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## **Islamic economy and application of Islamic contracts in finance**

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### **Abstract**

Islam is a comprehensive religion which have integrated and relevance principles which ties with all the branch of life. Economic problems are as much interest to Islam as it circulates the life. Islamic Finance is financing activity that complies with Islamic laws and its practical application through the development of Islamic Economics. Islamic finance arises from the desire of Muslims to repute their finance in accordance with requirements of faith. Accordingly, the Islamic way of life as derived from the Quran and the tradition of the prophet Mohammed (S) is expressed in the form of ordinances and rules known as Sharia.

Islam has its own unique economic system. The last revelation to humankind-Quran, brought to Muslims a pious code for financial deals with each others. But it has faded and many western Economic systems had arrived. The economic system, however communism, socialism or capitalism cannot provoked effectively or they were ineffective in nature.

The mobilization of deposits in Islamic finance and banking is through Contracts permissible by the Sharia. Islamic Financing Contracts are derived from the practice of Prophet Mohammed (S) community in Madinah which are known as Classical Financing Contracts and others which are practiced in contemporary Islamic Financing known as Hybrid Contracts.

Throughout this paper, the comparison between the Islamic Economy and Western Economies is shown and the diverse Contracts have been highlighted and reviewed. The paper shows how these Contracts are formulated and how the Islamic Financing principles are reflected in legal terms and how it can be a strategy for Development.

**Keywords:** islamic economy, western economy, islamic finance, islamic contracts

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### **Introduction**

*“Islamic economy has proven successful in poverty alleviation and promoting sustainable growth in many countries, including United States. And it is very relevant in our country where 20 million people are starving”*

- Justice Krishna Iyer

An economy is a geographical location where the production, distribution and consumption of goods and service are held. Economic system is a way in which a nation or state locates its resources, goods and services in the community. Every economics has its own major objectives. Islamic economics has its major objectives as welfare of mankind and wealth maximisation through permissible means. Islam is a perfect way of life and it provides many guidelines and rules for every sphere of life and society especially in economy.

Islam has its own unique economic system. The last revelation to human kind – Quran-brought to Muslims a pious code for financial deals with each others. But it has faded and many western economic systems had arrived. The economic system, however communism, socialism or capitalism cannot provoke effectively or they were ineffective in nature.

The major economic system adopted by western and modern world are Capitalism. It is facing many crisis. We are aware about the economy of America and the Japan which is called as Sick of Asia.

The distinctiveness of any financial transaction has some basis which differentiates it in conventional or Islamic Financial transactions. These are Contracts. The mobilization of deposits in

Islamic finance and banking is through Contracts permissible by the Sharia. Mudarabah, which makes partnership in a commercial enterprise where one partner provides money and the other provides its expertise and management, while Musharakah, Ijarah, Murabaha etc are some kinds of Contracts.

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### **Islamic Economy**

*“Islamic Finance is about ethics, integrity, accountability, and social responsibility, it encourages business and entrepreneurship purely on profit and loss sharing basis and completely prohibits fixed incomes.”*

-Mr. Imthiaz Merchant (MD. Pragmatic wealth management)

Islam is a perfect way of life and it provides many guidelines and rules for every sphere of life and society especially in economy. Economic in Islam or Islamic economy system is based on Islamic rule called as Sharia. The fundamentals of the rule-Sharia- are the holu Quran and the Sunnah of the last prophet Muhammed (PBUH). They provide as guideline of economic and shows how an economic system should be organised for its better quality. Islamic principles has set some thoughts and laws based on justice and practicality to prevent the enmity which is a common happen in our socio-economic section.

All the economic systems are considering the major or power tool in society as Money. For money they might do anything they wishes, they forgets all when having money, moreover forgets the goal of their creation which is worshipping the god. Islamic economic is not concerned more on amount of financial income, even though it is important Islamic economic is more focussing on the spirit of the economic system. Which means even though people have lot of money and if they are not made in a way of justice and truth which said as Halal, that money is no longer valid in Islam.

Islamic economy also merely concern on justice. It prevents any kind of injustice like interest or uncertainty. Islamic economy is part of the religion of Islam which covers the various branches of life. According to the Islamic view, god had created the universe for the benefit of all human beings. God has made the resources of this earth available to mean who has the responsibility to make use of them, to mould them and to transform them according to the needs of each. Islam treats everyone as equal. All are recognised in Islam as the children of Adam. As human beings all are equal, visualises that they wants equal opportunity. At the global side, it expects all nations of the world to live a respectable life. Thus the present day situation in which poor countries are heavily indebted to the rich countries is not in conformity with Islamic vision of the world. In by the same hand, in Islam the justice should be provided and partitioned to everyone and to all nations. Then it opposes all kind of the exploitations. Islam encourages a free market economy but it would prevent the building up of concentration of economic power. At the global level all nations should exercise restraint in the use of the resources of the earth. The belief of Muslims in god make them vary from all others. They believes that the resources seen are not for us only but it should be sustainable for the future generations. Islam gives thoughts that says all the actions and works will be judged hereafter, the real power of the resources and wealth are god who created us, so it is our duty to move as he says. The belief in final judgement, one of the five pillars of Islam, places all actions under divine scrutiny.

Prof. Naqwi (the national professor in Economics of Pakistan) presents four foundational principles for the Islamic approach to economics. They are Unity, Equilibrium, Free will, and Responsibility.

### Western Economy

Economy is an organized way in which a state or nation locates its resources, goods and services in the nation or community. Western economic systems were derived from the theories of western scholars such as Adam Smith, Schumpeter, Jeremy Bentham and Max Weber. It has been widely practiced in the societies. The western economic system is also named as conventional economic system. It has some features including the concept of absolute scarcity, self-interest based, absolute freedom, materialism, and Unitarianism, and positivism versus norms. The concept of scarcity states that all the resources are limited and human wants can be fulfilled. Adam Smith states that an individual should act on his own in order to gain their own self-interest and does not need assistance from the government to do that. The freedom in conventional economies is reflected that everyone can have as they wish. No any restrictions are there on what they can and cannot do. In other words absolute freedom does not involves any laws or morality since people can do

anything to achieve their individual goals including giving bribe to expand their influences in economic world.

Capitalism is the major western economic system adopted by the most modern world today. It also faces many crises. The American economy is not growing as which it has before. Capitalism in the 21<sup>st</sup> century is a capitalism of uncertainty. Capitalist economic system begins with the publication of the Wealth of The Nation Adam Smiths essay. He said the the key of the prosperity is wealth, which is the need for capital. The definition of capitalism is always changing according to the situations, modifications, and conditions has been going on for centuries. Capitalism assumes that the ownership or management of private wealth as something is very important to the individual initiative. Capitalism does not like the importance or role of government or collective assessment.

The US is not the only capitalist nation with a huge chunk of its population that cannot meet its basic needs. The UK for instance without social welfare, would have a large proportion of its population with no means for food or housing. The extensive use of social welfare in Western countries shows that the idea of increasing production leads to the fulfilment of the basic needs for all is flawed.

Edward Bawman says about the economy of the capitalism, that

*:- “ Capitalism has not necessarily corrupted democracy – Republicans have done more in that regard with disenfranchisement and gerrymandering, but it has become sufficiently corrupt that it is undermining its value for those who are not wealthy. In particular, when the middle class stops growing and increasing its economic value, capitalism is failing its primary function. No economy does well in the long-term unless its middle class does so as well”*

The definition of socialism varies widely, but it can be described as an economic system between communism and capitalism. Like communism, socialism seeks to redistribute the wealth more equitably by the communal ownership of natural resources and major industries, such as banking and public utilities.

The major problems of western economy are Irrational Behavior, Inequality, Monopoly Behavior, immobilities, Equity, Unemployment.

### Comparison of Islamic Economy with Western Economies

Both the forms of economy wants to generate profit but it differ in both systems. The basic difference between capitalist and Islamic economy is that in secular, conventional, capitalism, the profit motive or private ownership are given unbridled power to make economic decisions. The liberty which Islam gives is not restricted by anyone. There are some restrictions as are human beings but they are told to be changed as per democratic movements. The theories of western economies made the peoples to have money or wealth more and to have it with them. It made a huge impact on the society, the society was divided and the poor sections where more. The unethical economics made to concentrate wealth on the hands of few. Usury is prohibited in Islam, Islam had made heavy restrictions to usury, but the modern economies had granted more money from usury. It will be the money which wants to be hold on other peoples but it had been concentrated at the hands of usuries.

In terms of practical application, we find that only 5 percent of the global economy is based on real investment, while the remaining is mere venturing, prediction, and unreal wealth.

The difference between Islamic economic system and conventional economic system is by comparing these both types of economics by their concepts. The conventional system is from capitalism and socialism economic systems.

### **Right of Ownership**

The conventional economical system believes in the private ownership of the means of production, distribution, and exchange are in the hand of private or individuals. And the profits are private profits.

While in Islam the concept of ownership is unique. In really all belongs to God. And some rights only had given to humans and they are to fulfil the purpose of God.

### **Economic Freedom**

Economic freedom is another concept. Unrestricted economic freedom is the feature of capitalist economy. Every individual has the permission to initiate groups and organize enterprises. It leads to midrace and lead to war of quarrelling and problems for becoming wealthier.

Islam also allows economic freedom. But the freedom given in Islam range is limited. Islam makes distinction between Halal and Haram.

### **Monopoly**

Competitional mind in conventional economy leads to destruction of minor and small enterprises and firms.

While in Islam Sharia had forbidden unhealthy competitions and banned the ways to it.

### **Institutions of Interest**

The institution of banking and interest is the main aspect of conventional economies and it is the main part of interest.

Islam had banned and not encouraged the institutions of interest.

### **Why World Embraces Islamic Economic System**

Islamic economy works very differently from other Western or Conventional Economic systems. Islamic economy promotes the good values in economy which strategies should achieve unity as well as harmony between the material and also the spiritual life of people. Islamic economic system provides equal opportunities and better fulfilments for the individual life and helps in better prosperity, and have a great guidelines from the Holy Quran and from Sunnah of prophet Muhammed (PBUH) which touches all the parts of life.

### **Islamic Contracts**

Islamic Law divides all it's legal acts into either Ibadath or Muamalath. The relationship between man and Allah is mainly known to as Ibadath and the relationship between Man and Man is Muamalath. The term Muamalath literally means 'Transactions' while technically it is any form of mutual dealings held between men to solve their day to day needs which especially in matters relating to trade and commerce. All economic activities are legally permissible as long as it do not transgress any of the principles of Sharia. No contracts or trade

should be made for selling or buying forbidden products like Alcohol or Pig meat.

It is clearly stated by prophet Muhammed (s):

*"Surely, Allah and His Messenger have prohibited the sale of wine, the flesh of dead animals, swine and idiols"*

Likewise, no contracts should be made for any financial deals on the bias of Riba or Usury. *"Allah has permitted trade and forbidden Usury"*.

The contracts which involves in Gambling (Maisir) and Gharar are also forbidden in Islam.

Muamalat can be divided into three main categories, namely, Trading Contracts (such as Murabahah, Bai Salam, Bai Isthisnae), Contracts of Profit Sharing (such as Musharakah, Mudaarabaha, Muzarae ), lastly service based contracts( like Rahn, Vakalath, Kafalath).

The concept of Islamic banking and finance mobilization of deposits is through the contracts permissible by the Shariah. Islamic contracts that are frequently used is Islamic finance can be broadly classified into equity and debt modes. Some of the main Islamic contracts are as follows:

#### **Murabaha**

Murabahah is a sale contract at a mark-up. The seller adds a profit component (mark-up) to the cost of the item being sold or it is a sale based on the cost price plus profit. The cost price or profit must be known to the buyer. It is the popular mostly used in trade and asset financing. The bank purchases the goods and delivers them to the customer, deferring payment to a date agreed by the two parties. The expected return on murabahah is usually aligned with interest payments on conventional loans. n a penalty be imposed, unless the buyer has deliberately refused to make a payment. Also, the seller has to assume any liability from delivering defective goods. It works in the following way – The Client approaches the Islamic Bank to purchase a specified commodity. The Bank, either itself or through an agent, collects all the required information about the nature and specification of the commodity, its price, colour etc. then the Bank will buy the commodity for him and a charge on it. If the client accepts this format, then the Murabaha Agreement is Signed. The Client pays the price, either in Instalments or in a lump sum, at an agreed later date. There are some principles attached to Murabaha, they are There should be genuine purchase and sale of goods by the bank, the goods must be clearly identified, Islamic Bank must have the ownership of the goods before selling them to the client. Then it sells the commodity to client on a deferred payment basis against an agreed price.

The Murabaha form of financing is widely utilised by Islamic banks to satisfy various kinds of financing requirements.

#### **Musharakah**

Musharakah is a general partnership whereby two or more parties into a contract to exploit their labor and capital jointly and to share the profits and losses of the partnership.

It is another type of financing utilized by Islamic Financing Tools. Sharikah is a partnership between parties in which financial capital act as shared inputs and profit is distributed according to the capital share of the partners or in some agreed upon ratio. The loss, however, is distributed according to the

share of the capital. Musharakah is financial partnership. Or musharakah in which partners share both in capital and management of the business enterprise. Thus partners in musharakah have both control rights and claims to the profit. All the partners have a right to participate in the management of the project.

There are two types of Musharakah basically. They are *Permanent Musharakah* and *Diminishing Musharakah*. In permanent musharakah the funds may be committed for a long period, while in diminishing musharakah not last for long period. The Islamic Bank can finance Industry, Trade, Real estate, Contracting and almost all legal enterprises through Musharakah. The essential elements of Musharakah are Partners, Capital, Business, Profit Sharing and Contract.

### **Mudarabah**

Mudarabah is a contract in profit sharing, with one party providing funds and the other manages or it is a contract between the provider of funds known as Rabbul Mal and the managing trustee known as Mudharib. In another words Mudarabah is a contract where the owner of capital entrusts his funds to an entrepreneur who contributes skills in a business and the profits generated is to be shared between them. The share in profits is determined by mutual agreement but losses, if any, are borne entirely by the financier, unless they result from the Mudharib's negligence, misconduct, or breach of contract terms. Mudarabah is sometimes referred to as a sleeping partnership because the mudharib runs the business and the financier cannot interfere in management, though conditions may be specified to ensure better management of capital. Rabbul Mal has the right to restrict the Mudharib to a specified purpose, Period, Level of risk.

There are two broad types of Mudarabah, Multipurpose and Specific purpose. In Mudarabah, the Rabbul Mal should scrutiny the work and process. In case of Islamic Bank, the bank should closely monitor the performance of the Mudharib in order to ensure that there are no problems or delays. The Rabbul Mal can appoint representatives to the board for Auditing.

### **IJARA (Leasing)**

Leasing is also an approved method for earning income according to Islamic Law. In this method, a real asset such as machine, car, house etc can be leased by the lessor to lessee for a specified period against specified price. Under this scheme, Bank purchases an asset and leases it to the Client.

At present, Islamic banks perform many types of leasing like in which at the end of the leasing period, the asset can purchase at an agreed price.

Whereas Murabaha involves the purchase and sale of the commodity itself, Ijara involves the sale of only the 'use of commodity'.

### **Salam**

Salam is a form of forward agreement where delivery occurs at a future date in exchange for spot payment. Such transactions were originally allowed to meet the financing needs of small farmers as they were unable to yield adequate returns until several periods after the initial investment. A vital condition for the validity of a Salam is payment of the price in full at the time of initiating the contract, or else the outcome is a debt-against-debt sale, which is strictly prohibited under Shari' ah. The subject matter, price,

quantity, and date and place of delivery should be precisely specified in the contract. In the event that the seller can neither produce the goods nor obtain them elsewhere, the buyer can either take back the paid prices with no increase, or wait until the goods become available. Should one of the parties fail to fulfil their contract, the bank will get back its initial investment, but will have to accept the lost profit. To reduce exposure to credit risk, the bank may ask for a financial guarantee, mortgage, advance payment, or third-party guarantee.

### **Isthisna**

Isthisna is a contract in which a commodity can be transacted before it comes into existence. The unique feature of isthisna' (or manufacturing) is that nothing is exchanged on the spot or at the time of contracting. It is perhaps the only forward contract where the obligations of both parties are in the future. At the request of the Client, the bank places an order for the manufacture of some equipment or the construction.

### **Conclusion**

Islamic law or Sharia is created based on Human nature. It gives many benefits for the citizens. The Islamic economic system actually is the best economic system to be followed. As we can see many injustice and inequalities in conventional systems, it is better to have Islamic Economic System in a democratic country. Because it will ensure great equality and opportunities to every citizens of the community or nation.

While we look to the contracts in Islam, we can see that Contemporary economic crisis has shaken the investors and Business field. Islamic Economics hold the key to mankind's future economic problems. Islam has a clear view about the human nature and it put forward a hope for the future. Islam seeks to transform the society from its state of initial endowment to a state of Falah. The contracts which Islamic Banks provide is friendly for investors and for common people. I put forwards the view that an Islamic Economy can ensure welfare of the society. Islamic economics lights for a better welfare of people.

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