

# Finance, Entrepreneurship, and Economic Development in Islam

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## INTRODUCTION

*And shake towards thyself the trunk of the Palm-tree:  
It will let fall fresh ripe dates upon thee  
The Qur'an (19:25)*

There is a dearth of an inclusive inquiry, literature, and field research dealing with Islamic perspectives on entrepreneurship in the realm of Islamic development. An inclusive inquiry should attempt to explore the approaches, views, and attitudes of Muslim entrepreneurs toward entrepreneurial activity and the role Islamic entrepreneurship plays in the wider issue of “development.” In this paper, we endeavor to survey entrepreneurial activity from an Islamic perspective. Section one deals with Islamic perspectives on entrepreneurship and the case for the development of models of Islamic entrepreneurship. Section two delves into the unique nature of Islamic entrepreneurship and integrates Islamic specific features into the suggested Islamic model of entrepreneurship.<sup>1</sup>

There have long been presages regarding the gradual demise of the influence of religion in public life as secularism emerges to dominate public life. These predictions were premised on the idea that the seeming rigidity and backwardness of religion could not withstand the evolutionary and dynamic nature of modernization, materialism, and technological innovation. In the face of these forces, religion would slowly and surely crumble and peter out. These predictions have not come to fruition. Religion, especially in Islamic countries, has witnessed resilience.<sup>2</sup> The presence of religions all over the world and particularly Islam is being restored on more solid foundations. It is thus not yet ripe to celebrate the universality of modernization, which is an upshot of secularism. To this end, Voll foretells the “end of secularism.”<sup>3</sup> In sum, we cannot yet neither proscribe religion from developmental issues

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nor discount its role in our economic behavior. “Religion,” as the former president of the World Bank 1995–2005, James Wolfensohn, believes, “cannot be excluded from the debate.”<sup>4</sup> There is a need for in-depth study of the under-researched topic of the relationship between entrepreneurship and religion.<sup>5</sup>

Dodd and Seaman are among a small number of researchers who have investigated the relationship between entrepreneurship and religion, focusing on this relationship in UK. Their research is demarcated into three levels; One: the relationship between society, religion, and entrepreneurship. This level investigates how a religious attitude influences the creation of new firms. Two: the relationship between an individual’s faith, religion, and entrepreneurship. The focus of this level of study delves into the resolution and the motivation of an individual to become an entrepreneur; the entrepreneur’s behavior and work ethics, and the entrepreneur’s set of connections. The last level of the study is centered on the relationship between theory, religion, and entrepreneurship. In this level, the authors explore the envisaged role of religion in entrepreneurship development. They conclude that there exists a “complex and interdependent” relationship between religion and entrepreneurship.<sup>6</sup> Moreover, the study finds that “the low level of religiosity amongst the surveyed British entrepreneurs was comparable with the level of religiosity among the non-entrepreneurial surveyed samples.”

There are four hypotheses that can explain the nature of the relationship between religion, development, and entrepreneurship.<sup>7</sup> The first theory proposes that each religion, particularly Islam, plays a developmental role, which culminates in liberation.<sup>8</sup> This is because all religions share a near-universal goal of bettering humankind by “being more,” as opposed to “having more.” Religions also have mutual expectations and require their adherents to exercise both moral and ethical deeds and conduct at all times and predominantly in all business undertakings.<sup>9</sup>

The second hypothesis advocated by Perkins<sup>10</sup> and Sutcliffe<sup>11</sup> views religions, and notably Islam, as “outdated, unnecessary and divisive.” Religions are thus unnecessary hindrances to progress and impediments to development. This view, through an oversimplification and a generalization, presents the role of religion in development in a generalized sense of “either/or.” A more impartial view of how religion and development are related is proposed by Goody, who argues that religion has twin developmental effects.<sup>12</sup> However, his propositions are more skewed toward the perspective that religion is an obstacle to both progress and development. This, he argues, is premised on the seemingly universal thinking that religion tends to inhibit the process of free thought and the scope of inquiry. “It is possible that the very absence of a world religion, with the various restrictions that implies, was in part responsible for the enormous expansion of intellectual horizons in Greek thought.”<sup>13</sup>

The third hypothesis upholds that religion and all its appurtenances are strictly private and individual issues.<sup>14</sup> To this end, religion and all other human undertakings, including economic activities, should be strictly distinct and separate. This is the more popular view officially approved by Western nations, since it advocates for dual exclusion of religious and state affairs from each other's domain. This view has been enshrined in the constitutions of these nations. The idea behind this view is that religion (which is a personal matter) should not mix with business (public lives of individuals).

The last proposition is hinged upon Weber's thesis. This view divides religions into two main categories:

- a) Religions that are pro-development and entrepreneurship (religion plays a beneficial role in the advancement and progression of entrepreneurial activities); and
- b) Religions that are anti-development and entrepreneurship (religion is a catalyst of conflict and a stumbling block to development of entrepreneurship).

The Weberian thesis is popular in intellectual debates and studies examining the function of religion in development. In sum, the degree of support or encumbrance religion affords to entrepreneurial undertakings in a given culture is still an unsettled issue.

Methodological tools do not exist to test causality and gauge the effects of religion on entrepreneurship.<sup>15</sup> However, it is imperative and certainly intuitive, especially in religion-based cultures, to investigate and explain religious attitudes toward and views of entrepreneurship. Theoretical development of Islamic entrepreneurship is still budding. Since the literature available on the subject is especially limited in breadth and depth, this study attempts to fill this gap.

## **ENTREPRENEURSHIP: AN ISLAMIC PERSPECTIVE**

The aim of this study is to investigate the existence and expand our perception and knowledge of any differences in views regarding Islamic entrepreneurship on the one hand and Western entrepreneurship on the other hand. If differences in views exist, two fundamental questions could be answered:

- a) Are these differences too stark to be reconciled?
- b) Is it then justifiable to develop an Islamic entrepreneurship model to capture idiosyncratic Islamic entrepreneurship issues not captured by Western models?

Since the Western entrepreneurship model has been extant for eons, this study limits its scope to the Islamic view of entrepreneurship as a feasible developmental stratagem.

Debate about Islamic entrepreneurship has been around for a long time. Prominent Muslim intellectuals have pointed out the distinction between the logical foundation of Western economics and the spirit of the Islamic moral code of behavior and value system.<sup>16</sup> These scholars have emphasized the need for development of Islamic economics to enhance awareness and recognition of an Islamic worldview. This is because Western economics neither acknowledges the peculiarities of religion-based Islamic culture nor does it accommodate Islamic economic concerns. However, Chapra argues that “Islamic economics is only necessary and justified if the more advanced Western economics, with all its variables, methods of analysis and mechanisms, fails to attend to Islamic views of what constitutes suitable allocation and fair distribution of scarce resources.”<sup>17</sup>

From the foregoing and by the same token, the great debate revolves around whether the Islamic entrepreneurship model is necessary, granted the existence of the extensively recognized and accepted Western entrepreneurship and development model. The creation of a new Islamic model is warranted if and only if:

- a) Such a model could provide solutions to unresolved issues or questions; and
- b) Such a model would integrate issues that the existing conventional model has failed to exemplify.

If these two conditions are met, we can, with a degree of assurance, state that the proposed model will afford practical and theoretical benefit to the universal foundation of Islamic entrepreneurship.

## TOWARD AN ISLAMIC ENTREPRENEURSHIP MODEL

If a religion propagates economic productivity and a positive attitude toward work, it will positively contribute to the creation of new, high-quality businesses and nurture an environment conducive to entrepreneurship. A positive attitude toward work, buttressed by political goodwill, firm commitment by the government, and an all-inclusive framework, will yield abundant and rewarding results.

Several studies have investigated, in a general context, how religion and economic activity are connected.<sup>18</sup> However, the submission that religion is pivotal in determining the form and degree of entrepreneurial activity is gaining extensive recognition and acceptance.

All individuals are entitled, and should actually enjoy, the basic right of access to income opportunity. Using the theory of “social equilibrium,” it has been argued that socioeconomic justice implicitly demands that all individuals have a right to equal opportunity.<sup>19</sup> However, socioeconomic justice does not talk about equality in poverty or richness. The ability to

earn lawful (*halal*) living is justifiable if individuals engage in productive activities. The two aspects of productive activities are employment (working for others for a fixed salary), self-employment, and employing others (engagement in entrepreneurial activity). Islam advocates and encourages Muslims to engage in entrepreneurial activities to earn *halal* income as opposed to employment.

Islam encourages Muslims to undertake entrepreneurial activities and work hard to earn *halal* income not only to meet their immediate needs but also to cater to the needs of society at large.<sup>20</sup> The ability to generate *halal* income through entrepreneurial activities and simultaneously assist others in earning a living not only ensures that public wealth is not misused by a small clique of people, but also dissuades people from relying on the state. This is because public wealth is owned by the public and should thus be invested in projects that meet the common interest and needs of society.

To this end, Islam offers both the incentives and favorable structures for entrepreneurship and economic development. These arguments are premised on the interpretation of the Qur'anic verse "And when prayer is over, disperse in the world and search for the bounty of God,"<sup>21</sup> and on the many traditions of the Prophet Muhammad. Other scholars have cited the verse "It is He Who made the earth manageable for you, so traverse ye through its tracts and enjoy of the sustenance which He furnishes: but unto Him is the resurrection."<sup>22</sup>

The command to "search and steer through the earth's tracts" transcends simple engagement in entrepreneurship or looking for employment opportunities. The "search" involves exploring unfamiliar territories to find new horizons and unearth fresh opportunities to profit humankind. An active search of this nature entails risk-taking and innovative thinking. This is the true spirit of "entrepreneurship."<sup>23</sup>

The traditions of the Prophet Muhammad and the Qur'an explicitly extol entrepreneurship and laud moral entrepreneurial activity: "But God hath permitted trade (*bay*) and forbidden usury (*riba*)."<sup>24</sup> The buying and selling activities to consummate economic transaction (*bay*) for profit means that an entrepreneur is extant. It is narrated that the Prophet Muhammad said, "A faithful and trustworthy businessperson will be resurrected on the Day of Judgment with the prophets, the truthful, and the martyrs" (Ibn Majah; al-Tirmithi). Furthermore, the Prophet Muhammad and many of his close friends were successful and truthful entrepreneurs. The Prophet Muhammad clearly stressed the need for entrepreneurship and encouraged Muslims to actively get involved in business activities. Nu'aym Ibn Abd Al-Rahman recounted that the Prophet Muhammad said, "Nine-tenths of the sustenance (*rizq*) is derived from trade (business ventures)." The second Caliph, Umar bin Al-Khattab, used to say that "Nothing is more beloved to me than to earn my living through my own hard work and efforts."

The concept of communal responsibility (*fard kifayah*) in Islam hinges on the capacity of society to derive basic needs from a particular activity or

meet public challenges and commitments. It is thus imperative that a good proportion of the Muslim population ought to have the latitude to engage in entrepreneurial activities to guarantee the stability of the nation's economic feasibility. If such a level of economic performance is not achieved by the private sector, the Islamic government has the moral and legal obligation to step in and clear the deficit. Perkins investigated the function of Islam in the "wealth creation" process, and ascertained Weber's conclusions: "There is no doubt that Islam is an economic hindrance and barrier to prosperity and fulfillment of human ambition, potential and welfare."<sup>25</sup>

However, the assertions that Islam has the tendency to daunt development<sup>26</sup> and that Muslims generally have low achievement<sup>27</sup> have been theoretically questioned even by Western scholars. Numerous Western intellectuals as well as Muslim scholars have recognized the progressive character of Islam and its ability to inculcate positive attitudes toward success and the yearning to engage in entrepreneurship activities. Islam generally has firm rights of ownership and instills a positive attitude toward entrepreneurial activities.<sup>28</sup> Wilson recognizes the singular nature of the Islamic code of business ethics and the helpful role of cost effectiveness and organizational competence that "trust" can render to economic activity. This view is supported by Sullivan, who concedes that Islam is "a religion of knowledge,"<sup>29</sup> and Wiene, who states that "Islamic tradition has always included a positive approach to economic activity."<sup>30</sup> He also notes that the Prophet Muhammad was "a merchant before his prophetic mission." Hooker has documented Muslims' seminal contributions to the world's civilizations. He argues that

One can write volumes on the contributions of medieval Islam to Western science and letters . . . There is every reason to assume that Islam can provide the foundation for a tolerant and prosperous culture today, as it has done in the past. It will not be a clone of the Western culture.<sup>31</sup>

In a similar vein, Pelletreau recognizes these contributions and gladly understands the value system that led to the demonstration of these contributions:

Muslim scholars preserved classical learning during the Dark Ages and made vital contributions at the dawn of the Renaissance in the areas of science, astronomy, mathematics, commerce, law, history and medicine.

And today, we see in the traditional values of Islam—including respect for knowledge, for justice, for good works, for private entrepreneurship, profit with honesty, and compassion for the poor.<sup>32</sup>

## THE MOTIVES AND INCENTIVES

Among the most significant factors that can explain the importance and course of entrepreneurship activities in a country is the individual's drive and motive for starting a business. The motives of the founding owners of a business and their ability to coordinate and direct economic revolution results in elemental changes in the cultural, social, and economic frameworks and realms of a country. Policymakers also use motives as a bellwether of their policy options and in targeting entrepreneurs in resource allocating. This is because entrepreneurs and their businesses later become the engines of economic growth and creation of new employment opportunities.

The motives for starting a business vary among individuals and range from the desire to be independent and exercise more control over one's work to the need to earn more money, the drive to create a new and elevated social status, the availability of opportunities to be more innovative, the compelling fear of unemployment, and the aspiration toward a secure and comfortable standard of living. From an academic perspective, researchers have classified the motives of business start-ups into discrete categories which include creativity of small firms, economic and lifestyle reasons, self-employment through starting up small businesses, and the social aspects of being self-employed. The "push/pull" motive drives business start-ups.<sup>33</sup> This view, which has gained currency in research studies, is based on classical economic theory. Storey argues that people are "attracted by the opportunity or the 'pull' of perceived profit."<sup>34</sup> The "push factors" are so called because they "push" people to consider self-employment as the only available and best option under prevailing circumstances. Such "push factors" include career dissatisfaction<sup>35</sup> and the threat of unemployment or unemployment itself.<sup>36</sup>

Islam highly approves of entrepreneurship, whether it is opportunity-or necessity-driven. The necessary condition is conformity of such entrepreneurship with the Islamic moral and ethical code of business conduct. This is unlike Western entrepreneurship, which is primarily premised on the prospect of financial rewards. Islam does not prohibit Muslims from engaging in business activities to generate profit, but it requires every Muslim to acknowledge and recognize that every business venture takes the form of worship (*ibadah*), intended firstly to appease The Almighty God. Accordingly, all business undertakings are meant to build up the Muslims' faith (*iman*) by entrusting them to the tribute of God and attending to His religious duties. "[are] men whom neither traffic nor merchandise can divert from the remembrance of God, nor from regular prayer, nor from the practice of regular charity."<sup>37</sup>

Islamic entrepreneurship is punctuated by high moral standards and stringent guidelines, which forbid greed, dishonesty, exploitation, and monopoly in accumulation of profits. Islamic entrepreneurship aims to

bring forth high-value Muslim entrepreneurs who are allowed and goaded to undertake only socially desirable and morally acceptable productive business ventures. To this end, Islam strictly forbids business undertakings that involve prostitution, alcohol, gambling, drugs, usury, and highly speculative business activities irrespective of their potential for economic viability.

The motives of Islamic entrepreneurship also sharply contrast with Western entrepreneurship in the areas of religious and altruistic motives. That is, Islamic entrepreneurship is not only a way of worship that partially enables Muslims to fulfill their religious obligations and make their faith complete (*iman*), but it is also a vehicle by which Muslim entrepreneurs can extend assistance to their fellow Muslims and others in the society. Islamic entrepreneurship thus takes a wider dimension, while the altruistic role assumed by entrepreneurs goes beyond satisfaction of personal interest and immediate needs. Therefore, the “pursuit of self-interest”<sup>38</sup> and “self-centered wealth creation”<sup>39</sup> lack a fit with the principal motives of Islamic entrepreneurial undertakings, since altruistic motives supersede personal and self-interest, which are considered natural and spontaneous outcomes of advancing the society’s shared well-being.

Islamic entrepreneurship is also considered a means of appreciating God for His countless blessings and a way of assisting others:

But seek, with the (wealth) which God has bestowed on thee, the Home of the Hereafter. Nor forget thy portion in this World: but do thou good, as God has been good to thee, and seek not (occasions for) mischief in the land: For God loves not those who do mischief.<sup>40</sup>

There are many Qur’anic verses and traditions of the Prophet Muhammad that recommend that Muslims ought to give munificently to propagate the spirit of collaboration among Muslims and promote socioeconomic equality among Muslims. It can be persuasively argued that opening a new business motivated by the need to provide employment opportunities to others can be considered a form of giving to God. Actions of this nature by Muslim entrepreneurs enable them not only to generate potentially high returns on investment and self-satisfaction, but also warrant rewards in the hereafter. Thus, the Islamic motivation for involvement in entrepreneurial activities has both moral and material dimensions. Entrepreneurial activities in Islam are based primarily on a divine incentive system. Islam as a religious system not only advocates for divine incentive, but it also endorses and accepts Western motives.<sup>41</sup>

Muslims are required to devote their intellectual, moral, physical, and financial resources in seeking the good pleasure of God with the twin benefit of making progress in worldly life and in the hereafter. The ability to earn *halal* through entrepreneurial activities enables Muslim entrepreneurs to meet their *ibadat* of a “financial nature,” like giving *zakah* and contributing for



charity, while simultaneously fulfilling their personal needs and those of their extended family. These actions will be rewarded munificently in the hereafter.

In sum, the design and building of a new developmental model requires compatibility and integration among its various components, and the most noteworthy components are institutional and cultural. Therefore, the Islamic culture and its entrepreneurial spirit require strong institutional structures and an enabling environment for it to succeed in fulfilling its will.

## **THE ROLE OF ISLAMIC FINANCING IN ENTREPRENEURSHIP DEVELOPMENT**

Every country has a unique set of hurdles that impede the growth of the entrepreneurship sector. Individual entrepreneurs, on the other hand, face unique challenges in their efforts to create a business. However, many entrepreneurs across different countries share certain common challenges. These difficulties range from government regulations and inadequate financial resources to social attitudes that frequently depress risk-taking.<sup>42</sup> Among the many hindrances to business start-ups, inability to access adequate capital to start a business is by far the best-known and most difficult obstacle facing all entrepreneurs across the world. This problem is not limited to certain cultures or backgrounds, but it is more prevalent in developing countries.

There are some well-known causes of limited collaboration between existing and/or potential entrepreneurs and conventional commercial lending institutions in Muslim countries. First, commercial financial institutions are hesitant to grant credit to (potential) entrepreneurs primarily due to high failure rates and the prohibitive administrative costs of granting credit to SMEs. Usually, the amount of the loan is too small to be economically feasible. However, failure to fully comprehend the operational nature and dynamics of SMEs, coupled with commercial bank personnel who are not adequately qualified to correctly appraise viability studies and assess and monitor small business loans are perceived to be the actual reasons driving such lending reluctance.

Commercial lending institutions often impose unreasonable prerequisites before extending credit. For example, the demand for historical business records showing profitability trends as an indicator of ability to repay the loan are difficult to fulfill, particularly by fresh and potential entrepreneurs without an established credit history or a prior record of success. Moreover, most lending institutions are unwilling to finance innovations or new products without either a track record of success or a guarantee of future performance due to unknown acceptance by the markets arising from insufficient reliable information. Since providers of loans have to guard their investments and ensure the loans are secure, banks request that potential entrepreneurs produce sizeable collateral, the value of which

often times far exceeds the amount of the loan. Since most entrepreneurs cannot meet such tough requirements demanded by commercial banks, they cannot rely on conventional banking institutions to secure start-up capital. The entrepreneur is left with two difficult options: either try to secure an alternative financing and pay exorbitant interest charges, or simply abandon their vision of entrepreneurship.

Nevertheless, potential entrepreneurs who satisfy the requests of the lending institution and become eligible for a loan are still burdened with repayment of predetermined interest charges in addition to the principal amount borrowed. The prohibitive costs of accessing capital to engage in business ventures inflict a weighty financial burden on the entrepreneur. The high interest charges put the entrepreneur in a precarious position even before the business picks up. This increases the odds against the success of a business venture. Worse still, the fixed financial obligation to repay the loan and related interest is invariant to future performance and activity of the business. If the venture is successful and generates a higher rate of return relative to interest rate, then the fixed interest rate is seemingly unfair to the lender. Conversely, if the venture is unsuccessful, the lender still recovers the entire loan and interest while the entrepreneur bears all the losses. This practice is seemingly unjust and undeserved and is explicitly prohibited in Islam.

Second, the majority of potential Muslim entrepreneurs do not deal with conventional commercial banks on a religious basis. They regard commercial banks as unethical institutions that expand the gulf between the needy and wealthy via the morally wrong interest (*riba*)-based financial practices. Studies by many scholars often ignore this element, but it has important and enormous implications. Third, a large fraction of Muslim entrepreneurs prefer sharing instead of taking the risks associated with new business ventures.

### **FROM A DEBT-BASED TO AN EQUITY-BASED BANKING SYSTEM**

Islamic economics is not a new concept even though the modern attention given to Islamic economics is fairly current.<sup>43</sup> The cradle of Islamic economics can be traced to the period of the revelation of the Qur'an about fourteen centuries ago.

The subsequent argument in this study limits itself to the scale and depth of the Islamic financial system and the potential function that Islamic banking can play in promoting the development of a dynamic Islamic entrepreneurship segment. We start with some definitions. The legal rules that dictate the social, political, economic, and cultural issues of Islamic societies are called shari'a. The main sources of shari'a are the Qur'an and *sunna*. The tenets of the Islamic financial system are based on the philosophical

belief that wealth accumulation and distribution should be fair and just. It should neither be biased against the majority poor nor favor the minority rich. The intended goal is to broaden socioeconomic justice amongst all. Islamic banking is not equal to the Islamic financial system, although there exists the widespread erroneous belief that the Islamic financial system can be provincially and exclusively defined by Islamic banking.<sup>44</sup> Likewise, most observers define the whole economy as an “interest-free” economy.

. . . Describing the Islamic financial system simply as “interest-free” does not provide a true picture of the system as a whole. Undoubtedly prohibiting the receipt of and payment of interest is the nucleus of the system, but it is supported by other principles of Islamic doctrine advocating risk sharing, individuals’ rights, property rights, and the sanctity of contracts. Similarly, the Islamic financial system is not limited to banking but covers capital formation, capital markets, and all types of financial intermediation.<sup>45</sup>

The exclusion and ban of interest (*riba*) in Islamic economics has received a great deal of attention. Most Western scholars argue that the proscription of interest in Islamic economics goes against the grain of capitalism and it not only impedes the efficient functioning of a modern economy but also limits economic growth and development. Conversely, other Western proponents of a ban on interest argue that charging or receiving interest lacks moral or economic justification. They opine that imposing interest on entrepreneurs increases their financial burden and is effectively counterproductive. Therefore, an interest-based economy cannot effectively afford socioeconomic justice.

Ahmad investigates the potential association between prohibition of interest and economic development and makes several interesting conclusions. First, money made from charging interest and other forms of “rent-seeking activities” generates new but artificial capital, which is the core means of support for the markets. Ahmad finds that “the essence of the market is entrepreneurship” and explains that “trade, not banking, is the primary function of markets.”<sup>46</sup>

Second, the partnership agreement involving the entrepreneur and financier removes the negative impact, if any, of forbidding interest. Islamic finance utilizes two main partnership-based financial instruments, namely *mudaraba* and *musharaka*. These two are used as substitutes for interest rate-based mechanisms used by conventional banking. Specifically, *mudaraba* and *musharaka* hinge on the concept of “rate of return,” where the financier and the entrepreneur share the risk (profit/loss generated by the investment) based on a pre-agreed ratio. This is unlike the predetermined fixed “interest rate” and principal paid by the entrepreneur regardless of the upshot of the business venture.

Third, Islam strictly prohibits paying or receiving interest on borrowed/lent money based on a pre-specified fixed rate of return. The novel idea behind this is that imposing interest (*riba*) creates more of a financial burden on the poor and increases their poverty level while the rich generate more wealth without engaging in any economic activity or sharing the risk of any business venture. Essentially, *riba*, which is neither a result of productive economic activity nor an outcome of an increase in commodity supply, generates wealth for a minor sector of society. Therefore, according to Islam, any form of interest-based financial arrangement is unjust, unfair, and morally unjustifiable. Moreover, any money generated by interest-based transactions is considered as unearned money since *riba* is unlawful. Fascinatingly, the Abrahamic faiths (Judaism, Christianity, and Islam) and other world religions such as Buddhism and Hinduism mutually deplore charging interest as unethical and morally wrong.

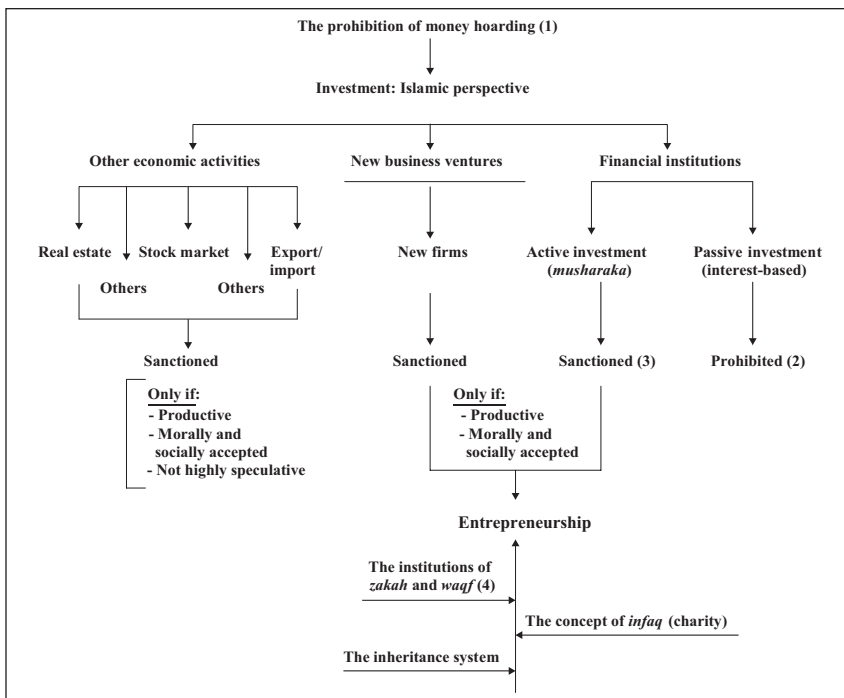
Early studies advocated for an interest-free economy.<sup>47</sup> Other studies persuasively argue that an equity-based economy will outperform a heavily credit-dependent economic system.<sup>48</sup> Another study on Islamic finance makes the suggestive conclusion that a movement toward equity-based financing will be a future global event.<sup>49</sup> From an Islamic perspective, Muslim governments can only receive finance through equity-based financing to provide public goods and services. This does not impose a debt burden on future generations, unlike debt-based financing, which runs the risk of imposing a heavy financial burden on future generations as they have to repay current public debt.<sup>50</sup> The debt-based economic system has led to insurmountable problems among most developing nations in Africa and Asia. The G8 summit of 2005 reported that debt servicing by African countries consumes all of their GDP.<sup>51</sup>

### **KEY ISLAMIC FINANCIAL THEMES CONDUCTIVE TO ENTREPRENEURSHIP DEVELOPMENT**

The main challenge facing individuals with financial resources is how to protect their money while remaining true to the core tenets of Islamic financing. Figure 1 below outlines the key premises of the Islamic financial system. The revolving theme reveals the developmental and entrepreneurial nature of Islam while simultaneously reflecting how the Islamic financial system is committed to the preservation of both the socioeconomic and spiritual welfare of humankind.

Money hoarding is forbidden in Islam since it amounts to preventing money from serving its intended purposes. This also stifles its function as a feasible tool of facilitating development as well as obstructing the achievement of socioeconomic fairness for all. “Those who hoard up gold and silver and do not spend it in the way of God, give them the tidings of a

**Figure 1. Key Islamic Financial Themes Conducive to Entrepreneurship Development**



painful punishment.”<sup>52</sup> The sound alternative to money hoarding is investing it by choosing investment opportunities.

Passive investment of money in financial institutions to generate fixed interest income is reviled and prohibited in Islam and hence unlawful. Other alternative investment channels, such as investment in the stock market, real estate, and import/export, among others, may constitute both productive and unproductive or even destructive business undertakings. Islam specifically permits productive business activities which conform to Islamic rules as laid down in shari‘a and which conserve Islamic ideals.

Islam propagates investment of money in productive, socially desirable, and moral business activities as an alternative to hoarding, and spending money in a way that pleases God. To this end, Muslim investors are encouraged to initiate their own business ventures or engage in partnership contracts with potential entrepreneurs to start new business ventures. The concept of contractual partnership arrangements is premised on the idea that individuals may be endowed with financial resources but lack entrepreneurial skills and traits. Conversely, potential entrepreneurs may have the requisite traits and entrepreneurial skills but lack financial resources. This resource

mismatch calls for the partnership between potential entrepreneurs and potential financiers, which enables both to have a stake in a business venture. This partnership arrangement is exemplified within the realms of Islamic financial arrangements called *musharaka* and *mudaraba* (direct partnership with the entrepreneur or through an Islamic financial institution). The partnership arrangement guarantees that the potential entrepreneur will not commence the business and bear the heavy burden of paying interest and principal borrowed invariant of the performance of the business venture.

Capitalism regards money as capital, while Islam treats capital as the share of wealth used in productive undertakings. Money is not a commodity for speculation but rather a measure of worth and medium of exchange. Therefore, money remains potential capital in anticipation of investment in productive economic activity in addition to other factors of production (land, labor, and entrepreneurship). Islamic banking thus performs the critical role of converting money into capital via entrepreneurship to achieve economic development. While Islamic and classical economics treat capital as a factor of production together with land, labor, and entrepreneurship, a sharp difference arises in the definition of profit generated by capital as an upshot of the production process. Classical economics considers interest income as return on capital, while Islamic economics takes profit/loss generated by the capital invested in the partnership arrangement as the capital’s share of income. Therefore, profit loss sharing (PLS) between the financier and the entrepreneur is a key feature of Islamic entrepreneurship.

Table 1 illustrates the convergent and divergent points between Islamic and classical economics in relation to return for each of the four factors of production generated by entrepreneurial activity.

**Table 1: Factors of Production**

Factors of production		Entitlements/remuneration	
		Classical economics	Islamic economics
Human-related	Entrepreneurship	Share of profit (PLS)	Share of profit (PLS)
	Labor	Wages	Wages
Material-related	Land	Share of profit/rent	Fixed fee/compensation
	Capital	Interest	Share of profit (PLS)

Table 1 provides evidence that the classical and Islamic economic systems have a similar opinion regarding entitlement of human resources (labor and entrepreneurship) as factors of production, while they differ on defining returns to material-related production factors/physical and financial resources, namely land and capital.

## ISLAMIC BANKING AND ENTREPRENEURSHIP

In Islamic banking, *mudaraba* and *musharaka* instruments are favored as means of enabling Islamic banking to play a constructive role in promoting the roots of Islamic entrepreneurship. In this setup, human and financial capitals are combined to create new business ventures. Islamic banking affords potential entrepreneurs *halal* capital to initiate and/or enlarge their businesses. The partnership arrangements protect entrepreneurs against risk and uncertainty by sharing risk (profits and losses) with the investor (financier). It is further expected under *musharaka* that banks have dedicated units or departments equipped with highly qualified and trained professionals with managerial expertise to guide and encourage entrepreneurs to engage in new and innovative business ventures. The quality of entrepreneurship is also promoted since, as entrepreneurs try to win available financial capital, financiers are spontaneously presented with the opportunity to assess the proposals and business plans of multiple entrepreneurs and engage in partnership contracts that present the best prospects.

The most widespread Islamic modes of finance are *musharaka* (active partnership), *mudaraba* (passive partnership), *murabaha* (cost plus financing), and *qard hasan* (benevolent or good loan). *Mudaraba* and particularly *musharaka* are the two most important forms of Islamic financial instruments to Islamic entrepreneurship, since they operate within strictly defined risk realms and strict PLS rules. *Qard hasan*, on the other hand, is a form of interest-free loan whose repayment amount is equal to the principal borrowed. *Mudaraba* is a partnership contract between two parties: the bank and the entrepreneur. The bank is the financier, since it provides required capital, while the entrepreneurs devote their time, ideas, skills, and expertise to investing the money in socially desirable and productive *halal* business activity. The partnership arrangement is premised on the doctrine of PLS; profit, if realized, is shared by both parties on the basis of pre-agreed ratios. If the business venture generates a loss, the bank shoulders the financial burden to the extent of incurred losses, unless the loss is occasioned by irresponsible actions, misconduct, or negligence on the part of the entrepreneur or violation of the mutually agreed-upon conditions. The loss to the entrepreneur is limited to the time invested and effort expended in managing the business.

Evidence from diverse research studies shows that banks have been extremely wary in their reaction to potential entrepreneurs in the past. In many instances, banks were not willing to engage in these forms of financial arrangements, since under *mudaraba* the entrepreneur totally manages the business while the bank becomes a passive partner with minimal or no actual ability to shape the course of the business venture. The bank more often than not uses faith, trust, and a reasonable confidence that the entrepreneur will

uphold the requisite Islamic business ethics. To this end, the bank demands that the entrepreneur provide a convincing case for the economic viability of the proposed business venture.

*Musharaka*, in Arabic, means “partnership.” It is a PLS-based financial instrument that strictly obeys the Islamic financial rules and norms. *Musharaka* is similar to the *mudaraba* contract between the entrepreneur and the financial institution, except that in the former, the entrepreneur contributes to the starting capital in addition to his/her physical and mental contributions toward the business venture.

Therefore, unlike *mudaraba*, the *musharaka* contract affords both the entrepreneur and the bank the twin chances of sharing the finances (assets or working capital) and management of the business. Under *musharaka* arrangements, the entrepreneur bears some exposure to capital loss and the bank can influence the management and operation of the business. Profits and losses are shared on the basis of pre-agreed ratios (such as a percentage of the total start-up capital contributed) after deducting the management fees of the entrepreneur. Anwar (1987, p. 24) argues that in an interest-free Islamic economy, Muslim entrepreneurs work very hard to optimize their returns, thereby also maximizing the earnings of their partners. A mutually beneficial relationship is thus created and this promotes a proper spirit of collaboration and partnership between the entrepreneur and the local investors. This ultimately has the effect of advancing the foundation of entrepreneurship in development by ensuring wider participation by the community.

The partnership between Islamic banking institutions and potential entrepreneurs also results in the emergence of high-quality business ventures. This is because Islamic banks, morally obligated to defend the interests of their depositors and shareholders, will implement guarded but practical investment measures and alternatives. This motivates them to engage in partnership agreements offering the most promising business prospects.

Islamic banks prefer *musharaka* arrangements to *mudaraba* arrangements, as the former exposes entrepreneurs to the potential risk of losing a share of their invested capital. This is enough to motivate any entrepreneur to be careful in investment decisions and make extra effort in managing the business venture. Besides this benefit, *musharaka* arrangements present the financial institution with the opportunity to actively participate in entrepreneurial activity and supervise the operations of the business.

The structure of Islamic entrepreneurship does not integrate taxes. However, the fourth pillar of Islam, *zakah* (religious alms), which literally means “purification,” obliges all Muslims (with minimum threshold), to pay 2.5% to enable the state to properly and justly redistribute the *zakah* funds among the poor. The moral obligation of the Islamic state to fulfill its role of ensuring the general welfare of all its citizens, especially the less privileged,



does not make it a *welfare state*. *Zakah* is construed and effectively defined as an empowerment tool and *zakah* funds are utilized to attain the critical goal of achieving socioeconomic justice. This is the spirit of *zakah*; hence it should not be defined, viewed, or interpreted in terms of *welfare*.

According to Metwally, Islam condemns hoarding money and passive investments such as bank deposits to earn interest. There is unanimous agreement among Muslim scholars that idle money exceeding *nisab* still falls within the realm and characterization of money hoarding.<sup>53</sup> According to Ibrahim (1994), idle wealth is still hoarded money irrespective of whether the Muslim has paid the due *zakah* on such inactive wealth. This is aimed at goading Muslims not to accumulate wealth but rather spend it by investing in productive and beneficial ways in the cause of God. There is a strong argument that imposing *zakah* on all idle wealth is not only a clear and obvious mechanism of calling upon Muslims to invest their wealth in productive business ventures but also acts as a fine to enforce the utilization of such idle wealth (through involvement in entrepreneurship) and contribute to the welfare of the Muslim *umma*.<sup>54</sup>

## CONCLUSION

This paper has explored and critically examined Islamic forms of economic development and entrepreneurship. It started by briefly reviewing differing views on the nature of the relationship between religion and development. It highlighted the Islamic perspective of development and the role of entrepreneurship as a developmental tool in realizing the ultimate goal of development, according to each society's own definition and convictions. The Western conceptualization of development does not differentiate between economic development and development in its wider context, since the overriding objective of the Western model is the creation of material wealth. This is in contrast to the Islamic holistic view of development as a two dimensional process that accounts for both material and spiritual needs. The discussion further concluded that such differences between the two incompatible perspectives are too real to be overlooked or reconciled, thus justifying the call for building an Islamic model of entrepreneurship.

It has been demonstrated throughout this study that Islam goes beyond displaying a positive attitude and passive encouragement, to profoundly attaching a religious significance to entrepreneurial activity. Islam considers entrepreneurial activity to be *fard kifayah* on the Muslim *umma* intended for pleasing God, and to contribute to the spiritual as well as to the socioeconomic well-being of Muslims. Such a dynamic attitude entails that Islam puts in place an enabling framework to create a supportive environment where entrepreneurship can develop and flourish.

### Endnotes

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