

Riba Free Economy Model

MUHAMMAD ARIF

Treasurer

University of Education

College Road Township

Lahore, Pakistan

DR. ASHIQ HUSSAIN

Controller Examination

University of Education

College Road Township

Lahore, Pakistan

MUHAMMAD AZEEM

Assessment Expert

Punjab Education Assessment System (PEAS)

University of Education

College Road Township

Lahore, Pakistan

Abstract

The purpose of this research is to develop a model of Riba Free Economy in Pakistan. A research, more inclined towards Islamic way of life needs to find out the principles, Quranic and Hadith support. Islam as a religion presents novel systems for the welfare and benefits of the society and prohibits a system where people earn profit without putting labour or efforts. Islam believes in a business of commodities, changes with same commodity and does not allow changing with precious commodity or with inferior commodity at the same rate. In such a case the rate and wealth of commodity would be determined and then the exchange would be made. Logic has been sought, taking riba as an economic issue and in the perspectives in which it is condemned by Islam, Christianity and Judaism. References from Quran and Hadith have also been forwarded. The conditions for riba has been laid down as increase in principal amount and increase with respect to payment period, the more period causes more increase. Riba has been categorized into two types like Riba Al-Nasiyah and Riba Al-Fadl. Riba Al-Nasiyah is the amount over and above the principal amount received by the lender from borrower at pre-determined rate. Riba Al-Fadl is the exchange of homogeneous commodities. After describing riba and its types, reasons have been sought for prohibition of riba from Quran referring to Surah Al-Rum-39, Surah Al-Nisa-161, Surah Al-Imran 130-2 and Surah Al-Baqrah 275-281. Help from Hadith (Muslim, Ahmed, Tirmidhi and Ibn-e-Majah) has also been sought. Riba generates various evils like moral evils, social evils and economic evils. Many people argue that even if the interest is prohibited in Islam, interest free banking system is not practicable in the modern world. An economic system minus interest cannot be visualized. Researcher has given the comparison of interest based banks and Islamic banks. Today banks play a very vital role in economic development of a country. In view of the important role of modern banking system why it is necessary to replace it with interest free banking? Reasons for launching interest free banking in Pakistan have been narrated. A brief analysis of economic systems i.e. Capitalism, Communism and Islamic system, is made. Features, principles and objectives of Islamic economic system have also been explained. Types of takaful (Islamic Insurance) and various models of takaful have also been discussed. According to our opinion the element of riba, gharar and gambling is involved in conventional insurance as practiced by the insurance companies and this insurance system is not acceptable in Islam. A model of riba free economy has been developed. Two Stage Least Square (2SLS) technique to estimate structural equations has been used. The focus of our research and model has been on the possible impact of riba free economy on savings, investments, growth rate and its pattern, allocative efficiency and the overall stability of the Islamic economic system. This research recommends that a riba free economy in Pakistan will have positive effects on the economy.

Introduction

Interest (Riba) has been characterized as the very backbone of modern and capitalistic economy. The web of interest encompasses banking and finance, business and commerce, industry and agriculture. Interest has gradually and surreptitiously crept into all aspects of modern life so much so that one is often reminded of the aptness of the Prophet's (PBUH) saying "a time will come over people when not a single person will remain who does not devour riba, and if there be any who refrain from it still its vapour will overtake him" (Abu Daud, Sunan Kitab-al-Buyu, Bab fi ijtinab-al-Shubukat). The prohibition of "riba" is one of the basic features of the economic percepts cherished by the Holy Qur'an and the Sunnah of the Holy Prophet (PBUH). Much has been written on the interpretation of the term 'riba' on the wisdom underlying its prohibition, on its economic and social implications and on the practical aspects of the Islamic economy which is supposed to work without interest. It is explained that the people not conversant with principles of Islam and economic philosophy of Islam believe that elimination of riba from banks and financial institutions makes them charitable, rather than commercial concerns which offer financial services without a return. This is their wrong assumption that interest free loan is meant for cooperative and charitable activities and not normally for commercial transactions. It is clear that elimination of interest from financial activities does not mean that lender cannot earn profit. If financing is made for commercial purpose, it can be based on the concept of musharakah and mudarabah. Islam animated novel systems which were beyond the reach and perception of human beings to think and develop. Riba creates an imbalance.

We can understand that one forty million tones gold is available with people of the world and mostly it is with the Asians, Africans and the banks since as a tradition it is not used as ornament for the women or the men of English society. One sixty billion tons of wheat is produced likewise one forty billions of rice is produced all over the world. The rate of zakat is fixed and if by that rate it is paid by the bearers of the commodities, no one on the earth remains hungry, poor or ignored in the society. The imbalance is created when it is accumulated with the few people on this universe. In the modern scenario today, there are many interpretations made by the ethics, Jews and Christians to justify the profit with maximum dividends and no loss. This has been rejected in Suurah Al-Baqrah, Surrah Al-Nisa and Surrah Al-Rum. The argument that the bank, expertise of the people and the facilities are being used for making business with collection of clients of the bank. So, they have right to give the amount on profit rather compound profit with the justification that they use their inside resources and expertise to earn profit out of their business invention. Islam prohibits all such investments, all such interpretations on the simple plea that no labour is put in, so the profit for banks and individuals is not permissible.

The next plea that is put by most of the scholars, is the consumption of the resources of the bank in the name of service utilization (named as service charges) but the same with the earlier justification, is not accepted by Islam. Islam believes in a business of commodities i.e. change with the same commodity and does not allow changing with a precious commodity or with inferior commodity at the same rate. In such a case the rate and wealth of the commodity would be determined and then the exchange would be made. References about prohibition of riba are not only available in Quran but its well elaborated interpretations are also available in Hadith. Riba takes different forms on different commodities/items some where it is recited as Riba Al-Nasiyah, at other places it is Riba Al Fadl. The evils of the two have also been put before the community to be free as far as possible; moral evils, social evils, common evils. The interest and investment have also been seen by the scholars differently but under the shade of riba to warn the society not to practice; interest and distribution of wealth, trade cycle and interest, interest and business, interest and efficiency, interest and economic instability, interest and internal loans need very extensive discussions and clarity.

The objections, reservations and their valuations opens a new avenue of discussions for which the researches of the scholars may be seen and where need put it as well. Banking is such a sector which not only rules the economy of a community but a country well. The comparison to this effect makes the researcher more clear and Islamic scholars more informed about riba and its applications in the formal banking sector. The formal banking practices and the riba prohibitions if put in comparison can guide the bankers to develop a system to some extent free from riba. Riba has been very extensively applicable in the society it's a new term regarding financing by lending. Financing by lending takes two shapes i) loans with service charges and ii) Qarz-e-Hasana. The names are popular in Islamic society but the conventions in banking takes the shapes which are not normally acceptable to the Islamic society. Yet another type of financing by lending takes the shape of trade related modes. Which normally relates to the purchases under different conditions and obligations.

The discussion may go more extensive. The efforts have been made to turn the economy into an Islamic model with the help of various agencies like Islamic Ideological Council of Pakistan, Federal Shariat Court, Islamic Research Institute, Introduction of Zakat and Ushr and Commission for Islamization of Economy. No doubt the efforts made is headway but even now criticisms have been made against these efforts. This research is a petty effort to explore the real state of affairs in the light of Quran, Hadith, intellectuals and Islamic scholar's perceptions to draw an image that may lead to the development of a model of economy in consonance with the Islamic teachings which would be free of riba.

RIBA: PHILOSOPHY AND PRACTICAL MEANING, RATIONALE

RATIONALE FOR PROHIBITION OF RIBA

Before discussing the rationale for prohibiting riba by the Quran and Prophet's Sunnah, it is pertinent to mention Islam means human submission to divine will. Islam provides moral values such as justice, benevolence, equality, freedom and brotherhood. It is source of inspiration for mankind for a true and positive moral conduct. It caters for human welfare through providing harmony of moral, material and spiritual needs of human beings. The basic moral values and principles of Islamic economics are contained in the Holy Quran and in the teaching of Holy Prophet Muhammad (PBUH).

Riba (interest, usury) is primarily an economic issue in view the fact that all religions and mythologies have prohibited riba in one way or the other since the inception of human interaction. All three major revealed (Ilhami) religions i.e. Islam, Christianity and Judaism have strongly condemned and proscribed riba in its original versions.

Islam condemns all forms of exploitation particularly the injustice continued in the form of lender being guaranteed of a positive return without assuming the share of risk with the borrower, whereas the borrower takes upon him all sorts of risks in addition to putting in his skills and labour. A person spends his labour, time and utilizes his skills. When he invests money in trade, industry or agriculture but there is no guarantee of profit or rate of profit on his investment. He also faces a risk of loss of capital or part thereof. But on the other hand, the money lender simply lends funds does not invest his time or labour in the business but is guaranteed at fixed rate of profit in the form of interest. Islam says in clear terms that the lender is not justified in earning a fixed rate of profit, irrespective of the operational result of the business.

It is pertinent to mention that the payments of installments of loans, eat away a substantial portion of their income and the miserable persons (debtors) are unable to meet even their basic needs and that of their families, leading to poor health, sub-standard living conditions and no education. All this gives rise to a never ending tussle between haves and have-nots and results in tension, anxiety, frustration and hatred.

CONCEPT AND MEANING OF RIBA

Prohibition of Riba Act 1997 states that riba is an stipulated payment over and above the principal amount lent in consideration of the time given for repayment, either on simple or compound basis or any discount given on assignment of debt or any financial paper representing money.

Interest or finance charge which is claimed, paid, given, received, credited, debited-actually or through accrual-by banks and other institutions including Government, in their operation or on amounts outstanding either against them or for them is riba.

Any charge, fees and commission charged for services other than the provision of capital, rendered by banks and financial institutions is not riba.

Chapra (1985) explains that "Riba literally means increase, addition, expansion or growth".

Allah says in Holy Quran:

"Allah deprives riba of all blessing and develops charity" (Al-Baqara-276)

"The interest that you give in order to increase the wealth of the people, does not increase in the sight of Allah" (Al-Rum-39)

The above said verses make it clear that any addition to capital shall be called riba. However the Holy Quran has not declared all additions as unlawful because addition to capital takes place in trade also. The Quran forbids a particular kind of addition, which is over and above the principal amount lent at predetermined rate of interest.

A person gives loan to another person on condition that after a period of time he will receive so much amounts in excess of principal amount. This excessive amount is riba which is the price of period of time for which loan was given. When a condition is imposed that a stipulated sum will be charged on loaned capital against a period of time. It is an interest based transaction and the sum charged in excess of the capital as the price of the period of time is called interest.

Every interest (riba) based transaction has three elements:

- 1) There is an increase in principal amount.
- 2) The increase is determined in relative to the payment period.
- 3) The transaction is conditional to interest payment.

Tahir (1999) describes that riba is a discrepancy which results from the contractual obligations of a party in the context of a direct exchange of items of the same general kind (such as loan transaction) between two parties.

Encyclopedia American International Edition (1970) expresses the meaning of interest that it is a charge for the use of money. Interest has not always been considered legitimate or even moral payment. Until the end of middle ages, any charge for a loan was general considered to be usury. The teachings of Christian, Judaic and Islamic religion, all condemned in varying degrees, the taking of interest. In more recent times, however, usury has come to be regarded as only the charging of illegal rates of interest.

It is explained that Islam prohibits predetermined pricing of capital. Briefly, the Islamic position is that if a loan is given or taken for moral or humanitarian reasons, the principal amount should be protected and any excess on that is forbidden as immoral and exploitative. If loan or investment is made for economic reason, then the owner of the capital has no right to demand a fixed rate of return. One cannot legitimately ask for any additional payment without sharing the risk of business. Thus if a simple loan is advanced without risk sharing, any additional payment, small or large, in excess of the original amount of the loan, constitutes riba and as such is forbidden.

Some economists have made an effort to differentiate between interest and usury. Three caveats are presented:

- 1) that riba means usury and as such interest, particularly bank interest, does not fall into the ambit of riba;
- 2) Usury or riba relates to loan contracted by the poor and the needy persons for consumption purposes while interest constitutes reward on commercial, productive and profitable loans.
- 3) Interest stands for a reasonable rate of return on capital while usury represents an excessive, exorbitant and exploitative rate of interest.

It is stated that all the three premises are totally incorrect, theoretically inadmissible and empirically baseless. There cannot be any economic or shari'ah justification for confining riba to usury and excluding interest from its jurisdiction. As far as economic analysis is concerned there is no technical difference between interest and usury. When we look upon the phenomenon from the demand side of economic analysis or the supply side, the rationale developed in economic theory for interest and usury are the same. If it is a reward for waiting or time preference, there cannot be any differentiation between interest and usury. If it is examined from productivity approach, again there cannot be any differentiation between the two. That is why whatever differentiation has been introduced in the literature comes mostly on moral grounds alleging that one is high and exorbitant (usury) and the other is low and as such reasonable and secondly that usury deals with loans to the poor for consumption purposes while interest deals with profitable commercial advances.

As far as Islam is concerned it has laid down very clear and precise criteria. If the loan carries a predetermined fixed reward related to time of loan used and decided upon as a condition of loan it is riba, pure and simple. There is no difference between consumption loan or production loan or high rate or low rate or loan taken by a poor person or rich. Both the caveats are inadmissible. Interestingly enough, the shari'ah and economics have no quarrel on this count.

TYPES OF RIBA

Usmani (2002) expresses that riba means excess, increase or addition which correctly interpreted according to Shariah terminology, implies any excess compensation without due consideration (consideration does not include time value of money).

It is however, not every increase, addition, expansion or growth which has been prohibited by Islam. One has to evaluate the context in which something is referred to and then comprehend the essence.

Quran is a Holy book in which rationality plays a big part. The term riba must, therefore, be construed in the broad sense of an unequal exchange which also includes lending on interest or usury. Riba in the context of exchange would therefore occur either in a thing, commodity or money without giving in return, equal/just counter-value to the other party (debtor), there-by creating exploitative relationship. There are two types of riba namely ‘Riba Al-Nasiyah’ and ‘Riba Al-Fadl’.

RIBA AL-NASIYAH

Usmani (2002) explains that Riba al-Nasiyah is an excess amount over and above the principal amount received by lender from borrower at predetermined rate (fixed rate). This type of riba has been strictly forbidden in Islam and there is no ambiguity about it. There are very clear instructions in the Holy Quran and the Ahadith about Riba al-Nasiyah. There is no evidence present which could back up the long held belief that is prohibited only in case of loans taken for consumption purposes. Rather no distinction has ever been made in consumption and production loans in case of Riba al-Nasiyah. Both type of loans, if conditional to interest payment come in the category of prohibited transactions because these transactions give birth to exploitative thinking.

If a person takes loan for consumption purpose, then taking interest from him is very unfair, because someone who already has not been able to fulfill his needs from his income, could hardly manage to pay interest.

There are other people as well who take loans for investment purpose which are called productive loans. Taking interest from productive loans is also unfair because in this case, the lender is just sharing the return, not the risk inherent in production of that return. While borrower is taking all the risk himself and even then, a significant amount of the total return has to be paid by him to the lender. In most cases, when loss occurs, it has to be borne by the borrower and it has no impact on the principal and interest payments.

One of the ahadith quoted by Ali ibn al Talib (RAA) has defined Riba al-Nasiyah in similar words. The Holy Prophet (PBUH) said

“Every loan that draws interest is riba”.

Usmani (2002) describes that Imam Abu Bakr Hasses Razi has outlined a complete and prohibiting legal definition of Riba Al-Nasiyah, in the following words:

“That kind of loan where specified repayment period and an amount in excess of capital is predetermined”.

He further quotes that the famous Sahabi Fazla Bin Obaid has also defined riba in similar words:

“Every loan that draws profit is one of the forms of riba”.

This is the real and primary form of riba. Since the verses of Quran has directly rendered this type of riba as haram. It is called Riba Al-Quran. Similarly since only this type was considered riba in the dark ages; it has also earned the name of Riba Al Jahiliya.

Allah has ordered for prohibition of riba in various verses of Holy Quran and has warned those who persist in practicing it of a war which is certain to be declared on them by Allah Himself and His Messenger and has seriously threatened those engaged as writer, witness and dealer in riba transactions. Riba Al Nasiyah is haram has never been disputed in the Muslim community.

According to the above definition of Riba al Nasiyah, the giving and taking of any excess amount in exchange of a loan at an agreed rate is riba irrespective whether at a high or low rate. It has been proven through ahadith that the Holy Prophet (PBUH) paid excess at the loan repayment time but since this excess was not paid at an agreed rate, it cannot be called riba.

RIBA AL FADL

Niazi (1995) states that Riba Al-Fadl was excess or increase which was found in one of counter-values through weight, measure or count when two counter-values of same species were exchanged on spot at once.

Usmani (2002) states that:

Riba Al Fadl was that excess which was taken in exchange of specific homogenous commodities and encountered in their hand to hand purchase and sale as explained in the famous hadith.

The Prophet (PBUH) said “sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dates in exchange of equivalent dates, sell wheat in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barley in exchange of equivalent barley, but if a person transacts in excess, it will be usury (riba). However, sell gold for silver any way you please on the condition it is hand to hand (spot) and sell barley for date anyway you please on the condition it is hand to hand (spot)”.

Although there is disagreement among jurists as to whether the injunction applies only to the six commodities referred to above or whether there is some general principles which emerges covering other aspects, it is evident that the prohibition of Riba al-Fadl is intended to ensure justice and remove all forms of exploitation through unfair exchange.

It therefore follows from foregoing that the main rationale of prohibiting riba is on account of exploitation in lending or in exchange, when an equal return or counter value is not given to the other party, whether seller/purchaser or a debtor.

The present controversy over definition and interpretation of riba in Pakistan (whether it is interest or usury) to a large extent reflects the facts that the concept of riba cannot be correctly understood without understanding its original social and economic context. We do not intend to redefine riba but for the purpose of this study, we shall try to interpret it in order to underline the essence of subject matter in consonance with teachings of the Holy Quran and the Sunnah.

PROHIBITION OF RIBA IN THE HOLY QURAN

The Holy Quran emphasizes the need for justice, which is beneficial for both parties involved. Either both of them should have profit or none should have profit. A close look at the business of interest based lending/borrowing and the philosophy behind it would reveal that the final result ought to be impoverished state of a vast majority of the society while filling beyond capacity the coffers of a few capitalists. The economic disparity results in disaster of the country and that is why Islam has forbidden this business.

These are following verses of the Holy Quran on the subject.

First Revelation (Surah Al-Rum, verse 39)

- 1) “That which ye give in riba in order that it may increase on (other) people’s property hath no increase with Allah; but that which ye give in charity, seeking Allah’s countenance, hath increase manifold.”

Second Revelation (Surah Al-Nisa, verse 161)

- 2) “That they took riba, though they were forbidden; and that they devoured men’s substance wrongfully. We have prepared for those among them who reject faith, a grievous punishment.”

Third Revelation (Surah Al-Imran, verses 130-2)

- 3) “O ye who believe! Devour not riba, doubled and multiplied; but fear Allah; that ye may (really) prosper”. “fear the fire, which is prepared for those who reject faith.” “And obey Allah and the Prophet; that ye may obtain mercy.”

Fourth Revelation (Surah Al-Baqarah, verses 275-281)

- 4) “Those who devour riba will not stand except as stands one whom the evil one by his touch hath driven to madness. That is because they say: ‘Trade is like riba’. But Allah hath permitted trade and forbidden riba. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge). But those who repeat (the offence) are companions of the fire; they will abide therein (forever).”(275)
- 5) “Allah will deprive riba of all blessings, but will give increase for deeds of charity; for He loveth not creatures ungrateful and wicked.” (276)
- 6) “Those who believe, and do deeds of righteousness and establish regular prayers and regular charity, will have their reward with their Lord: on them shall be no fear, nor shall they grieve.” (277)
- 7) “O ye who believe! fear Allah and give up what remains of your demand for riba, if ye are indeed believers.” (278)
- 8) “If you do not do so, then take notice of war from Allah and His Messenger. But if you repent you can have your principal sums. Neither should you commit injustice not should you be subjected to it.”(279)

- 9) “if the debtor is in difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you, if ye only knew.” (280)
- 10) “And fear the day when ye shall be brought back to Allah. Then shall every soul be paid what it earned, and none shall be dealt with unjustly.” (281)

As the money lending transactions involving usury and interest were prevalent among the Arabs for a long time and had taken deep roots in their society.

The injunctions of *riba* in the Holy Quran were revealed in a period spread over a number of years. The above Quranic verses refer that the contents of Surah Al-Rum, verse 39, are merely of an advisory nature and do not in fact prescribe any punishment. The Almighty Allah in His infinite wisdom tells his followers that wealth does not in fact increase by interest earnings. This verse also motivates people to give more and more to the poor and needy and Allah assures that with his blessings, the wealth of a person, giving charity, will increase manifold. This point has again been emphasized in Surah Al-Baqarah verse-276, wherein Allah says that he deprives *riba* of all blessings but blesses charity. This is also true from social, economic and moral points of view.

Further in Surah Al-I-Imran Verses 130-2, Allah prohibits Muslims to take usury (compound interest) and promises prosperity to people who obey the orders. In Surah Al-Baqarah, verse-275, it has been clearly mentioned that the thinking that ‘trade is like *riba*’, is incorrect and that Allah has permitted trade and forbidden *riba*. The return on capital invested by an entrepreneur in the business is either positive or negative depending upon the operational results. In case, however, of interest on loan including bank interest, a positive return is assured and a negative return or risk of a negative return is not shared by lender. The basic difference between trade of commodity and trade of money as prevalent today (*riba*, usury or interest) is that in the former case, there is no guarantee of a positive return, whereas in the later case, there is a certainty of a positive return at a fixed rate.

In the context of above discussion *riba*, usury and interest, have one and the same meaning and have a common factor of predetermined positiveness. This obviously is in sharp contrast to trade. It is crystal clear that according to the verses of the Holy Quran referred to above, *riba* usury and interest are strictly prohibited, in all forms and intent.

The Surah Al-Baarah verse 279 has warned that those who do not forego *riba* which was already accrued and do not desist from taking it any further, then they are at war path with Allah and His Prophet (PBUH). It is however, significant to note that *riba* which had already been recovered before revelation of this verse of the Holy Quran was also not justifiable due to obvious reason that *riba* was prohibited in earlier religions also, as well as in the earlier revelations of the Holy Quran. Allah however, did not declare it illegal, as it would have opened a Pandora’s box in the form of endless litigations between parties. No demand could, therefore, be made for the return of the amount of *riba* already paid. The income already earned on account of *riba*, however, remained unethical and polluted. The matter in individual cases would be, therefore, be taken up by Allah on the Day of Judgment.

Shahid Hassan Siddiqui (1994) expresses the views of Maududi. Muslim scholars are, therefore, of the firm opinion that this money should not be spent on self or family but one should voluntarily return it to the person from whom, it was recovered. If he is not available then the amount should be spent on social welfare.

It is significant to note that the verse (2:278) of the Holy Quran specifically says that: “Give up what remains of your demand for *riba*” and the verse (2:279) says, “you shall have your capital sums.” In view of this clear and unambiguous directive of the Holy Quran, all the arguments that prohibition of *riba* does not cover bank interest, do not merit any consideration and are automatically invalidated. There is, therefore, no doubt left that according to the injunctions of the Holy Quran, in money lending transactions, anything recovered in excess of the principal amount is prohibited, by whatever name it is called, *riba*, usury or interest.

According to Surah Al-Baqarah verse (280) Allah permits the lenders to take back only the amount advanced and no more. It is, however, laid down that if the borrower is in difficulty he should be given extension in repayment date and in fact, believers have also been motivated to forego the principal amount as charity, if the circumstances so warrant.

Finally, there is a reminder from Allah in the Holy Quran Surah Al-Baqarah verse (281), to be fearful of Him and that when they will go back to Him on the day of Resurrection, each one of them will be dealt with in a just and equitable manner.

RIBA IN HADITH

There are numerous Ahadith on the subject of riba. The Ahadith containing the directives of the Holy Prophet Muhammad (PBUH) have been narrated by authorities.

GENERAL HADITH

- 1 From Jabir (RAA) The Prophet, (PBUH) may cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said: “They are all alike [in guilt]” (Muslim, Tirmidhi and Musnad Ahmad).
- 2 Jabir ibn Abdallah (RAA) giving a report on the Prophet’s Farewell Pilgrimage, said: The Prophet, (PBUH), addressed the people and said “All of the riba of jahiliyyah is annulled. The first riba I annul is our riba that accruing to ‘Abbas ibn ‘Abd al-Mutalib (the Prophet’s uncle); it is being cancelled completely.” (Muslim, Musnad, Ahmad).
- 3 From ‘Abdullah Ibn Hanzalah (RAA) The Prophet (PBUH), said: “A dirham of riba which a man receives knowingly is worse than committing adultery thirty six times” (Mishkat al-Masabih, Kitab al-Buyu’, Bab al-riba, on the authority of Ahmad and Daraqutni). Bayhaqi has also reported the above hadith in Shu’ ab al-imam with addition that “Hell befits him whose flesh has been nourished by the unlawful.”
- 4 From Abu Hurayrah (RAA): The Prophet, (PBUH), said: “On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside I asked Gabriel who they were. He replied that they were people who had received interest.” (Ibn Majah, Kitab al-Tijarat, Bab al-taghlizi fi al-riba; also in Musnad Ahmad).
- 5 From Abu Hurayrah (RAA): The Prophet, (PBUH), said “Riba has seventy segments, the least serious being equivalent to a man committing adultery with his own mother.” (Ibn Majah).
- 6 From Abu Hurayrah (RAA): The prophet, (PBUH), said : “There will certainly come a time for mankind when everyone will take riba and if he does not do so, its dust will reach him. (Abu Dawud, Kitab al-Buyu’, Bab fi ijtinabi al-shubuhah; also in Ibn Majah).
- 7 From Abu Hurayrah (RAA): The Prophet, (PBUH), said: “God would be justified in not allowing four persons to enter paradise or to taste its blessings: he who drinks habitually, he who takes riba, he who usurps an orphan’s property without right, and he who is undutiful to his parents” (Mustadrak al-Hakim, Kitab al-Buyu’).

HADITH ON RIBA AL-NASIYAH

- 1) From Usamah ibn Zayd (RAA): The Prophet, (PBUH), said: “There is no riba except in Nasiyah [waiting].” (Bukhari, Muslim and Musnad Ahmad) “There is no riba in hand to hand (spot) transactions: (Muslim, and Nasa’i).
- 2) From Ibn Mas’ud (RAA): The Prophet, (PBUH), said: “Even when interest is much, it is bound to end up into paltriness.” (Ibn Majah and Musnad Ahmad).
- 3) From Anas ibn Malik (RAA): The Prophet, (PBUH), said: “when one of you grants a loan and the borrower offers him a dish, he should not accept it; and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually.” (Sunan al-Bayhaqi).
- 4) From Anas ibn Malik (RAA): The Prophet, (PBUH), said: “if a man extends a loan to someone he should not accept a gift.” (Mishkat, on the authority of Bukhara’s Tarikh and Ibn Taymiyyah’s al-Muntaqa).
- 5) From Abu Burdah ibn Abi Musa (RAA). I came to Madinah and met ‘Abdallah ibn Salam who said, “You live in a country where riba is rampant; hence if anyone owes you something and presents you with a load of hay, or a load of barley, or a rope of straw, do not accept it for it is riba.” (Bukhari).
- 6) Fadalah ibn ‘Ubayd (RAA) said that “The benefit derived from any loan is one of the different aspects of riba.” (sunan al-Bayhaqi) This hadith is mawquf implying that it is not necessarily from the Prophet; it could be an explanation provided by Fadalah (RAA) himself, a companion of the Prophet, (PBUH).

HADITH ON RIBA AL-FADL

- 1) From ‘Umar ibn al-Khattab (RAA). The last verse to be revealed was on riba and the Prophet, (PBUH), was taken without explaining it to us; so give up not only riba but also raibah [whatever raises doubts in the mind about its rightfulness]. (Ibn Majah,)

- 2) The Prophet, (PBUH) said, “Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dates in exchange of equivalent dates, sell wheat in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barely in exchange of equivalent barley, but if a person transacts in excess, it will be usury (riba). However, sell gold for silver anyway you please on the condition it is hand to hand (spot) and sell barley for date anyway you please on the condition it is hand to hand (spot)”.
- 3) From Abu Sa’id al-Khudri (RAA): The Prophet, (PBUH) said, “Do not sell gold for gold except when it is like for like, and do not increase one over the other; do not sell silver for silver except when it is like for like, and do not increase one over the other; and do not sell what is away (from among these) for what is ready.” (Bukhari, Muslim, Tirmidhi, Nasa’i and Musnad Ahmad).
- 4) From ‘Ubada ibn al-Samit (RAA): The Prophet, (PBUH), said: “Gold for gold, silver for silver, wheat for wheat, barely for barely, dates for dates, and salt for salt-like for like, equal for equal, and hand to hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand to hand. “(Muslim and Tirmidhi).
- 5) From Abu Sa’id al-Khudri (RAA): The Prophet, (PBUH), said: “Gold for gold, silver for silver, wheat for wheat, barely for barely, dates for dates, and salt for salt like for like, and hand to hand. Whoever pays more or takes more has indulged in riba. The taker and the giver are alike [in guilt]. “(Muslim and Musnad Ahmad).
- 6) From Abu Sa’id and Abu Hurayrah (RAA). A man employed by the Prophet, (PBUH), in Khaybar brought for him janibs [dates of very fine quality]. Upon the Prophet’s asking him whether all the dates of Khaybar were such, the man replied that this was not the case and added that “they exchanged a sa’ (a measure) of this kind for two or three [of the other kind]”. The Prophet, (PBUH), replied, “Do not do so. Sell [the lower quality dates] for dirhams and then use the dirhams to buy janibs. [When dates are exchanged against dates] They should be equal in weight.” (Bukhrai , Muslim and Nasa’i)
- 7) From Abu Sa’id (RAA). Bilal (RAA) brought to the Prophet, (PBUH), some barni (good quality) dates whereupon the Prophet asked him where these were from. Bilal (RAA) replied, “I had some inferior dates which I exchanged for these-two sa’s for a sa’ . “The Prophet (PBUH) said, “Oh no, this is exactly riba. Do not do so, but when you wish to buy, sell the inferior dates against something [cash] and then buy the better dates with the price you receive.” (Muslim and Musnad Ahmad).
- 8) From Fadalah ibn-Ubayd al-Ansari (RAA): On the day of khaybar he bought a necklace of gold and pearls for twelve dinars. On separating the two, he found that the gold itself was equal to more than twelve dinars. So he mentioned this to the Prophet, (PBUH), who replied, “It (jewelry) must not be sold until the contents have been valued separately.” (Muslim, Tirmidhi and Nasa’i)
- 9) From Abu Umamah (RAA): The Prophet, (PBUH), said: “Whoever makes a recommendation for his brother and accepts a gift offered by him has entered riba through one of its large gates.” (Bulugh al Maram, reported on the authority of Ahmad and Abu Dawud).
- 10) From Anas ibn Malik (RAA): The Prophet, (PBUH), said: “Deceiving a mustarsal [an unknowing entrant into the market] is riba.” (on the authority of Sunan al-Bayhaqi).

EVILS OF INTEREST (RIBA)

The following evils are explained below which are happened due to interest in the economy.

MORAL EVILS

Interest generates such vices as miserliness, selfishness and petty-mindedness. Charity on the other hand develops such virtues as self-sacrifice, sympathy and magnanimity. The former are certainly a form of regression and the latter are signs of progress.

SOCIAL EVILS

A society in which selfishness and self-interest are the prime values and people instead of dealing with one another on the basis of consideration are bent upon taking advantage of the pressing needs of each other will always remain victim of chaos and disunity. In contrast, if members of a society are considerate and wish each other well, the society will make rapid progress.

ECONOMIC EVILS

From an economic point of view interest results in even more serious losses.

I) INTEREST AND INVESTMENT

According to Lord Keynes capital investment depends on the one hand on the rate of interest and on the other on MEC (Marginal Efficiency of Capital). The process of investment in a country will continue as long as MEC is higher than the interest rate or at least at par with it. As soon as MEC falls below the interest rate, the process of investment will come to a halt. This phenomena may be illustrated by the following table:

Investment	MEC	Interest Rate
10 Million	24%	18%
20 Million	22%	18%
30 Million	20%	18%
40 Million	18%	18%

Suppose the interest rate is 18% and an investment of Rs.10 million is made on which the MEC is 24%. Since MEC is higher than the interest rate, investment is profitable. So the process of investment will continue. Now an additional investment of Rs. 10.00 million is made on which the MEC declines from 24% to 22%. Investment is still profitable. So the process of investment will continue until MEC is equal to interest rate. As the above table shows at an investment of Rs. 40 million the MEC is at par with the 18% interest rate.

After that the process of investment will stop because MEC will fall below the 18% rate of interest. The investment will then be non profitable. At this point the only hurdle in the way of investment is the interest rate. Further investment will continue only if the interest rate is reduced. If the interest rate is decreased to zero the process of investment will continue till the level of full employment is achieved.

In other words from an economic point of view interest prevents a society from achieving the level of full employment.

II) INTEREST AND PRICE

When interest (as compensation for capital) is used as a factor of production it becomes part of the cost of production. Its burden is consequently shifted to the consumer. Moreover, interest is not added to the price once only, but it continues to be added to the price at several stages. Take the case of manufacturing of cloth. In the first place, the farmer will add interest to the price of cotton. Interest will again be added to the cost of production of yarn. It will be added to the cost of weaving, then to the cost of dyeing and finally to the price of finished cloth.

Thus at every stage of production, interest enhances the price of goods which is totally unjustified. Interest by increasing the real price manifold causes inflation.

III) INTEREST AND DISTRIBUTION OF WEALTH

The distribution of wealth in a society becomes inequitable due to interest. Interest is an overhead charge which does not form part of any factor of production. Interest is received by the capitalist who continues the use his wealth to earn more wealth. Hence instead of circulating in the society, wealth is concentrated in the hand of the capitalist class. This causes an unjust distribution of wealth in the society. In this way due mainly to interest the rich in the society get richer and the poor, poorer.

In regard to the distribution of Wealth, Abdul Qadir Salim writes in the October 1997 issue of the Tarjuman-ul-Quran:

“Now when there is no significant rival to the capitalist system, what is the situation in the world? In this age of free economy and privatization twenty per cent of total world population is still living below the poverty line and its share in the gross wealth of the world is only 1.5%.

The poor are getting poorer. Growing poverty is not the problem of the third world alone. The advanced countries face this problem too.

Sixty per cent of world's resources are controlled and consumed by the twenty per cent rich. The prestigious journal “The Economist dated 5th Nov. 1996” complains: Never during the last fifty years has there been such a large gap in incomes in Britain as there is today. In other industrialized countries also the gulf between the rich and poor has widened.

Prof. Khurshid Ahmad in his article “Islamic banking: The Challenge of the 21st Century” (Tajuman-ul-Quran July, 1997) writes:

“Today 23 Western countries control and run to their own advantage the economic system of the whole world. The sixteen per cent richest part of the world population exploits eighty four per cent of the gross wealth of the world. In the words of the former Secretary General of the World Federation of United Nations Associations. “Twenty per cent minority of the North controls 82.7% of GNP of the world, 81.2% of International trade, 80.5% of internal investment and 94% of research and development”.

IV) TRADE CYCLE AND INTEREST

Interest creates trade cycles also. It plays a special role in bringing about a slump in the market. According to Hawtray’s Monetary Theory, the Banks issue loans with a free hand when the trade is brisk but as soon as signs of a slump appear they start of trade cycles recovery of the loans. In this way capital shrinks and the slump starts declining to its lowest level.

V) INTEREST AND ALLOCATION OF RESOURCES

Chappra (2000) expresses in Tarjuman-ul-Quran: Financial institutions operating on the basis of interest evaluate the resources of the applicants for a loan. They demand proper security to ensure that the borrower will not only return their capital but also an additional charge.

How will the financial resources be utilized? This question is not the basic and decisive factor in extending a loan. In this way financial resources flow either to the rich who can provide the requisite securities or to the Government which is considered to be immune to insolvency.

Bank deposits are largely provided by various sections of the society. (It is estimated that eighty percent bank deposits in Pakistan are received from middle class and low income groups of the society). However, its advantages are largely monopolized by the rich class.

The MEC varies according to the sector of investment. So projects vital to national interest in which MEC is lower than interest rate will not attract investment. A society run on interest will shy away from investing money in those projects in which MEC is low. If interest is abolished investment will be available for every sector and project without discrimination.

VI) INTEREST AND BUSINESS

The capitalist fixes his share (interest rate) at the time of investment in business. Since his profit is guaranteed under all circumstances, he has no active interest in the business. He does not care if the business earns profit or incurs a loss. The running of business is entirely the responsibility of the management. A class of financiers thus comes into existence who supplies money and then sits idle. If interests are abolished, the financier class will take an active part in the economic struggle and the pace of economic development in the country will be accelerated.

VII) INTEREST AND EFFICIENCY

Interest has ill-effects on the efficiency of the people in general. The people who take loans to fulfill private needs are especially burdened with constant anxiety and mental depression. This condition has an adverse effect on their efficiency. Their interest in work is half-hearted because they are constantly nagged by the thought that a major portion of their earnings will go to pay the interest. Worry and depression weaken their physical health and their efficiency progressively deteriorates.

VIII) INTEREST AND ECONOMIC INSTABILITY

Chapra (2000) states in Tarjuman-ul-Quran that interest destabilises the economy. The well-known American Economist Milton Friedman relates economic ups and downs to rise and fall in interest rate. A high rate of interest creates conditions of extreme uncertainty in investment market. It causes constant ups and downs in the gross profit (interest + profit) on total investment and make it very difficult to take reliable decisions about long term investment.

IX) INTEREST AND INTERNATIONAL LOANS

The capitalist economy is virtually based on loans. So we can call it debt based economy. Individual or home consumption, private or public sector, economic activities in all spheres revolve round interest-based credit.

During the past two hundred years policies for economic development have used loans not only for physical development but also as instruments for financial expansion. So through credit creation financial expansion has not only been made the most dynamic factor for the economy but has been accorded the greatest importance for achieving economic stability.

The developing countries suffer heavy loss due to the dominance of interest-based economic order in the world. As debtors the developing countries have to tolerate the interference of the advanced countries in their internal affairs. Economically also the developing countries undergo a great loss because a large portion of their meagre resources is utilized in returning loans with interest.

A MODEL OF RIBA FREE ECONOMY—A SECTORAL ANALYSIS

Many books and articles on the Economics of Islam appeared during the last quarter of a century. This literature has mainly concentrated on the general rules and principles of the Islamic Economic System. It carried on a philosophical argument of its validity and the truthfulness of its values. To this literature we express our deep indebtedness.

How will the economy of a society which is ruled by the teachings of Islam function? What are the indigenous factors in the Islamic economic system which governs its activities and how do they work to bring about the achievement of its targets? What are the exogenous elements or tools which can be used to effect the direction and the volume of economic activities in this society? What are the conditions of equilibrium and stability in this economy? What are the characteristics of equilibrium and stability?

This thesis is an attempt to answer some of these questions. It does not claim any comprehensiveness or definiteness to its conclusions. Its purpose is to express an economist's observations of the functioning of a hypothetical Islamic economy.

THE ASSUMPTIONS

We assume the existence of an Islamic economy. An economy where the Islamic rules and institutions exist and function; where the authority, the society, and the law respect and guarantee these rules and institutions. The assumptions are as follows:

1. Zakat is collected and distributed according to the Islamic injunctions. A zakat fund exists as a department of the executive branch of the government. Zakat is considered as a constant ratio of net worth. There are no restrictions on the collection and distribution of Zakat. The ownership of Zakat should be transferred to one or more of the eight categories specified.
2. Riba does not exist. There is no interest on loans. Mudaraba exist as a legal economic institution. It is the act of injecting money assets in the production activity through the cooperation of the entrepreneur who puts labour and Rab-ul-Maal who furnishes the capital. The net income of the project is divided between them.
3. The economy is divided into various sectors. Developed markets and institutions for producers goods, consumers goods and financial instruments (SUKUK) are available.
4. Profit maximization is considered the goal of the economic unit.

THE MODEL

CONSUMPTION SECTOR

Zakat has three effects on the household as far as the allocation of income is concerned:

- a) It urges a higher saving ratio in order to maintain the level of wealth intact. For example, if the rate of return on wealth is 10%, one needs to save 27.5% of one's income in order to keep one's wealth intact. This effect is reinforced by the entry of new people due to growth.
- b) It penalizes idle wealth. Money saved is immediately invested.
- c) Zakat increases aggregate demand through upward shift in the consumption function. As there is no interest, current consumption increases at the same level of income.

INVESTMENT SECTOR

The household as income earner is interested in increasing the ratio of current consumption out of income, because the higher saving ratio, the lower the utility as current utility is a function of current goods consumed. Assume a person's income is Y . It is received at the beginning of the period, say one year. Assume also that he saves as a ratio of s for one full year and that at the end of the year, he will use his savings for consumption. His total consumption in the two periods is:

$C = (Y-S) + (S-Sz)$, where z is the rate of zakat imposed on savings. Saving is a function of income and is a constant proportion (s) of the income.

This equals:

$$C = (Y-sY) + (sY - zsY)$$

$$C = Y - zsY$$

So there exists an inverse relationship between C and s .

The household, as wealth holder, is concerned about at least maintaining its wealth intact, the saving effect shown as,

$$\Delta W = S \geq z(W+S), \text{ where } W \text{ is wealth.}$$

We assume that income is generated from Mudaraba, written as

$$Y = Q(vW)$$

Where Q is the rate of profit share and v is the rate of utilization of wealth. The utilization of wealth in Mudaraba market produces income; the volume of income produced, along with saving ratio, determines the level of income constraint.

Mudaraba is a profit-sharing system in Islam, in which one lends money and financial assets and participates in the risk and profit of the debtor.

For the sake of simplicity, we assume an economy with two firms and one financial intermediary and two sectors, the capital goods sector and a consumption goods sector.

Let K_1 = capital stock of firm 1

K_2 = capital stock of firm 2

K = economy's aggregate capital stock

Let $K = K_1 + K_2$

L_1 = labor force employed in firm 1

L_2 = labor force employed in firm 2

$L = L_1 + L_2$: total employed labour force in the economy

Let $X_1 = G(K_1, L_1)$ be the production function of firm 1

And $X = F(K, L)$ be the aggregate production function in the economy

X_1 = output of firm 1,

X = aggregate output of the society.

It is now assumed that of the two firms, one specializes in consumption goods, and the other in capital goods, but the value of these together constitute the national production.

Let P_x = price of the national output X ,

P_{x_1} = price of consumption goods,

P_{k_1} = rent on capital K_1 ,

P_{k_2} = rent on capital K_2

P_{L_1} = wages for labour L_1

P_{L_2} = wages for labour L_2 .

The internal forces of the system make the perspectives of investment an integral part of the saving decision. Saving is positively related to investment opportunities and expectations. This relationship implies that at times of declining investment expectations, saving will decline and consumption will rise. This, in turn, increases aggregate demand and raises business expectations.

The society's profits are then given by,

$$\Pi = p_x F(K,L) - p_{k1} K_1 - p_{k2} K_2 - p_{L1} L_1 - p_{L2} L_2 \tag{1}$$

And firm 1's profits are given by,

$$\Pi_1 = p_{x1} G(K_1,L_1) - p_{k1} K_1 - p_{L1} L_1 \tag{2}$$

Π_1 can be considered as the net profit foregone by the Public Treasury as a result of loaning out an amount of capital to firm 1, in a competitive economic state. Therefore, net profit for the Public Treasury is given by,

$$\Pi - \Pi_1 = p_x F(K,L) - p_{x1} G(K_1,L_1) - p_{k2} K_2 - p_{L2} L_2 \tag{3}$$

If dK_1 amount capital is loaned out to firm 1, the net 'marginal profitableness of capital' is defined by,

$$\frac{d(\Pi - \Pi_1)}{dK_1} = p_x r - p_{x1} r_1 - p_{k2} \frac{dK_2}{dK_1} \tag{4}$$

In a Golden Age equilibrium, $\frac{d(\Pi - \Pi_1)}{dt} = \text{constant}$

Hence, $\frac{d(\Pi - \Pi_1)}{dK_1} = \text{constant}$,

$\Pi - \Pi_1 = C_1 K_1 + C_2$, C_1, C_2 are constants, Let $\Pi = \Pi_1 = 0, K_1 = K_{10}$ for $t=0$

Therefore, $\Pi - \Pi_1 = C_1 K_1 - C_1 K_{10} = C_1 (K_1 - K_{10})$, $K_1 \neq K_{10}$ near the Golden Age equilibrium.

Now the social rate of return would be given by $\frac{d\Pi}{dK_1}$ and the private rate by

$\frac{d\Pi_1}{dK_1}$. In equilibrium, the social rate equals the private rate of return¹. Hence $C_1 = 0$ is the only possibility.

Hence, in the Golden Age equilibrium the rate of interest is zero and corresponds to the optimal allocation of resources in the society. In such a situation, the allocation of resources between the consumption and capital goods sectors is given by the relation,

$$\frac{dK_2}{dK_1} = \frac{p_x r - p_{x1} r_1}{p_{k2}} \tag{4}$$

If the allocation of resources is not optimal, we will have $\frac{d(\Pi - \Pi_1)}{dK_1}$ between the

financial intermediary, in our case the Public Treasury, and the firm 1. It therefore denotes a price for uncertainty in capital accumulation. Now the allocation of resources between the firms 1 and 2 would be given by,

$$\frac{dK_2}{dK_1} = \frac{p_x r - p_{x1} r_1 - a}{P_{K2}}, \tag{5}$$

$a >_< 0$

The expressions (4) and (5) need to be interpreted. $p_x r$ is the money value of each dollar worth of return from employing the capital stock in production; $p_{x1} r_1$ is the money value of each dollar worth of return from employing the capital stock in the production of consumption goods. $(p_x r - p_{x1} r_1)$ is the money value of the risk premium or the value of excess return for each dollar foregone by the Public Treasury, and given as loan towards the production of consumption goods. $p_{k2} dK_2$ is the money value of an additional loan of amount dK_2 made towards the production of capital goods. The expression (4) implies that in a mutually helping community, where K is the total amount of loanable funds available, the additional loans made towards the production of capital goods, comes from the excess returns accruing from each dollar worth of additional loans advanced towards the production of consumption goods. Therefore, in equilibrium their money values are equal.

The expression (5) implies that in a situation of non-optimal allocation of resources, additional loans made to the capital goods sector, will depend also on the value of net profitableness arising from the loan of capital stock (money capital) to the consumption goods sector. The higher is the net marginal profitableness of loaned capital, the higher will be excess returns to the Public Treasury, and conversely. Then $p_{k_2}dK_2$, the money value of additional loans made towards the production of capital goods, is determined accordingly. For a second best allocation of resources between the two sectors, we must have $p_x r - p_{x_1} r_1 |a|$, for then (5) implies, $^{mrs}K_{1,L} = \beta^{mrs} K_{2,L}$, where L is the labour force available to society. $B > O$.

The argument above is symmetric with respect to the capital goods sector.

As the process of allocation of resources between the two sectors, by transferring as Capitalization to one sector the excess returns accruing from production through additional investment made to the other sector, continues, the system moves towards a situation of optimal resource allocation in the economy. The so called ‘interest rate’ or the profit rate, then vanishes, and optimum output in the economy is attained².

So our model is a three equation simultaneous equation model, where Equation (1) is the equilibrium equation, Equation (2) is the consumption function depending on disposable income, the tax being 2.5% zakat. Equation (3) determines Y as a function of Mudaraba investment.

$$Y = C + I \text{ ----- (1)}$$

$$C = Y - szY \text{ ----- (2)}$$

$$Y = Q(vW) \text{ ----- (3)}$$

where

Y= GDP at market prices

C = Private plus general government current consumption expenditure

z = 2.5% of savings.

As the model is identified, we are using Two Stage Least Square (2SLS) technique to estimate the structural equations.

To estimate the above 3 equations, simultaneous equation Riba Free Model, macro economic data from Paksitan was taken. Time series data from 1999 - 2007 in million rupees is taken from Economic Survey of Pakistan.

ANALYSIS AND RESULTS

The econometric model was estimated by 2SLS. The result of consumption function is:

$$C = a + b \text{ GDP}$$

$$C = - 28858.35 + 0.825 \text{ GDP} \quad R^2 = 0.98$$

(0.125) (16.29)

The result of Income function is :

$$Y = c + d I$$

$$Y = 768317.7 + 5.29 I \quad R^2 = 0.79$$

The estimated model shows that income has a positive relation with investment and then consumption depends on income. Thus consumption and investment are positively related in a Riba Free Economy.

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