ISLAMIC ECONOMIC INSTITUTIONS

The economic institutions of the classical Islamic world include Islamic contract law and the waqf, a form of trust. Until modern times, these two institutions were generally beneficial to economic performance. However, each had limitations that eventually blocked modern economic growth. Islamic contract law discouraged the formation of large and long-lived partnerships, thus obviating the need for business techniques and organizational forms associated with economic modernization. The waqf, designed as a rigid organization, locked capital into inefficient uses. Not until modern times has the corporation, a more flexible organizational form, entered the legal systems of the Islamic world.

Prior to the 18th century, the Islamic world did not appear economically underdeveloped to outside observers. Comparative studies by economic historians confirm that it became ‘poor’ in relation to Europe during the Industrial Revolution. Until that point, economic institutions grounded in Islamic law had afforded a respectable level of wealth by standards of the day. They had also facilitated the spread of Islam across Asia, southern Europe, and the coasts of Africa.

Law of contracts

The first few centuries of Islam – c. 622–1000 AD – witnessed the gradual development of an elaborate law of contracts. It enabled the pooling of labour and capital through several forms of partnership, including ones providing limited liability to passive investors. Profit shares, negotiated in advance, could be unequal or contingent. Islamic partnership contracts were enforced, with minor variations, wherever Muslims ruled. As merchants and producers moved, they carried Islamic law with them, helping to spread Islam. Huge numbers of people converted in order to gain acceptance into lucrative commercial networks managed according to Islamic law.

Islamic law limited neither the size of a partnership nor its duration. However, in practice the typical Islamic partnership consisted of two people, who pooled resources for a single economic venture expected to last just a few months (Çizakça, 1996). Lacking a life of its own, it was not what we call a firm. If a partner died during the contract period, the partnership became null and void, and the decedent’s share of the assets fell to his heirs. There could be numerous claimants, for the Islamic inheritance system, by
medieval standards remarkably egalitarian, assigns mandatory shares to a possibly long list of extended relatives. Accordingly, reconstituting a dissolved partnership could be very costly. Merchants and investors minimized the risk of dissolution by keeping their partnerships small and ephemeral (Kuran, 2003b).

A long-term consequence is that Islamic partnerships remained structurally simple, which obviated pressures to develop the sorts of organizational forms and business techniques that, in western Europe, gradually led to the modern economy. For instance, double-entry bookkeeping did not develop, and no markets arose for trading enterprise shares. This institutional inertia made it impossible to borrow new organizational forms, except as part of a comprehensive legal reform. Advanced organizational forms, such as the joint-stock company and the corporation, reached the Islamic world in the 19th century through the imposition of secular commercial law. By that time the financing and organization of the region’s external trade was largely under western control; and, as a result of the Industrial Revolution, productivity was much higher in the West than elsewhere. The very commercial institutions that had served Muslims well through the Middle Ages were now hindering the exploitation of modern technologies.

**Role of minorities**

The religious minorities of the Islamic world might have escaped the limitations of Islamic commercial institutions, because they enjoyed ‘choice of law’ – the privilege to do business under legal systems of their own. Yet as individuals non-Muslims could opt unilaterally to take anyone to an Islamic court, whose decision would trump that of a non-Muslim judge or arbitrator. To achieve predictability in their economic relations, non-Muslims thus tended to base their financial and commercial contracts on Islamic law; their claims induced their own court systems to emulate Islamic legal practices. Consequently, until the 18th century the economic performance of non-Muslim peoples of the Islamic world did not diverge significantly from that of Muslims. Most non-Muslim communities started pulling ahead, however, as western Europe developed the legal infrastructure of modern capitalism. Vast numbers of Christians, Jews, and other non-Muslims gained an economic advantage over Muslims by doing business under Western or Western-inspired laws (Kuran, 2004b; Issawi, 1982).

**The waqf**

Another contributor to the Islamic world’s economic successes and also to its subsequent economic retardation is the waqf, Islam’s distinct form of trust. From the eighth century to modern times, Muslim-governed states provided few public goods directly, beyond law and order. They left the supply of public goods largely to waqfs established in a decentralized manner. Vast resources flowed into waqfs; by the early 18th century they owned between a quarter and half of all real estate, depending on the
country. The services financed through waqfs included mosques, schools, hospitals, water fountains, roads, parks, inns, bathhouses, orphanages, and soup kitchens.

A waqf is an unincorporated trust established under Islamic law by an individual owner of immovable property for the perpetual provision of a service. It emerged in the early Islamic period, a time of weak property rights, partly to enable landowning high officials to shelter wealth. Converting property into waqf yielded considerable immunity against confiscation, because waqf-owned assets were considered sacred, and this made legitimacy-seeking rulers reluctant to expropriate them. In addition to social status and religious satisfaction, the founder usually obtained pecuniary benefits. He could make himself the waqf’s mutawalli (trustee and manager), set his own salary, appoint relatives to paid positions, and designate his successor. This last prerogative enabled circumvention of the Islamic inheritance system. In founding a waqf, then, an individual did not simply engage in charity. In return for shouldering social responsibilities, he obtained the privilege of sheltering wealth for personal use. Local norms determined the share of a waqf’s income that its mutawalli could reserve for himself and his family.

For a millennium this system for supplying public goods remained a distinguishing feature of the Islamic world. It owed this remarkable longevity to identifiable benefits that it yielded to huge groups. Property owners achieved a measure of material security. Rulers unburdened themselves of the responsibility to provide public goods. And the average person received diverse forms of philanthropy. Nevertheless, the waqf system had a flaw that became increasingly serious over time. Although some opportunities existed to reallocate resources to new uses, the waqf was designed to serve its founder’s wishes for ever. As such, it could not adapt quickly to changing social needs, and it locked capital into inefficient uses. By the 19th century, a time of massive technological change, the waqf system had become conspicuously dysfunctional, and reformers took to dismantling it (Çizakça, 2000; Kuran, 2001).

Up to that time, services to the Middle East’s great cities were supplied mostly by waqfs. The 19th century saw the establishment of the region’s first municipalities, under secular laws. These municipalities, which attained corporate powers, could reallocate resources relatively quickly. Within a few decades, they assumed most of the functions previously relegated to the waqf sector.

**Absence of the corporation**

Islamic law, which borrowed from various pre-existing legal systems, had spurned the Roman concept of the corporation. Limiting legal standing to natural persons supported Islam’s political mission, which was to turn Arabia’s feuding tribes into an undivided religious community. Corporations might have undermined that goal by enabling tribes to form autonomous organizations. During the formative period of Islam – from the seventh through the tenth centuries – the Middle East thus experienced no incorporation wave analogous to that observed in contemporaneous western Europe. One
reason is that the waqf, by providing the means for delivering perpetual services with large sunk costs, alleviated the need for corporations. Another is that the waqf system spawned constituencies with a stake in preserving its key features; yet another that merchants and producers who stood to benefit from corporate powers could not muster the collective action necessary to reform the legal system. Not until the modern era did the concept of the corporation enter legal systems of the Islamic world.

In the late 20th century, certain predominantly Muslim countries started to revive their waqf sectors, though in modernized and secularized form. Unlike the traditional waqf, a modern waqf enjoys legal personhood, and its founder may be a group. It is managed by a mutawalli board rather than a single caretaker appointed for life. Most critical, as a self-governing organization it can remake itself. Secularists, civil rights groups, and economic liberalizers are the key constituencies of coalitions formed to promote waqf founding. These groups see their mission as a vehicle for shrinking the state, strengthening local governance, and promoting democratization (Çizakça, 2000). Thus, having played an enormous role in Islamic economic history, the waqf is now turning into an agent of political and economic modernization.

Because the Qur’an does not mention the waqf, many Islamists are indifferent to ongoing efforts to reinvigorate the waqf sector. Their overriding goal is to purge interest from financial transactions, largely in the belief that the Qur’an bans interest categorically (Saleh, 1986; Lewis and Algaoud, 2001; Kuran, 2004a). In fact, Islam’s prescriptions concerning interest have always been a matter of interpretation, and throughout Islamic history interest-based transactions have been common (Rodinson, 1966). Nevertheless, Islamists treat Islamic banking, intended to be free of interest, as the sine qua non of a properly Islamic economy. Yet Islamic banking is a modern creation. Pre-modern economies based on Islamic law had moneylenders but no banks (Udovitch, 1979). The first banks of the Islamic world, all foreign-owned and -managed corporations, date from the mid-19th century (Kuran, 2005).

**Property rights**

Until modern times economies of the Islamic world suffered from a lack of institutions to tie the hands of governments. This meant that private property rights remained weak. Although material insecurity varied across time and space, taxation was often arbitrary, and states resorted to compulsory labour. Private property rights did not achieve credibility even in the eyes of state officials – one reason why endowing waqfs was so popular. A scribe could be plucked out of obscurity to become a prosperous statesman, and then, all of a sudden, fall into disgrace and lose everything. The expropriation of large estates was especially common, all the more so in times of financial crisis. Because this practice violated the Islamic law of inheritance, typically it was based on the ground that the deceased was not the rightful owner of his estate (Findley, 1989).
In the seventh century, the first Islamic state in Arabia had instituted a tax-and-subsidy system that might have strengthened property rights. Known as zakat, it required the payment of taxes to the state in specific forms of income and wealth at predetermined rates. In providing the state the resources to fund various activities, including charity, it also capped taxation (Rahman, 1974). However, precisely because of the inflexibility of its rate structure, within a couple of generations revenue-hungry rulers abandoned it for taxes that gave them greater latitude. Thereafter zakat metamorphosed into a narrow religious duty, incumbent on people of means, to assist the poor on an annual basis (Kuran, 2003a). Modern Islamists have tried to turn zakat into a state-run social welfare system to which the wealthy make obligatory contributions. But throughout the Islamic world taxation remains an essentially secular matter. It has also become more predictable. The wealthy classes of the present have far better defences than those of the past against government predation.

Taxation can be arbitrary without being devoid of logic. In pursuing opportunities to raise revenue, rulers sought to limit transaction costs, in particular to minimize the costs of measuring income, identifying assets, and collecting taxes. To that end they tended to collect fixed taxes directly, leaving the collection of variable taxes to local officials (Coşgel and Miceli, 2005). They also made extensive use of tax farming, which assigns collection rights to people knowledgeable about tax units.

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See also contract law, economics and; corporations; development economics; institutional trap; public goods; religion and economic development

Bibliography


Index terms

charitable contributions
choice of law
contract law
corporation
double-entry bookkeeping
industrial revolution
inheritance
interest
Islamic economic institutions
limited liability
partnerships
tax farming
waqf
zakat