus and Muslims for the first and last time, it provided a fertile ground to political Islam (Wink 1991:30).

In later years, Muslims had the fortune of having leaders like the poet-philosopher Iqbal (1876-1938) and the statesman Jinnah (1876-1948)<sup>5</sup>. In the form of a separate homeland for sub-continental Muslims, Jinnah gave a precise political orientation to the Islamic sentiment nurtured by Iqbal and others. In 1940, enraged by the atrocities of Congress Rule (1937-39), Muslims under the Muslim League started the Pakistan Movement. The *Ulama*, scholars of Islam, were bitterly opposed to this movement on the ground that Islam does not acknowledge territory as basis of a nation (Rasheed 1999, Rais 1993, Wink 1991). On the other hand, the Muslim League presented Islam as the *raison d'être* of the new state, which undermined the grip of orthodox elements on the Muslim sentiment. It won this three-tier battle against the British government, the Hindu Congress, and the conservative Ulama and at midnight of 14-15 August 1947 witnessed the emergence of two nation-states in South Asia.

### **Political and Legal Factors**

Pakistan inherited a complex ideological equation with modernist Aligarh elements and orthodox religious variables fused and interlocked. The ten-year delay in adopting a constitution appropriately summarizes the confusions of early leaders. After its independence Pakistan had three broad options as far as the relationship between the religion and state was concerned (Haqqani 2000:106-111). The first option, which I call “Secularization”, was to develop a secular polity where religion would be considered as the private matter and practically insignificant for public policy. This was articulated explicitly in these words of the founder of the country:

“You may belong to any religion or caste or creed, that has nothing to do with the business of State (*Hear, Hear*) We are starting in the days when there is no discrimination between one caste or creed or another. We are starting with this fundamental principle that we are all citizens and equal citizens of one State (*Loud Applause*)” (quoted in Haqqani 2000:107).

The second option, which can be called “Theo-democracy” (Maududi), was to declare Pakistan an Islamic state, in which Ulama would be the final authority on interpretation

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<sup>5</sup> Both are quoted at the beginning of this paper.



of Islam for modern life, wherein they rule directly (e.g. Iran) or indirectly (e.g. Saudi Arabia). All religious parties were unified in their demands for such a model under the leadership of Maulana Maududi (died 1979) of Jama'at-e-Islami. Third option, which I call "Democratic Islamization", was to declare Islam as the state religion that would give "limited sovereignty" to elected representatives bounded by the interpretations of Ulama. Through the Objectives Resolution passed in March 1949, Pakistan officially adopted the third option. The resolution was kept intact as a preamble to all the subsequent constitutions until 1985 when it was made an operative part of the constitution. The central idea of the resolution was:

"Sovereignty over the entire universe belongs to God Almighty alone, and the authority which He has delegated to the State of Pakistan through its people for being exercised within the limits prescribed by him as a sacred trust" (quoted in Karim 1993:9).

Even the secularly minded Jinnah probably pre-empted this option, as he stressed the need of an Islamic economic system in his inaugural address to the State Bank, the central bank of Pakistan<sup>6</sup>. This was a significant departure from his earlier statement on 11 August 1947 on the nature of the state. The rising popularity of Islamists during the early years of Pakistan and the decline of the Muslim League's ideological and organizational muscle (Rasheed 1999:62) can plausibly explain this change.

Pakistan's first decade was consumed by emergencies and by framing a constitution for the new country. In 1958 the army overthrew the government and Pakistan entered an authoritarian yet progressive era under Ayub Khan. This decade of pro-capitalist growth and development culminated in a popular unrest masterminded and exploited by the former foreign minister of Ayub Khan, Zulfikar Ali Bhutto. The transition from a military to a democratic government was disastrous, as East Pakistan seceded to form an independent Bangla Dosh in 1971. Bhutto's regime (1972-77) is associated with massive nationalization, extensive labour rights, and equality of women (Karim 1993). However, like the capitalistic experiment, the socialist model failed to materialize the economic,

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<sup>6</sup> Excerpts from this speech are quoted at the beginning of this paper.

political and religious ideals of Pakistan. By the mid-seventies, the country was already experiencing the revitalizing authority of Islamists through constitutional amendments and demonstration of street power (Wink 1991). In the words of Naipaul, “people were turning to Islam because everything else has failed” (Naipaul cited in Wink 1991).

### **International factors**

By many accounts, the early and mid-seventies can be earmarked as the beginning of Islamic revivalist movements in the modern age. In 1973 the Arabs retaliated against Israel and demonstrated a short-lived superiority over the West by escalating the oil prices. In 1974 Pakistan hosted the second Islamic Summit at Lahore, which saw Shah Faisal (Saudi Arabia), Colonel Qaddafi (Libya) and Z.A. Bhutto (Pakistan) as the emerging leaders of the whole Muslim community, the *Ummah*. In 1975, amongst the euphoria of oil boom in the Gulf, first Islamic bank was launched in Dubai. In 1979, with the invasion of Soviet Union into Pakistan’s western neighbour Afghanistan, an “International Jihad<sup>7</sup>” was initiated, which was paradoxically funded by Saudi oil, U.S. dollars, and Pakistani armed forces and their intelligence agencies. In the same year, 1979, the Iranian religious establishment overthrew the mighty Shah in the “stable island” (President Carter’s phrase) after massive popular demonstrations and established a theo-democracy or ‘rule by the jurist’. In 1983 Iran followed the example of Pakistan in transformation of the banking system according to almost similar policy objectives and rationale. Since then, Islamic banking in Iran has ‘worked but at a high cost’ with almost similar restraints and contradictions experienced by Pakistan (Amuzegar 1993:120).

Islam played an important role in extending economic relations with the rich Middle and Near East countries that eventually became markets for Pakistan’s goods and also accommodated a tremendous flux of Pakistani manpower (Moscalenko 1991:22). Their remittances would become one of the most reliable and rich sources of foreign reserves for the exchequer in the coming decades. Socially, the exposure of Pakistani manpower

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<sup>7</sup> Jihad is an Arabic word that means ‘to exert’ or to struggle. According to a popular tradition, internal jihad is superior to external jihad, i.e. war. Jihad is often connoted as holy war between Islamists and “un-Islamic forces”.

to culturally more conservative Arab societies, increased female seclusion back home (Björkman 1987:4).

### **The Advent of Islamization: 1977-88**

Internationally, but more so regionally and locally, Pakistan experienced an escalating euphoria of Islamic Revival, Fundamentalism, and Restoration in the late 1970s and early 1980s. This set a perfect stage for the pro-Islamic coup led by General Zia-ul-Haque in 1977, which drew ideological and public support from lower-middle conservative elements of the society that were orchestrated by the Jama'at-e-Islami (Rasheed 1999:75). The relationship between these two power centres remained uneasy, dynamic and inconsistent, but the Islamization programme provided a sound legitimacy to the Islamist elements in the state and the society. The Zia regime introduced extensive Islamic laws governing education, media, religious, punishment, and economic policies. Islamization was institutionalized and well grounded into the state apparatus.

Legally speaking, Zia's most important contribution to Islamization was to make the 'Objectives Resolution' an operative part of the constitution in 1985, which was earlier used only as the preamble without any substantive implications (Hassan and Azfar 2001). This step was preceded by two equally important decisions, which resulted in establishment of Federal Shari'ah Court and Shari'ah Appellate Bench of the Supreme Court of Pakistan in 1980. They were empowered to strike down any law determined to be against the injunctions of Islam and as their records show, they used this power generously (ibid). These steps brought Islamic clerics from the 'shades of the seminary and political fringe' to the mainstream of political and legal battles.

### **Democratic Islamization 1988-1999**

When Pakistan was reopened to pluralistic democracy after the death of General Zia, a fresh Shari'ah Bill was awaiting the attention of the legislature. However, the National Assembly did not even debate the bill, which signified a change in the state's attitude towards Islamization. Prime Minister Benazir Bhutto, daughter of Z.A. Bhutto, publicly condemned Islamic codes of punishment for being "inhumane". She was succeeded by

the conservative Muslim League that assumed power in 1991 in coalition with Jama'at-e-Islami under the leadership of Nawaz Sharif. The National Assembly immediately demonstrated its commitment to Islamization by adopting the "Enforcement of Shari'ah Act" in 1991. This commitment was inconsistent and selective, as the same government filed a petition against a decision of Federal Shari'ah Court that had declared all interest-related laws repugnant to Islam and hence ineffective. We will later explain this struggle between various organs of the state on the issue of Islamization (Chapter 5).

The next important legislation towards Islamization was the proposed 15<sup>th</sup> Constitutional Amendment passed by the National Assembly in 1998 during second term of Nawaz Sharif as premier. The distinctive feature of this amendment was the level of authoritativeness and centralization by the federal government to impose Islam. It appealed the more extremist religious groups due to its obvious dictatorial stance but faced severe resistance from all the political and moderate religious parties at national scale. The government did not table the bill in the upper house, the Senate, where it lacked a simple majority. The proposed 15<sup>th</sup> amendment was finally shelved with an expression of increasing frustration by the state for its failure to take on board all the stakeholders in the process of Islamization.

Islamization of Pakistan's economy received a tremendous boost in December 1999 when the Shari'ah Appellate Bench of the Supreme Court passed a landmark judgement declaring all interest-relevant laws null and void within one and a half years of the decision, i.e. by 1<sup>st</sup> July 2001. However, near the end of this deadline, a major bank appealed for an extension and the court granted a grace period of one year. On the other hand, the decision of the Supreme Court – notably granted after Nawaz Sharif had been ousted by the military in October 1999 – was apparently taken seriously by the government because it established various working groups in the State Bank and the Ministries of Law, Finance and Economic Affairs to reform laws, policies and procedures accordingly. These working groups are working under the broad parameters set by a high-powered 'Commission on the Transformation of the Financial System' (Hassan and Azfar 2001).

This most influential power centre of Pakistan, the military, adopted an anti-fundamentalist tone when General Musharraf assumed power in 1999 for he banned many extremist Islamist groups and called for moderation in society (*Dawn* 2001). Later global events i.e. terrorists attacks on the United States and subsequent war in Afghanistan provided international legitimacy for these decisions at home. It is believed that in the wake of search of financial basis of terrorist organizations, many Islamic banks have faced problems and threats of closure especially in the West<sup>8</sup>. On the other hand this trend has also encouraged Muslim investors to increase inter-dependence within Muslim block.

Time line	Mode of Islamization	Regime
1947-58	Liberal-Modernist Islam	Multiple; democratic
1958-68	Developmentalist Islam	Ayub Khan; military
1968-72	Nationalistic Islam	Yahya Khan; military
1972-77	Socialist Islam	Bhutto; democratic
1977-88	Political-Fundamentalist Islam	Zia-ul-Haque; military
1988-99	Democratic Islam	Multiple; democratic
1999 to date	Anti-Fundamentalist Islam	Musharraf; military

**Table 4-1: Islam as a legitimizing force in Pakistan<sup>9</sup>**

## Conclusion

The Islamization process in general and Islamization of the economy in particular has received staunch criticism due to its “superficiality” and “insensitivity” to the exploitation of the poor by the rich, especially in rural Pakistan (Khan 1999:154). IPE has focused its attention on elimination of formal shapes of interest in the banking system but it has overlooked the presence of an interest-based money lending system prevalent in the rural and backward areas of the country. Historically it is analogous to usury or ‘Riba’ condemned by the *Qur'an* due to its exploitative character but Islamic economists only attend to its ‘urban’ form in banks and financial institutions<sup>10</sup>.

<sup>8</sup> This observation is based on an ongoing debate on ‘Trade between Muslim countries’ on [www.ibf.net](http://www.ibf.net)

<sup>9</sup> Table 4.1 is based on a work by Ahmad (1988). I added the last two rows to update the account.

<sup>10</sup> Despite this realization, this paper will not discuss the money-lending process in rural Pakistan as it is not envisaged in the policy of Islamization under review. Moreover, data constraints do not allow such analysis.

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The Islamization of Pakistan's economy rests on the failures of both 'Developmental-Capitalistic Islam' and 'Socialist Islam' in achieving economic equity and the alleviation of poverty. The Islamization process has been uneven and incremental. It was largely steered through ordinances issued by a non-elected government led by the military. Thus it was legal but not legitimate and was carried to seek legitimacy. In addition, political unrest in the country and an upsurge in Islamic revival at the international level have contributed to the advent of Islamization. But over the years, the Islamists in Pakistan have failed to build strong, nation-wide, democratic and popular support for their programmes as evident in the results of elections (Chapter 5). The state's support for Islamic institutions in general in the light of domestic and international policy shifts is likely to decline. The effects of these contextual changes on IPE are not immediately obvious and the response of civil society will largely determine the ultimate fate of this idealizing agenda.

## Chapter 5

### **Stakeholders Identified**

#### ***Socio-political context and Policy space***

Stakeholders create a policy space according to their perceptions and preferences by manoeuvring within the socio-political context of reform. The nature of reform also influences the relative importance of various stakeholders. This chapter describes policy elites in the Islamization of the economy and analyzes the implications of their perceptions and mutual relationships on desired outcomes. It argues that Islamization occurs when policy reforms are simple, skill development is enhanced, and bureaucratic and political support are present.

#### **Stakeholders in IPE**

The Islamization of Pakistan's Economy (IPE) juxtaposes conflicting and competing interests. It engages interest groups from different quarters of polity and society and thrives on a constant mode of reform, resistance and alterations. We can identify these stakeholders in the context of IPE:

1. The State (the military, the judiciary, State Bank, Finance Division, Ministry of Religious Affairs & Council of Islamic Ideology)
2. Societal Interests (political parties, financial institutions, landlords, religious groups)
3. Common People (depositors and the poor)

#### **The State**

Within the state elites, the reliable strongholds of Islamists are the Council of Islamic Ideology (a federal government advisory body), the Ministry of Religious Affairs (which administers collection and disbursement of Zakat), and the judiciary. These institutions have leaned towards conservative, literalist and traditionalist versions of Islam (Pal 1999:43). The most consistent support for Islamization has come from the judiciary, which has in fact led IPE since its inception. It has successfully resisted the delaying

tactics of the government over years by finally awarding the landmark anti-Riba judgement (Chapter 4). The overall attitude of state towards IPE remains ambivalent as evident from its official policy of financial liberalization and its borrowing practices (Chapter 7). The most important state elite, military has apparently changed sides from an agent of Islamization during General Zia to an agent of modernization during General Musharraf (Chapter 4).

### **Societal Interests**

In the context of IPE, we include business elite, political parties, landlords, and religious groups in the societal interests. The business and financial elite in Pakistan is largely trained according to neo-liberal and pro-capitalist models. Their reaction becomes intense when a religiously inspired policy reform seeks to change the very rationale and methodology of business. Therefore bankers in Pakistan, with the exception of those who work in the Islamic banks, at worst do not believe in the viability of an interest-free regime, and at best remain indifferent towards these changes.<sup>11</sup> On the other hand, Islamic banks and financial institutions has outlined the need for capacity-building in the area of Islamic finance by building training centres.

### Political Parties

Political parties, like governments in various times, have always shown their commitment with Islamic ideals. Even parties with socialist agenda such as Pakistan Peoples Party professed 'Islamic Socialism', when it came to the economic system they pledged in elections of 1971. Conservative or right wing parties like Pakistan Muslim League have formed successful coalitions with the religious parties to come to power (see Table 5.1). Most of political parties maintain their special *Ulama* wings to keep close contact with Islamic groups.

### Landlords

Seventy percent of Pakistanis still live in rural areas and most are influenced, in one way or another, by powerful landlords. Traditionally landlords have made coalitions with the ruling parties and in most of cases the appointment of local religious leaders is influenced



by their preferences. In the context of IPE, they become important as Zakat imposes one-tenth deduction from their farm income. But this has been the weakest component of implementation of the Zakat policy because landlords have virtually refused to pay Zakat. In fact the system of collection of Zakat from them (Chapter 6) is too weak to get any meaningful amount. Landlords also have close connections with moneylenders, if they are not so themselves. Money lending is a private activity in the rural areas that exploits poor farmers but still remains outside the official anti-Riba campaign (Chapters 7 & 8).

### Religious Groups

Islamization is a dream-come-true for all Islamists regardless of their varying ideological dispositions. The mode, intensity and direction of Islamization depend partially on which religious groups have access to power. This is aptly demonstrated in the case of IPE that has been closely associated with Jama'at-e-Islami. This arch religio-political organization is democratic, constitutionalist and progressive in its ideology and structure and its association with the military dictatorship under Zia is considered as a compromise in its original political vision (Ahmad 1991). Its legalist approach towards Islamization has implied an emphasis on constitutional amendments, legal frameworks and institutional set-ups. It can be concluded, therefore, that if a more un-democratic, pro-militant Islamic group gains influence on power, the Islamization process would become more assertive and pervasive. The authority of Islamists on public policy has been exerted as a pressure group and restrained due to their consistent electoral failure (see Table 5.1).

IPE suffered a major symbolic blow when the Shi'ite community – a heterodox religious minority in the Islamic world – reacted to the imposition of compulsory deduction of Zakat (Kuran 1993). Resisting the Zakat policy through the platform of *Tahrik-i-Jafria*, the political manifestation of Shi'ites in Pakistan, they undermined the inclusiveness of Zakat policy. Subsequently they were exempted from payment of Zakat for which they just had to submit a declaration at the bank.

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<sup>11</sup> This impression is based on my interviews with various bankers working in the private and public sector.

Zakat policy officially recognizes students and institutions for religious learning – *madrissahs* – as legitimate recipients of Zakat funds (Clark 2000:209). Although these *madrissahs* no longer depend upon Zakat funds and largely rely on private funds from local and overseas sources (Stern 2000:119), their mushroom growth coincided with the introduction of Zakat policy (Wink 1991:37). Thus IPE has provided a sound economic base for expansion of Islamists' influence in the society. The role of these religious schools in the increasing militarization of Pakistani society, especially in wake of Afghan war, is widely acknowledged (Stern 2000).

<b>Table 5.1: General Elections in Pakistan</b>						
	<b>Seats in the National Assembly: 1970-1996</b>					
	1	2	3	4	5	6
<b>Party/Alliance</b>	<b>1970</b>	<b>1977</b>	<b>1988</b>	<b>1990</b>	<b>1993</b>	<b>1996</b>
Awami League	151 (52%)					
Pakistan Peoples Party	81 (28%)	155 (77.5%)	93 (45%)	44 (36.83%)	89 (38%)	18 (23%)
Pakistan Muslim League (Alliances)	18 (6.2%)	36 (18%)	55 (26.5%)	106 (37.37%)	71 (43%)	137 (49.5%)
Islamists (combined)	18 (6.2%)				3 (3.33%)	Boycott
Others	7 (2.4%)	1 (0.5%)	17 (8.21%)	24 (9.95%)	28 (9%)	30 (12.5%)
Independents	16 (5.5%)	8 (4%)	40 (19.32%)	22 (10.3%)	16 (7.28%)	21 (15%)
<b>Total</b>	<b>291</b>	<b>200</b>	<b>207</b>	<b>207</b>	<b>207</b>	<b>207</b>

- Entries in parenthesis in Columns 1-3 show percentage of seats obtained in the National Assembly
- Entries in parenthesis in Columns 4-6 show percentage of votes obtained
- Highlighted entries in Columns 2-4 indicate alliance of Muslim League, Islamists and other conservatives
- Electoral performance of Islamists have been combined with exceptions. Despite boycott by major Islamists in last elections, one small Islamic party, Jamiat-Ulema-Islam (F) won 1 seat.
- The Awami League was largely based in East Pakistan, which seceded in 1971 to form Bangla Desh.
- Smaller factions of the Muslim League and Peoples Party have been included in 'Others'.

### Common People

In the context of IPE, we can identify two groups of stakeholders amongst common people: the poor in the case of Zakat policy and depositors for interest-free banking. By a conservative official account, the poverty rate in Pakistan has grown alarmingly from 17.3% in 1987 to 32.6% in 1998 (GoP 2000:46). Islamization of the economy, through

the instrument of Zakat, is targeted at the alleviation of poverty. Thus an increase in this fund would be beneficial for the poor. However, Zakat is also used as a device of political patronage since the list of recipients changes with political change. Zakat committees – about 40,000 in total that each consists of seven to ten notables of the locality – have become important players in local politics, especially in the larger rural areas of the country (Clark 2000). Although comprised of volunteers, the access of Zakat committees to public funds and their essential role in identification of the poor give them political leverage.

On the other hand, the common depositors in banks are likely to be discouraged by the elimination of a fixed rate of return – especially when loss accrues, which is an expected outcome of Islamic banking. But like any other state-sponsored programme, interest-free accounts receive explicit and implicit support to avoid transfer of loss to the depositors (Gieraths 1991). Thus the stakes of depositors remain protected.

### **Coalitions of Policy Elites**

Policy elites interact and build alliances to pursue common agenda. In the case of IPE, Islamists have demonstrated political acumen in making alliances with the military and political parties. A “Fundamentalist-Military Alliance” (Mayer 1993:132) was formed during the Zia regime. This so-called alliance re-surfaced in the form of an alleged Islamists’ coup from within the military, code-named Operation *Khilafat*, during Prime Minister Benazir’s second term in the office (1993-96). The convicted officers faced court martial and were awarded rigorous punishment. It is believed that Zia consciously encouraged the inflow of conservative, lower-middle class youth as commissioned officers (Rizvi 2001:207). New coalitions have also emerged in anticipation of the demand of training in Islamic finance. To cite one example in Karachi, the Al-Meezan Investment Bank, the Institute of Business Administration, and Dar-ul-Uloom (The [Islamic] House of Knowledge) have started a joint certification programme on Islamic Banking (*Pakistan Economist* 2000). Thus IPE has come to favour Islamists socially, politically and economically.

## **Characteristics of Reaction to Policy Reform**

Policy characteristics determine the nature and location of reaction to a policy reform. The costs of reform in the banking system under IPE will be dispersed widely in the society through the investors, but more intensely through the depositors. Thus the reaction would come from the public. Through imposition of Islamic taxes and their restructuring, the government aims at expanding the safety net for the poor by direct cash assistance. Therefore, the poor people support the imposition of Zakat.

Technically the Islamization of the economy is a highly complicated process, involving painstaking experiments at all levels in fiscal and monetary policy. The public rarely reacts to such changes because it cannot readily understand its impact whereas the bureaucracy, which supposedly not only understands but also implements it, is offering resistance because the policy reform demands changes in their style of thinking and decision-making. The Islamization of banking laws demands extensive participation, which invites reaction. Getting broad-based support becomes increasingly difficult. As the impacts of the Islamization of the economy cannot be seen in a short time, there is almost no reaction, positive or negative, from the public. Had the public experienced these impacts, either by an observable reduction in the poverty level or by an increase in the investment scale, or even by the accrual of a loss on their deposits, they would have reacted sharply and strongly.

## **Conclusion**

We have established that the economic reforms sought by IPE are complex and this complexity weakens the implementation process. The lack of appropriate skill and training to understand and implement Islamic finance has also hampered the speed of implementation. On the other side, Islamization has enjoyed explicit political patronage or at least has not faced overt political resistance. Islamization has broadened the influence of Islamists in the society and on the state but this influence is not reflected in electoral results. The bureaucratic response remains ambivalent, due to differences in perceptions and ideological dispositions. Islamization has occurred and continues to

thrive on tensions between its supporters and opponents spread among various stakeholders.



## **Chapter 6**

### **Zakat and Poverty Alleviation Compared *Implementation, Performance and Outcome***

This chapter reviews the implementation process of Islamic policies for income transfer and the redistribution of wealth i.e. Zakat, Ushr and Bait-ul-Maal. This review puts two questions. First, the output issue: what has Zakat and Ushr administration delivered in terms of its structure? Second, the outcome issue: to what extent have Zakat and Bait-ul-Maal reduced income inequity and alleviated poverty? It delineates problems in implementation according to the Grindle & Thomas and Björkman models explained in Chapter 2. Consistent with the research objectives, this chapter focuses on the ‘politics of Zakat’ by raising issues of power, authority and patron-client relationships.

#### **Policy Analysis**

##### **Policy Objectives**

When General Zia promulgated the Zakat and Ushr Ordinance of 1980, he called it an ‘essential pillar of Islam’s welfare system.’ It stems from the central rationale of IPE, i.e. social justice (Chapter 3). The primary objective of Zakat policy is to assist the needy, the indigent and the poor (Clark 2000:199). Other important objectives were (1) economic rehabilitation of those who can work, (2) elimination of beggary and (3) redistribution of wealth in society. Broadly speaking, Zakat would not only serve as a measure to reduce income inequity but also as an additional source of state revenue. It is my contention that an unstated but important objective behind the imposition of Zakat was to enhance the legitimacy of the military government, which it sought on the promise of establishing an “Islamic system”. This policy appealed especially to the conservative, lower-middle and religious-minded segments of Pakistani society on which the military government relied for popular support.

## Output: Administration and Distribution of Zakat

Traditionally and historically, with the exception of first four decades of Islamic history, Zakat had been an individual responsibility while the role of the state was almost eliminated. Thus the Zakat and Ushr Ordinance of 1980 was seen as a radical reversal in order to identify the system with its original Islamic spirit. The state increased its political penetration by taking the collection and disbursement of Zakat funds into its hands. Traditionally every financially capable Muslim would pay his share of Zakat at a fixed time each year on a self-assessment basis. Shari'ah emphasized spending on needy people in the family and in the neighbourhood. Thus Zakat money remained confined to either extended families or communities, which strengthened the mutual ties of society. The centralization of Zakat reversed this centuries-old, community-centred procedure. The state argued that this system would facilitate actual transfer of wealth from richer to poorer communities as well as standardization and expansion of the revenue base (Kuran 1993:322). Practically, however, even under the state's control, Zakat remained community-centred and decentralized because it was disbursed through local voluntary committees set up for this purpose. The process of collection and disbursement is shown in the figure 6.1.

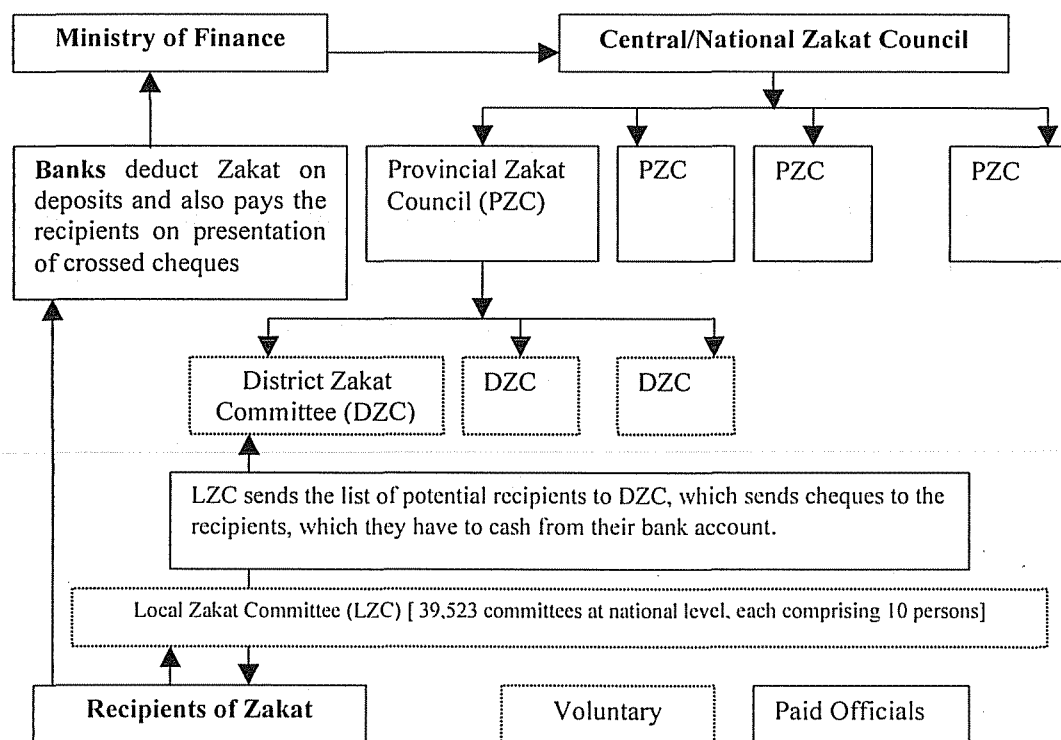


Figure 6.1: Procedure of collection and disbursement of Zakat



This elaborate system of distribution follows the principle of decentralization and community empowerment but brings its own costs. The minimum number of total personnel working in this combination of voluntary and paid jobs i.e. 400,000 is roughly the same as the number of Zakat recipients nation-wide. After the recent redesign of the Zakat system that seeks to give a grant of Rs 50,000 (US\$ 814<sup>12</sup>) per person as one-time cash assistance to start up a business, the number of recipients would be reduced to 100,000 (*Dawn* 2001b). That would bring the ratio of Zakat personnel to Zakat recipient from 1:1 to 4:1, which would lead to a possible reduction in the number of Zakat committees to match the decrease in the number of recipients or worse, it would increase the cost of human efforts involved in the process.

The administration of Zakat and Ushr follows a long yet simple chain of command and does not involve the complex calculations entailed by normal tax systems. Zakat is deducted from bank accounts each year on a fixed date (First Ramadan – the month of fasting) at a pre-determined rate (2.5%) and sent to the Federal Ministry of Finance. The Ministry sends the money to the Zakat Administration that distributes it through district and provincial bodies according to the demands received from the local committees. Zakat includes a flat rate of 5% as tax on all agricultural produce, which is collected at the local level. This simplicity should help to achieve the desired outcomes.

Over the years this system has seen a number of changes. Payment through cross cheques was adopted in 1991, which caused complications for the rural poor who rarely have access to a bank and also suffer from the minimum deposit requirements of the banks, which varies from Rs 500 to Rs 1000. Such an amount is not substantially less than the actual quarterly payment, i.e. Rs 900 that an average recipient receives. Although the system reduced the chances of corruption by issuing the cross cheques directly to the recipients, it shifted a significant portion of the cost back to the recipient due to the minimum deposit requirement and transportation costs. Previously, the recipients used to receive the money in cash in their own communities through LZCs. Thus over the years

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<sup>12</sup> US\$1=Pak Rs 61.45 on 31 October 2001 (*Dawn*)

the net financial gain for a recipient was not substantial despite an increase in the disbursement amount.

An institutional change was *Bait-ul-Maal* (public treasury) established by the Nawaz government in 1992 as a separate institution for giving payments to the poor. This institution was funded directly from the federal budget and enjoyed strong political and bureaucratic support for being a part of the regime's agenda for the welfare of the poor. As it did not depend on Zakat receipts, the government exhibited relative flexibility in its spending, which now included even the non-Muslim poor (Clark 2000:208).

### **Location and Intensity of Reaction**

In 1994, the Central Zakat Council was brought under the Ministry of Finance from the Ministry of Religious Affairs and the requisite external audit of the Zakat fund was dropped. Later, in 1995, the Benazir government dissolved all the local Zakat committees and restricted the disbursement function to the federal government. It led to an egregious suspension of the disbursement of the Zakat fund for three continuous years until 1998, which was a gross misconduct both morally and legally. This suspension of the grant, however, did not lead to any unrest or even protest (ibid:210), which suggests that the recipients of these grants were not desperate for them. It also indicates the possibility that many Zakat recipients were not actually poor but were enlisted due to political reasons. According to the model of Grindle and Thomas (Chapter 2), if poor people were getting significant benefit from Zakat, they should have reacted strongly upon losing it.

Zakat and Ushr administration has been funded by the Federal Consolidated Fund reserved for the administrative expenses of civil servants. It does not depend on the amounts received as Zakat although, according to Islamic law, not only the Zakat and Ushr Administration but also the whole state can spend Zakat funds to run its machinery. Concentration of costs within the bureaucracy reduces the possibility of any intense reaction from the public. But when the imposition of Ushr affects influential stakeholders such as landlords, they sternly react and practically refuse to pay their dues. That is why the amount collected through Ushr is nowhere mentioned in the official balance sheets

whereas the amount collected as Zakat always remains significant. If the Zakat deduction is also made voluntary and collected through local communities like Ushr instead of through bank deposits, one wonders what will be the result in terms of collection. It is my contention that, for one reason or another, people would react more readily as the deduction would be considered immediate and obvious. Zakat policy has faced a more explicit and severe resistance, and was ultimately altered for the influential Shi'ite minority when it challenged their religious beliefs. Thus, as Grindle and Thomas (1991) predicated, the contents of the policy process do affect the nature and location of reaction.

### **Implementation Analysis of Zakat Policy**

The implementation of Zakat policy is analysed according to the 'Interactive model' that includes both intended and unintended consequences (ibid). Its intended consequences are examined because the outcome of Zakat policy for poverty alleviation and unintended consequences are considered to have social and political effects on the system.

### **Outcome: Zakat and Poverty Alleviation**

Table 6.1 shows the heads and percentage of allocation along with Zakat funds collected in 1999-2000.

<b>Disbursement Heads</b>	<b>Percentage 1999-2000</b>	<b>Amount Allocated (billions of rupees) 1999-2000</b>
<b>Total</b>	<b>100</b>	<b>2.18</b>
Subsistence	60	1.31
Educational scholarships	18	0.39
Scholarships for religious training schools	8	0.17
Health institutions	6	0.13
Social welfare rehabilitation	4	0.09
Dowries for orphan girls	4	0.09

**Table 6.1: Zakat: Relative and Absolute Allocation**

Source: *Economic Survey of Pakistan 1999-2000*  
Total Zakat Fund: US\$ 35.48 millions

Official and semi-official evaluations of Zakat policy suggest that the system has helped to decrease the poverty gap by two to three percent and to raise the living standards of the lower income group (Clark 2000:214). It has at least helped to enlarge the choices for the poorest of the poor – the main recipients of Zakat (ibid). Taking the most widely used caloric-based poverty (headcount ratio), and depending upon the modest official documents, the incidence of poverty declined sharply from 46.5 percent in 1969-70 to 17.3 percent in 1987-88. Afterwards, the incidence began to grow again and in 1998-99, it stands at 32.6 percent. If someone were to pick the poverty rate in 1980 when the Zakat and Ushr Ordinance was promulgated, it would be easy to conclude that the poverty has declined.

However, that would be an attribution error as Pollitt (1955:137) would warn. First, it is the same period in which Pakistan enjoyed generous aid from the United States and Saudi Arabia during the Afghan war, and also heavy remittances from Pakistanis working abroad (Husain 1999:7). Second, the declining trend in the poverty ratio started immediately after the industrial revolution under Ayub Khan in 1969 (GoP 2000:50) and hence cannot be exclusively associated with the Zia era. Third, if Zakat were to have a positive correlation with decline in the poverty rate, then the sudden rise in poverty after 1988 cannot be adequately explained because Zakat collection continued to grow after a decline of three years (Ibid:appendix 49). In fact one of the main reasons for the rising rate of poverty in the 1990s can be attributed to the gradual decline in development expenditure, which fell from 6.4 percent of GDP in 1990 to 3.2 percent in 1999 (Ali and Bari 2000:49). Therefore, the claims of a *significant* positive correlation between growth in Zakat funds and a decline in absolute or relative poverty become questionable when subject to academic scrutiny.

The poverty line in Pakistan, i.e. the minimum income needed to meet basic needs, was estimated to be between Rs 800 and Rs 1000 per month in 1999 (Clark 2000:215). Zakat receipts in the same year per person averaged Rs 6250 per annum or Rs 520 per month. It means that, on average, Zakat amounts to 58 percent of the income needed by recipients to cross the poverty line. However, Zakat recipients (400,000 in total) are a meagre 0.93

percent of the total number of poor in the country, who have reached the alarming figure of 42.5 million. The present government has decided to reduce the number of recipients to 100,000 to encourage a meaningful amount for the short-listed. This is a positive step as far as economic rehabilitation is concerned, but that would also imply that 300,000 poor people would probably go below the poverty line again.

The government of Pakistan acknowledges that the reduction in the poverty rate over last decades is largely due to “inherited values” and “unintended and intended beneficial policies” (GoP 1999:5). An independent study confirms this claim by arguing that the “private transfers are currently the main means of protecting the economically disadvantaged” (Husain 1999:197). One can deduce that the Islamic spirit of sacrifice and brotherhood inspires while the extended family system facilitates these private income transfers.

### **Unintended consequences**

Zakat policy has resulted into many unintended social, economic and political consequences. The committee-based system of Zakat distribution brought to the fore the problem of patron-client relationships. Thus people who could access the local Zakat committee chairperson by ‘the right connection’ would be declared as more needy than others (Kuran 1993:323). Political parties in power use the respectable position of Zakat committee chairpersons to favour their allies and supporters. Dailies often report how a chair exploits his position to extend benefits to some of his own relatives (Jang 2001). Other doors of corruption in the disbursement, which started to grow after the death of President Zia in 1988, included appropriation of the funds for personal use by LZC members, shoddy record-keeping, and favouritism (Clark 2000:207). An important unintended beneficiary, especially from the changes in 1991, is the banking system itself, which benefits from the money deposited in anticipation of later being giving away to recipients. Since every beneficiary has to open and maintain a minimum account deposit of Rs 500, the total figure comes out to around Rs 200 million.

As the case of Zakat policy reveals, unintended consequences are not necessarily negative. After the imposition of Zakat at the state level, it has become a social issue and

its collection and disbursement have become a moot point among Islamic scholars and social development actors. Thus it has not only generated healthy debate on the possible expansion of Zakat heads but has also attracted private and non-governmental social welfare organizations to claim their share from Zakat. Many of the leading organizations such as the Shaukat Khanum Memorial Hospital and the Qarshi Foundation now depend heavily upon Zakat receipts to meet their expenditure, which they use in various projects of social importance. It is my contention that if Zakat were not brought into the limelight by the state, its use would have been limited to meeting consumption needs of the needy in the family and the community and its social and institutional significance could not have brought to the fore. Thus Zakat policy has diversified the resource base for social development organizations. Another positive consequence of the Zakat system is the creation of more jobs at federal and provincial levels because it is now administered by an independent ministry. Besides formal employment, its distribution system has also created avenues of social service for local volunteers.

### **Problems in Implementation**

Implementation of a policy could face any or all of three possible types of problems: dispositional, capacity and communication (Chapter 2). The Zakat system in place depends on extensive and honest participation by the public and, as the Grindle and Thomas model suggests, this would not allow implementation as desired. Many depositors withdraw heavy amounts from banks just before the Zakat deduction date in order to lower their deposits below the minimum amount. Many others take advantage of the jurisprudential exemption of Shi'ites from payment of Zakat and declare themselves Shi'ite on bank papers, which bars the bank from collecting Zakat from them (Husain 1999:198). This practice results from a dispositional difference of people who do not consider the state as a legitimate institution to use a sacred trust. However, the rather simpler and common phenomenon of tax evasion due to corruption cannot be gainsaid in the case of Zakat deduction. Furthermore the capacity of local committees to collect Ushr from powerful landlords has undermined the success of Ushr policy. Landowners in Pakistan are simply too powerful to be persuaded by voluntary obligations such as Ushr.

One of my hypotheses was that a public policy, if introduced as Islamic, would attract larger public support in a country like Pakistan (Chapter 1). However, Ushr, the land-tax component of Zakat, has dismal results as a policy: the total revenue collected under this head in 1993-94 was a paltry sum of Rs 200,000 (US\$ 3255) (Husain 1999:198), a figure so negligible and embarrassing that it is nowhere mentioned in the official balance sheets. Thus it creates doubts about our hypothesis that an Islamic public policy has a greater chance of being implemented.

## **Conclusion and Recommendations**

The Zakat and Ushr system combined with Bait-ul-Maal collectively constitute the only formal channels for income transfers in Pakistan (ibid). Hence their importance cannot be gainsaid. Though the government has started to depend heavily on foreign-assistance based Social Action Programmes (SAPs) for human development, the Zakat and Ushr administration remains a potentially indigenous yet unexplored source of human development through direct income transfer. If the collection and disbursement heads of Zakat could be expanded – a possibility that many modern scholars have worked out (Saleem 1995) – this indigenous resource could play a key role in income transfer and, subsequently, in the redistribution of wealth.

Zakat significantly alleviates the poverty of an insignificant number of people. But the output of Zakat as a public policy is much more noteworthy than its outcomes. It has created a large implementation machinery whose contribution to poverty alleviation is negligible, but which nevertheless has created more jobs. This can be said of the overall Islamization project as well. It has created momentous legal and institutional infrastructure with a lot to cover on ground. It remains dependent on the choices made by any incumbent regime in terms of budgetary resources and political support.

## **Revamping Zakat System**

Restructuring the Zakat system has been routinized. Every new government, whether military or democratic, has come up with new proposals for collection and disbursement methods. Thus the Zakat system has been dynamically changing. It has the potential to

become an efficient means of income transfer for poverty alleviation. Over the years, it has become more complicated, especially after adding the banks as channels. This channel has also reduced the net amount that recipients get. Thus it is important to revert to a cash-based system by increasing the component of local community. It is understandable that a cash-based system would invite more chances for corruption than a crossed-cheque system, but it can be countered by more monitoring at the local level. The military government has instituted a new local government structure throughout the country. It should effectively employ local bodies to monitor and participate in the Zakat collection and disbursement procedures.



## Chapter 7

### **Riba Eliminated** ***Illusions and Prospects***

This chapter discusses the viability of an interest-free regime and the performance of Islamic financing instruments. It examines the hypothesis that alternative Islamic financing instruments offer competitive rates of return. This discussion follows the same structure as adopted in the preceding chapter on Zakat policy by delineating the outputs and outcomes of the Islamization of Pakistan's Economy (IPE), problems in its implementation and the politics of policy reform. It explains the location and intensity of reaction from various stakeholders to IPE. It also highlights the possibilities and constraints of Islamic finance in a global capitalistic world. The chapter concludes with a discussion on policy implications for the banks in terms of procedural and substantial requirements.

#### **Policy Analysis**

##### **Policy Objectives**

The primary objective of IPE is the elimination of Riba and the enforcement of alternative Islamic financing instruments. The central rationale behind this emphasis is the principle of social justice, which is arguably abandoned in the interest-based system. The rationale of social justice in this case leads to the principle of sharing profit and loss between the investor and the entrepreneur (Chapter 3). This principle leads to the creation of many new instruments and the revival of some ancient ones, which Islamic banks have adopted and launched.

##### **Output: Islamic financing instruments and banks**

For depositors, the alternative instrument is the profit-and-loss sharing (PLS) account. These were first introduced in scheduled banks in 1981 alongside traditional bank accounts. By 1985, this duality ended and only interest-free PLS accounts were

entertained. Gradually the branches of leading international banks like Chase Manhattan, Deutsche Bank and Citibank started providing interest-free financial services to their clients. Like bank deposits, Islamic finance was applied to trading, financing and investment areas. To meet this end, the State Bank issued twelve permissible modes or instruments. The most popular modes are *Murabaha* (mark-up), *Ijara* (leasing), and *Mudaraba* (project venture).

Besides Islamic accounts in 'secular' commercial banks, IPE paved the way for the establishment of separate Islamic banks and Islamic funds and stocks in the financial market. The initiative came from the private sector both inside and outside Pakistan especially from the oil-rich Gulf countries. Currently there are four investment banks (out of 16) and two private scheduled banks (out of 15) working on Islamic principles (GoP 2000) in Pakistan. Besides, numerous companies have floated Islamic stocks in the kurb market.

#### Faysal Bank: A micro-case study of Islamic Banking

With a net profit of Rs190 million in the second quarter of 2001, Faisal Bank leads the investment banks of the country (*Jang* 2000). It is sponsored by a Bahrain-based group of Islamic financiers heavily supported by the Saudi royal family. In an interview with the author, a senior official explained that in one year, the actual rate of return was 0.5 percent less than the declared and expected rate, an accepted practice in Islamic banking. This change was received with protests from the investors, including a prominent Islamic political party. The official also said that the bank heavily depends on external financial support from its parent company; otherwise, if it only looked to domestic investment, it would have to report losses. The banker also noted a trend in some leading business concerns like Sitara Group, Chaudhary Dairies etc. to turn completely to interest-free financing even if it entails losses for the companies. However, the sustainability and replicability of this trend remains questionable as these companies are financially very strong and have enjoyed decades of tremendous growth.

### **Location and Intensity of Reaction**

Over a course of twenty years, PLS accounts have not transferred any loss to the account holders although the rates of return have varied across nationalised scheduled banks and private banks (see table 7.1 below). As key players in the banking system, the depositors have therefore not reacted to Islamization of banking, either positively or negatively, because it does not bring any significant change for them. This confirms the earlier notion in Chapter 2 about the location of reaction to a policy reform (Grindle and Thomas 1991).

As earlier noted the reaction of the state towards IPE has remained ambivalent (Chapter 5), an ambivalence most obvious in the case of the elimination of Riba. The *Economic Survey of Pakistan* talks about financial liberalization, restructuring of interest rate structure, the link between the interest rate and investment etc. but remains indifferent to the issue of eliminating interest from the economy (GoP 2000: 79). It seems that the country's economic managers are aloof to the anti-Riba decision of the Supreme Court, which was awarded six months before the Survey. Similar ambivalence is observed in the government's borrowing practices, for example, the government started depending upon non-bank borrowings to avoid the label of interest-based financing (Husain 1999). However, all the new instruments like defence saving certificates and national saving schemes were interest-based.

After the 1999 anti-Riba decision of Supreme Court, the private sector has increased market-friendly interest-free financial services. One example is that of Citibank N.A., which has introduced 'Karobar Accounts' – interest-free deposit accounts. In an interview with the author, a bank official revealed that this scheme has registered an enthusiastic response from middle class businessmen and the bank is facing difficulty in managing the increase. The official, however, attributed the success of the scheme to the extensive free services that the bank offers and did not count its 'Islamic character' as a main reason. Moreover, just keeping deposits without paying any kind of interest to the depositors make good business sense because the bank does not need to charge for its services due to the economies of scale it has achieved. On the other hand, the same bank

does not grant interest-free or PLS based loans because those go against its commercial interests.

## **Implementation Analysis**

### **Political and Bureaucratic support**

Politics lies at the heart of implementation. Islamization of the economy is a part of a greater process started under the military regime in 1977 (Chapter 4). Thus it should be viewed as a way to enhance the legitimacy of the government. Although the state on whole has remained ambivalent towards IPE, its vital institutions like the military and civil bureaucracy and the judiciary have provided constant political support during implementation of IPE. The state has, for example, provided tax relief on the income of Islamic accounts and imposed additional taxes on interest-bearing accounts in the early 1980s (Gieraths 1991:72). The judiciary has played a special role, particularly during the democratic era (1998-99), by awarding anti-Riba judgements on various occasions (Chapter 5). Thus Islamization has occurred with strong political support but it has been undermined by the complexity of the reform process and the lack of capacity in the concerned quarters.

### **Outcome: comparison of rates of return**

The introduction of Islamic forms of bank deposits enlarged and diversified the market of financial instruments. Until 1985, when both types of accounts existed and an environment of competition was present, the rates of return offered by profit-and-loss sharing accounts were comparable with those offered by the commercial banks (Gieraths 1991). However, as the interest-bearing accounts were completely abolished, the rates of return on Islamic accounts declined. It seems that the success of PLS accounts follows the universal principle of market competition.

Almost all the scheduled banks, whether nationalised or denationalised, have reported a fall in the rate of return on average from 7.81 percent in 1995 to 6.34 percent in 1999 (*Economic Survey* 2000). The average rate of return for the same period in private banks

has increased from 9.3 percent to 9.99 percent, while it has declined from 9.4 percent to 8.4 percent in foreign banks (see table 7.1).

Nationalized and Denationalized Banks							Private Banks					Foreign
S.A.	ABL	HBL	MCBL	NBP	IDBP	Ave.	Union	Gulf	Askari	Faysal	Ave.	Foreign Ave.
'95	8.0	6.5	8.3	8.6	8.0	7.81	9.0	10.5	9.0	9.5	9.36	9.4
'96	8.5	6.5	8.5	9.0	8.0	7.95	9.5	11.5	9.5	9.8	9.86	10.0
'97	8.0	7.5	8.4	8.5	8.0	7.8	10.0	11.5	10.5	10.8	10.3	10.4
'98	7.0	7.5	8.0	8.0	8.0	7.44	13.2	11.5	11.0	10.9	10.8	10.8
'99	5.7	6.0	6.0	7.0	8.0	6.34	11.6	11.5	9.0	8.8	9.99	8.4

**Table 7.1: Comparison of Rate of Return on Bank Deposits in PLS Saving Accounts (S.A.)<sup>13</sup>**

This means that the rate of return on PLS accounts does not depend solely on their Islamic nature but also on particular banking practices. In 1999, all banks reported declines in their rates of return, which can be attributed to economic sanctions imposed on Pakistan and freezing of foreign currency accounts after its nuclear experiments in May 1998. Thus the Islamic character of savings accounts is mixed with endogenous and exogenous factors and is not the sole determinant of rates of return.

The performance of Islamic modes of financing has been quite commendable and competitive, at least at domestic level. The weighted average rate of return on Interest-bearing Advances for Precious Metal, Stock Exchange Securities, Merchandise, Real Estate etc. has slightly increased from 13.08 percent in 1995 to 14.22 percent in 1999. The rate of return by Islamic modes for Advances for the corresponding time period on the same items has risen from 14.27 to 14.44 in 1999 (see Table 7.2). The private sector Advances show similar trends (GoP 2000). Thus we can conclude that Islamic modes of financing offer competitive rates of return and diversify the financing base for both the

<sup>13</sup> The "Ave." column shows the average calculated for all the banks while figures from all the banks have not been included for simplicity. *Source: Economic Survey 1999-2000.*

public and private sector. This confirms our earlier contention that market competition encourages Islamic finance to prove its worth.

	Precious Metals		Stock Exchange Securities		Machinery		Financial Obligations		Total	
As in June	Interest based	Islamic Finance	Interest based	Islamic Finance	Interest based	Islamic Finance	Interest based	Islamic Finance	Interest based	Islamic Finance
1995	13.89	14.24	12.66	16.45	14.28	14.68	13.30	14.70	13.19	13.80
1996	12.50	16.32	13.58	16.50	14.92	15.28	13.66	15.76	13.04	14.48
1997	11.55	11.68	15.35	16.57	14.44	13.87	13.95	15.99	13.53	14.65
1998	14.47	15.87	16.38	16.61	16.12	16.39	16.32	15.21	16.09	15.59
1999	13.39	11.27	14.15	15.69	15.19	15.75	14.95	14.49	14.47	14.83

**Table 7.2: Comparison of Rates of Return:  
Interest bearing and Islamic modes of financing**  
Source: *Economic Survey of Pakistan 1999-2000*. Islamabad

### Comparison amongst various Islamic modes

Islamic finance permits as many as twelve forms of financing, trading and investment. Religiously speaking, Mudaraba (project venture), which is a type of Musharaka (profit and loss sharing), is the most desirable method while Murabaha (mark-up or cost-plus) is the least desirable due to its highest degree of similarity with interest-bearing modes. The figures reveal a different picture, however. The banks have adopted Murabaha as their main mode of financing and Mudaraba and Musharaka have been shelved (Gieraths 1991:64). A study of the World Bank confirms this notion, which states that about 75 percent of Islamic financial transactions are Murabaha, 10 percent are Ijara and 15 percent are Mudaraba, Musharaka and others (Iqbal 1997:3).

The excitement of Islamic bankers deflate when, in the light of above figures, Islamic financial instruments are termed as 'false dawn.' The fact remains that after imposition of Islamic laws in Pakistan, banks were permitted to invest their PLS accounts in the interest-based government securities (Hassan and Azfar 2001). Thus the whole rationale of indeterminacy of returns was turned on its head. That also resolves the query that why Islamic accounts did not transfer losses to their depositors. Thus 'instead of a revolution of Islamic finance, there had occurred only a shift in nomenclature' (ibid). This means

that market competition does not always lead to a desirable choice for Islamic finance and religious considerations are put aside when survival and growth becomes essential.

### **Unintended consequences**

The effectiveness of Islamic banking largely pertains to the assessment of projects and the participation of banks (Haque 1987:443) and thus depends on the availability and accuracy of information about the enterprise. This has a number of unintended consequences, both positive and negative. Under the Islamic system, the role of banks as investor inflates and constant monitoring of a system becomes a necessary condition. It has multiple effects: the entrepreneur comes under constant pressure and scrutiny from the bank because the latter could not afford to bear any loss, thereby curbing the freedom of the enterprise. This would become even more difficult in the case of long-term development projects. Islamic banking would require a greater role for the central bank in day to day operations of commercial banks. This practice militates against the essence of a deregulated environment that is so often emphasized in financial reforms.

On the positive side, it results into an efficient solution because no bank would engage in politically patronised projects with little commercial prospects. Another key requirement in Islamic banking is the need for skill development among bank staff for accurate project assessment. As a bank would always risk a net loss if a project failed, the bank would have to scrutinise the actual worth of the project in greater detail. It would mean an increase in the number of training centers tailored to the needs of Islamic finance, which implies more employment.

Islamic banking is heavily dependent upon ethical business practices. Abolishing interest as security for returning a loan requires that investors and entrepreneurs should report both profit and loss honestly. If an entrepreneur falsely shows a loss, it will be unjustly transferred to the bank shareholders and depositors, which would make the banking system unfeasible. Similarly, in the case of *Qard-i-Hasna* – interest free loans – the probability of bad debts would increase because the borrowers would be under no pressure to pay the penalty for a late payment or even for bankruptcy. The culture of

petty and grand corruption in Pakistan severely undermines the prospects of successful Islamic banking.

### **Problems in implementation**

The Björkman model of implementation analysis (Chapter 2) explains the problems encountered in trying to eliminate Riba. Dispositional problems are most pertinent and foremost because deep controversies exist among Islamic scholars but especially between Islamic scholars and ‘secular’ economists over alternative mechanisms. Each group has stakes in its position and any change in their respective positions could reduce their legitimacy. The lack of communication between the two groups also decreases the consensus on a specific method or framework of reform.

This problem goes back to the dual yet contradictory systems of education in Pakistan, wherein one stems from traditional and other from secular sources. In practical terms, Islamic finance is severely hampered by the lack of capacity, i.e. an insufficient number of economists who are also well versed with the Islamic law or vice versa. One of the most important skills required in Islamic banking is project assessment, which informs decisions by the bank about project proposals. This problem has an institutional background: there are no formal training centers to train bankers about the implications of Islamization for specific banking operations. These dispositional, communication and capacity problems undermine the implementation process. However, these problems open windows of opportunity for new areas of education, training, and skill development. One such example has been described in Chapter 5.

### **Islamic banking in a global capitalist world**

Internationally the assets of Islamic financial institutions cross the impressive figure of US\$ 115 billion at a remarkable growth rate of 15 percent (Warde 2001). As already indicated, the downgrading of the effectiveness of interest rates globally has helped Islamic bankers to argue against Riba (Chapter 3). Recent developments such as “the emergence of new Islamic states in Central Asia, a changing oil market, the rise of Asian Tigers, a growing Islamic presence in the West and the emergence of new Islamic middle



classes” also favour this phenomenon (ibid). There is a Dow Jones Islamic market index that shows the compatibility of Islamic finance at global level. However, to go beyond the financial market, Islamic economics needs much larger space in Muslim countries. The Islamic Development Bank reveals that intra-exports among its member states remain 10.4 percent of their total exports (IDB 2000). In other words, the Muslim countries look to the industrialized countries and other non-Muslim developing countries as their major market and not to themselves. Predominantly Islamic states like Iran, Pakistan, Libya, Afghanistan and Saudi Arabia follow same trend. Paradoxically the exports from less vocal Muslim countries like Syria, Lebanon, Azerbaijan, Kazakhstan, Tajikistan, and Turkmenistan to Muslim countries constitute more than half of their total exports.

## **Conclusion and Recommendations**

This chapter supports our hypothesis that Islamic financing instruments offer competitive rates of return. But this finding is nuanced by many parallel and often contradictory developments. For example how “Islamic” are these Islamic financing instruments? Islamic finance has preferred market choice to religious choice and thus competition has replaced reward in the hereafter. However, it is my contention that both from religious and market perspectives, this development is positive because “there is no compulsion in the religion” (*Qur'an* 2: 256). In the final analysis, Islamic finance has followed the ‘secular’ criteria of consumer choice and, like Islam as a religion, it has survived in the global market by its own merits.

The foregoing analysis has answered the questions raised earlier about Islamic finance (Chapter 1). Nevertheless it has also generated new questions. Like the Zakat system, the output of Islamic finance measured by the number of instruments and institutions is indeed impressive, as Islamic banking continue to growth at the rate of 15 percent. These developments provide reliable support for pro-Islamist governments and for Islamists themselves. Thus the influence of Islamists has expanded from the mosque to the bank and, like Zakat, this has diversified their social and economic base. These developments

have also opened the door of 'Ijtihad'<sup>14</sup> because ancient modes of trade have been adapted and many religious instructions have been reinterpreted. By its own, this is no small achievement as it melts the ice from the intellectual horizon in the Islamic world.

### **Moral Development**

Business culture in Pakistan suffers from pervasive tax evasion, non-documentation, double accounting procedures, and use of frivolous pleas and dilatory tactics by the defaulters (Hassan and Azfar 2001). In such a culture, Islamic banking, despite its tremendous growth and massive infrastructure, cannot take roots in the society. Thus Islamic banks and the government should launch a joint exercise of moral development through education system and mass media.

### **Capacity Building**

The policy reforms that IPE seeks are complex and need different professional training for understanding and implementation. This complexity is inevitable, especially for interest-free banking, which is built on a revolutionary framework. Thus the effectiveness of Islamization in this scenario would depend upon the availability of appropriate skills in the banking culture. Specifically, Islamic banks need experts in project appraisals and product innovation and diversification. These skills also a well-founded exposure to Islamic laws. This combination is rare and needs the collaboration of research institutes, banks and Islamic schools like the example in Karachi mentioned in Chapter 5.

### **Legal Challenges**

It is clear that economic development needs a mature legal framework and Islamic economics is not exception (Hassan and Azfar 2001). In spite of formidable legal developments, transformation of economy according to Islamic precepts still faces serious legal impediments. One of the most important is repeal or amendment in the Section 9 of Banking Ordinance 1979, which currently prohibits banks from trading activities, which is essentially the institutional change required by Islamic banking. The

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<sup>14</sup> Ijtihad, individual reasoning on the basis of the *Qur'an* and the Sunnah, is a source of legislation in Islamic law.

new legislation in this regard should similarly take into account the private foreign financial arrangements, and domestic and foreign debts. As the government itself is the largest debtor of the country, it ought to set example by not exempting, as practised in the past, itself from the enforcement of anti-Riba judgements.

### **Market exposure of Islamic finance**

Islamic banking has received appreciable state support. It was justifiable in the beginning but, after almost two decades of operation, these banks and instruments should be allowed to compete openly with the commercial instruments of investment and finance. The artificial protection of profit-and-loss sharing accounts should be lifted and banks should be allowed to transfer any losses to the depositors. This would reveal the degree of actual public support for an Islamic system. This would also make the banks function more prudently because they would not engage in politically motivated projects with little or no commercial benefits. It must be realized that banking is risky and Islamic banking is more risky, and this difference must be demonstrated in the actual operations of Islamic banks. To make Islamization widely accepted in society, it must be exposed to the risk, like Islamic banking and faith, of material failure.



## Chapter 8

### **The Islamization of Pakistan's Economy** *Conclusions and Policy Implications*

This chapter pulls the threads of a long argument together. It reverts to the original problem statement to see prospects and constraints of Islamization in solving the three-tier behavioural, socio-economic and political problem (Chapter 1). It portrays the 'big picture' of the Islamization of Pakistan's Economy (IPE) and suggests its overall outcome. Commenting on the scope of this study, this chapter identifies some policy implications of the study. It concludes by leaving the question of 'justification by works or by faith?' unanswered but more nuanced.

#### **Theoretical foundation of Islamic Economics**

As explained earlier, *de novo* Islamic economics is theoretically impossible and practically undesirable (Chapter 3). Developments of political, social and economic institutions in Islamic history have been pluralistic and universal. The 'Islamic state' under a 'rightly-guided caliphate'<sup>15</sup> gladly adapted the constitutional framework of the Persian Empire. All the trade practices now labelled as Islamic in fact predate Islam itself and should be viewed as Arabic traditions (Chapter 3) adapted by Islam. In the same spirit, IPE remains pluralist in its approach because it remains open to modern financial institutions like insurance and stock exchanges and produces Islamic versions. In the process it shows that an ideal, self-contained, self-sufficient Islamic economic system cannot exist as it interacts with the outside world. In fact, Islamic economic law provides a filter through which modern financial instruments are passed, altered and then adopted or rejected.

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<sup>15</sup> Reference to the reign of four consecutive caliphs after the demise of Prophet Muhammad, which is considered a golden era in the history of Islam.

## **IPE and its problem set**

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The paper started with a rather simple description of the three-tier problem that IPE has addressed. The ways in which IPE has attempted to resolve this behavioral-socio-economic-political problem have been discussed in the preceding chapters, especially in the last two that addressed Zakat policy and the elimination of Riba respectively. The behavioral problem, i.e. materialistic individualism, received the least attention by the key players because IPE focused on institutions and structures. In this context, the deduction of Zakat is equated with tax evasion behavior (Chapter 6), which signals several things. First, it reflects the lack of trust in the government as the legitimate institution to collect and distribute this vital religious levy. Second, it shows the pervasive corruption in society, which does not exempt even religious transactions. This behavioral problem also undermines the success of Islamic finance because it is an interplay of participation and ethics (Chapters 3 & 7). The only sustainable solution to this problem is provision of meaningful education that is inspired by faith and informed by modernity.

The second important problem that IPE attempts to resolve is socio-economic. On the one hand, IPE presents Zakat as an Islamic policy of poverty alleviation and income transfer. On the other hand, it argues against the economic benefits of interest rates as a treatment for economic ailments (Chapter 3). In the end, IPE could neither offer a reliable system of social justice nor it rectified the failures of 'Developmental' and 'Socialist' Islam (Chapter 4) but it did create its own niche by creating an independent system. It created a new Islamic lower-middle class that not only looks to Islam as the source of spiritual guidance but also for material support.

As perhaps one of the most important social consequences, IPE helped Islamists in moving from the mosque to the bank and thus expanded and diversified their institutional influence in society. While the utility of Zakat funds and elimination of Riba for social justice remain contested (Chapters 6 & 7), some facts can be easily established. IPE has diversified and enriched the social, economic and political base of Islamists in Pakistan. Through Zakat funds, many Islamic schools have received grants (Chapter 5) and later Islamic banks created safe havens for Islamic-minded investors and entrepreneurs.

Through IPE, both governments and Islamists focused most keenly on the problem of legitimacy and proved quite effective in this endeavour (Chapters 4-7). Pakistan is acknowledged as the leader of Islamic world in introducing Islam-inspired public policies and it has earned legitimacy from the Ummah – the global Muslim community. At home, the military government that started the process of Islamization managed to create successful coalitions with conservative and religious segments of society on the pretext of more Islamization. This linkage remained a central issue in the policy agenda taken up by succeeding democratic governments (Chapter 4).

## **Policy Implications**

### **Legitimacy, Inclusiveness and Authoritativeness of Islamic public policy**

The most distinguishing feature of a public policy is its inclusiveness and authoritativeness. Islamic public policies in the context of IPE should become more inclusive and authoritative to enhance their legitimacy. As mentioned earlier, the Riba component of IPE does not take into account the money lending institutions present in rural areas of the country (Chapter 4). Thus even if Riba is completely abolished from the mainly urban-based banks, a vast majority of the population would remain exposed to exploitation by moneylenders who charge much higher rates of interest than conventional banks. While Zakat has been expanded to the rural areas, there is no indication that the government plans to tackle the problem of private money lending. To make the public policies of Islamization more inclusive, the scope of legislation on the elimination of Riba should be widened to include rural moneylenders.

The lack of inclusiveness is evident from the scope of collection of Zakat because, due to theological constraints, industrialists and professionals are exempted from payment of Zakat altogether (Chapter 3). Thus Zakat policy remains an ancient tax instrument that assumes land to be the only source of capital. But here are some developments in the disbursement of Zakat, which has started flowing towards social goals like the provision of education and health (Chapter 6). Thus at least disbursement of Zakat is becoming more inclusive, which is enhancing its legitimacy.

IPE has suffered from lack of authoritativeness of the state, especially in the collection and disbursement of Zakat. Landlords have proved too powerful to be persuaded to pay Zakat (Chapter 5) and almost all Zakat funds are based on compulsory deduction from bank deposits, the majority of which belong to the middle class. Lack of inclusiveness and authoritativeness in Islamic public policy continue to restrain its legitimacy as a social objective. Both Islamic scholars and the state need to work as close partners to address this multi-dimensional problem.

### **Implementation issues**

Chapters 2, 6 & 7 indicated that the lack of implementation stems from dispositional, capacity and communication problems. To increase the chances of implementation of Islamic public policy, all three issues should be addressed during the implementation process. Dispositional and communication problems need open and consistent dialogue between the proponents and opponents of Islamization. In fact this dialogue does occur in the form of seminars, conferences and workshops. Mass media in Pakistan are reasonably free to publish different viewpoints on these issues and playing this role. The problem of capacity gets less attention, and the complications in understanding Islamic finance pose serious challenges to its success. A combination of religious and economic perspectives in training institutes is rare (Chapter 5) and needs to be expanded. Above all, the Islamic economists and the government must respond to the criticism that these reforms have been nominal in nature and not substantial.

### **Empirical Studies**

This study presents a limited overview for an empirical study of the Islamization of Pakistan's Economy. After twenty years in operation, the process of Islamization of the economy merits in-depth studies by economists, Islamists and development experts.

Islamic economics should be carefully scrutinized and more attention should be paid to the outcomes of the process instead of its normative and theological aspects. Such studies would help to identify practical links between religion and development in the twenty-first century, an issue that again occupies the attention of international policymakers.



## Epilogue: Islamization and the Muslim mindset

It is my contention that the limitations of the Islamization process are grounded in the Muslim mindset. The fact that IPE vehemently opposes pre-determination of rates of return in a business transaction is an amplification and implication of deeply grounded belief that the future cannot be known by human beings as this knowledge is 'ghaib'<sup>16</sup>. Zakat policy faces similar restrictions as Muslims give Zakat to *receive* 'religious dividends' rather than due to a genuine desire of poverty alleviation. This relationship between individual spending and spiritual reward is distorted by the state intervention, which claims the right to administer this spending on an Islamic basis. Ironically a religiously inspired public policy is increasingly seen as a hurdle to get an immediate spiritual reward obtainable by giving the Zakat *directly* to a person in need.

If, at this stage, one anticipates an answer to the thorny question of 'justification by works or by faith?' my findings are wrapped with more confusion than ever, although the question has become more nuanced and problematized. Islamization has justified itself partially by the intellectual, political and social works that it has inspired. Faith has created a formidable resistance within the new system to outward pressures and competitions. But the failure of Zakat policy to deliver its declared social objectives is also obvious. Similarly faith has been shelved in the selection of 'market-friendly' Islamic financial instruments. Finally, justification itself appears to be more complicated than the essentialism it poses by the binary equation of 'works *or* faith.' It seems, as the final outcome of this study has demonstrated, that the criteria of evaluation of IPE should be explored along equilibrium between 'works *and* faith.'<sup>17</sup>

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<sup>16</sup> An Arabic word, which literally means, unknown or hidden.

<sup>17</sup> "I swear by the declining day that perdition shall be the lot of man, except of those who have *faith and do good works*; who exhort each other to *justice* and to *fortitude*" (*Qur'an*: 103)



*“After more than fifty years of independence, Pakistan is now moving rapidly towards a wholly Islamic system of banking and finance... Within the growth of Islamic law in Pakistan, financial reforms have proved to be the most laboured, complicated and slowest of exercises as an important pillar of the modern economy of the state has had to be broken and shaped on the Islamic mould...The Pakistani chapter in the story of Islamic banking will certainly yield some important lessons for the viability of a wholly Islamic system of finance in the modern world. Failure of the interest-free experiment in Pakistan could be catastrophic for economic growth if financial markets become inefficient and for social stability if the middle class, widows and pensioners flock to black market financial institutions that provide fixed returns in contrast to the profit and loss scheme of Islamic finance.”*

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