

**ROLE OF GOVERNMENT  
IN ECONOMIC DEVELOPMENT:  
ISLAMIC PERSPECTIVE**

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## ROLE OF GOVERNMENT IN ECONOMIC DEVELOPMENT: ISLAMIC PERSPECTIVE

### Abstract

Islam is a total way of life. It covers all its aspects. The role of government in the economy is guided by three principles: Shura, or the rule of one man one vote, the Shari'ah-guided pursuit of public interests; and, ordaining the right or good and forbidding the wrong or bad. The revealed

guidance determines the areas of public interests, i.e., the economic objectives of the Islamic government. It also provides the constraints and criteria that guide the dynamic process of government behavior. Pursuit of public interests, together with ordaining the right and forbidding the wrong in its public aspect, creates a set of socio-economic institutions by generating a dynamic stream of norms, rules and guidelines which promote and enhance the private effort for economic growth and secure, at the same time, a necessary framework for the government to enact, finance and implement a program of constructing socio-economic infrastructures.

The historical experience of economic growth points out the importance of building “social human capital” which creates development-oriented institutions and policies. Embodied developmental values in the areas related to the behavior of individuals and groups create a kind of “wise up” attitude in the decision making in an economy. Economic development is a human-made product in the full sense of the word. It is an outcome that can be produced at the level of the individual firm and project, and “wise” institutions and policies create an environment of production that *enables* and *induces* managers to make real cost reductions that make major component of economic development.

The role of an Islamic government can be studied in term of creating such a work environment for all firms, projects and individuals. This can be shown in areas of contract enforcement and the law of market reward, enlarging the marketable human capital, creation and enhancement of development-conducive institutions and policies, measures for increasing the productivity of the poor, and improving the efficiency of the market, etc..

## **INTRODUCTION**

This paper aims to study the economic role of an Islamic government in economic development. It is divided into three sections. Section one argues for a support-private sector type of government on the basis of the guidance of the Qur'an and the Sunnah. Section two looks into lessons derived from the historical experience of economic growth while section three studies how to change policies and institutions and suggests a chart of developmental function for an Islamic State.

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**Section One**  
**THE REVELATION-BASED ECONOMIC**  
**ROLE OF ISLAMIC GOVERNMENT**

It has become an established fact that Islam provides a total way of life to men and women, and the Islamic system is complete, unique and comprehensive. Obviously, the system of government is a part of this Islamic system. Three broad, very much general, but axiomatic principles make the framework of the government behavior in the Islamic system: 1) the Shura principle; 2) the revealed-texts-guided public interest (Maslahah Ammah); and 3) the ordaining of the “known” (right) and the forbidding of the “rejected” (wrong).

Shura belongs to studies of political sciences and systems. The economic aspects of public interests, as guided by texts of revelation and the economic aspects of ordaining the right and forbidding the wrong are important areas of concern in the studies of Islamic political economics.

The pursuit of economic public interests along with public ordaining of good and forbidding of bad seem to define the economic objectives of an Islamic government. What makes this pursuit Islamic is that it must always be guided and oriented by revelation as given in the texts of the Qur’an and the Sunnah which represent a kind of economic-financial-cum-fiscal constitution for an Islamic government. Accordingly, the economic objectives of an Islamic government can briefly be said as:

- 1) Management of public properties to maximize public interests. Public properties cover both state-owned and community-owned properties. It does not usually cover the Awqaf

properties as the government has only a supervisory power over Awqaf and it cannot divert them from the purpose designated by the founders.

- 2) fulfillment of economic pre-requisites for building a state that can effectively protect the society and safeguard its cultural, economic, religious and political interests.
- 3) raising revenues sufficient to support the public administration and the functioning of the government.
- 4) enabling private individuals to produce efficiently and to increase their economic satisfaction, welfare and wealth. This implies creating conditions conducive to economic development. additionally, the state is required to guarantee a subsistence level of living to those who fall behind for any reason as human beings are respected and life is sacred regardless of race, ethnicity, abilities and actual economic performance.
- 5) preserving social and economic equilibrium, especially in the distribution and redistribution of income and wealth.
- 6) protecting the ethical environment of economic interrelations within and without the geographical boundaries of its society.<sup>1</sup>

The implications of the framework of Revelation, within which the pursuit of public interests is put into effect, can be seen by studying the constraints on the government behavior, as can be derived from the Qur'an and the Sunnah in the following:

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<sup>1</sup> Monzer Kahf, Islamic State and the Welfare State in M. Gulaid; Public Finance in Islam, IRTI, Jeddah, 1993.

- One) Abiding by the Shari'ah rulings that determine permissibilities of actions of the government.
- Two) Following the Shari'ah given priorities. Thus giving more weight to matters related to necessities, then to matters related to introducing easiness and removing hardship, then to conveniences.<sup>2</sup>
- Three) Relating certain government activities (and expenditures) to public revenues. For instance, unless for fulfillment of subsistence needs, the income (and wealth) redistribution function can only be done by means of Zakah and revenues from public properties. In other words, under normal circumstances, taxes and public borrowing cannot be imposed as instruments to finance redistribution activities.<sup>3</sup>
- Four) Protecting personal economic freedom and private properties and enabling the individuals to achieve their economic objectives.
- Five) People's approval for any regulations or commitments imposed on private properties and personal freedom, unless such restriction is made clearly obligatory in Shari'ah itself.<sup>4</sup>

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<sup>2</sup> Necessities (Dharuriyat) are defined as matters indispensable for maintaining the five essentials: life, mind, religion, posterity and wealth. If these matters are actions, they are considered obligatory; and if they are abstentions, they are forbidden. Matters that bring in easiness or remove hardship off any of the five essentials are called (Hajiyat). Conveniences add beauty and improvement to the essentials; they are called (Tahsiniyat).

<sup>3</sup> This does not mean that when taxation, and borrowing become permissible for other reasons, such as defence, their levy and burden distribution should not be used to achieve redistribution objectives. In fact, in Shari'ah, taxes and borrowing can only be imposed on the rich, i.e., they are redistributive by their Shari'ah legality itself.

<sup>4</sup> For details, supporting evidence and discussion, see Monzer Kahf "Economic Public Sector and its Role in Generating Public Revenues in the Islamic Economic System" in Monzer Kahf, Ed., State Revenues in a Modern Society from Islamic

Thus inasmuch as economic development relates to the above mentioned objectives, the Islamic government is required to pursue a developmental track that can allow the society to reach its economic frontiers. But to come down from the generality of objectives and framework to what is needed in terms of institutions and policies in a contemporary Islamic state that can fulfill the stated economic objectives, one has to look at the historical experience of economic growth and development and derive its imperative lessons.

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Point of View, IRTI, 1989, and Public Revenues in the Early Islamic Era and Its Contemporary Applications, IRTI, 1993, both in Arabic.

## **Section Two**

### **EXPERIENCE WITH ECONOMIC GROWTH**

In a distinguished lecture on *Economics in Government* M. Olson Jr. tried to answer the ever repeated question: why some nations are rich and others poor? <sup>5</sup> At the outset, he looked into the accumulated wisdom in developmental economics over the last quarter century, then concluded that the premise of “rational individual behavior eliminates the problems that activists’ policies were supposed to solve”, that is to imply that the selfish motive, as expressed in the profit incentive, and the ability to bargain are sufficient to place an economy on its production frontier, Nothing else is needed.

#### **Place of Institutions and Policies**

With high degree of aggregation, Olson briefly studied the causes of “variations in performance across countries.” He emphasized that differences in endowments, labor forces, technology and capital investment, though important, are not sufficient to explain such variations. He argued that the traditional theory of diminishing returns to any factor of production when applied to labor, capital and natural resources is incapable of explaining the differentials in economic performance between rich and poor countries. Furthermore, technology cannot be considered a decisive factor. The experience of South Korea (1973-1979) shows that less than one thousandth of GDP can be attributed to the embodied technology borrowed from outside the border. “Even if we treat all profit on foreign direct investment as solely a payment

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<sup>5</sup> M. Olson Jr., “Economics in Government: Variations in Performance Across Countries,” JEP, Spring 96, V.10, No.2, pp.3-24.

for knowledge and add them to royalties, the total is still less than 1.5% of the increase in South Korean GDP over the period” <sup>6</sup>.

Furthermore, studies on migration, both in the short run, and in the long run indicate that substantial immigration did not bring down local wages, and the economic geography of the world emphasizes that “most economic activity can now readily be separated from deposits of raw materials and arable lands ..... London and Zurich are not great banking centers because of fertile land” or deposits of iron ore and coal.

Additionally, scarce capital is not responsible for the low economic performance in low income countries inasmuch as most abundant capital countries are not characterized by high rates of growth of income. “Sometimes the shortcomings of economic policies and institutions of the low income countries keep capital of these countries from earning rates of return appropriate to its scarcity ... and it is not rare for capital and labor to move in the same direction ... out of some countries and into some countries.” <sup>7</sup>

All that leaves a large part of the explanation of poverty and richness to be done by **differences in economic policies and institutions** by process of elimination. Olson asserts that such differences are “surely the main determinants of international differences in per capita income.” <sup>8</sup>

North re-emphasized the role of institutions<sup>9</sup>. He asserted that “neo-

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<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid.

<sup>9</sup> Douglas C. North, “Economic Performance through Time”, AER, Vol.84, No.3,

classical theory is simply an inappropriate tool to analyze and prescribe policies that will induce development” because of an essential defect in ignoring the structure of incentives “embodied in institutions”. The study of the economic history of the world indicates that it is not sufficient to focus on technologies embodied in both human and physical capitals, and that studying the evolution of institutions over time is indispensable to understand the historical evolution of economic performance across political boundaries.

In his studies of activities and performance on areas of economic development in both developed and developing countries, Harberger argues that there are thousand and one ways to increase total factor productivity, which he prefers to call “real cost reduction,” and which lies in the center of development.<sup>10</sup> All such ways are invented by managers in response to their zeal to pursue their economic objectives. This process is heavily influenced by the “enabling” institutional and policy environment around them. The role of government in creating such an environment is essential.<sup>11</sup>

### **What are the Economic Institutions?**

Economic institutions represent constraints that shape human inter-relationships and patterns of activities of the economic agents. North distinguishes between two types of institutions (constraints): formal institutions that include laws and regulations and informal ones that

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June 94, pp. 359-3368.

<sup>10</sup> Harberger, Arnold C., “A Vision of the Growth Process”, AER V88, No.1, March 1998, pp. 1-32.

<sup>11</sup> Ibid.

include conceptual behaviours, norms, understanding, codes of conduct, etc. Both types of institutions together “define the incentive structure of societies and specifically economies”. Obviously there are many areas of feed back effects between formal and informal institutions.

### **What makes economic Policies and institutions?**

Al Mawardi differentiates between two types of “ordaining the good and forbidding the bad”,: individual and public. Public “ordaining the good and forbidding the bad” relates to policies and institutions that affects the public interests of the society.<sup>12</sup> In other words, while individual “ordaining and forbidding” reaches personal conducts, the public type reaches policy making, institution creating and individual norms and values that shape them. On a similar line, Olson distinguishes between two kinds of human capital: personal human capital and public-good human capital. Personal or Max Weber’s type of human capital is what Olson calls “marketable human capital”. It determines the individual performance of economic agents in the market place.

This kind of “personal culture” is indeed an important factor in explaining part of the differential in per capita incomes. Taking the observation and the experience of migrants in the United States, the personal culture may explain only a fraction of the differential in per capita income between rich and poor nations. In a thoughtful experiment, Olson argues that “Haiti with its present institutions and economic policies, and with West German levels of marketable human capital would have about

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<sup>12</sup> Al Mawardi, Al Ahkam Al Sultaniyah, Al Babi Al Halabi Print, Cairo, 1973, p.245.

twice the per capita income that it has. But the actual level of Haitian per capita income is only about a tenth of the West German level !”<sup>13</sup>

Another type of cultural element deserves strong attention that is “knowledge about what public policies should be”, what economic institutions are needed, how to work them out. This is a kind that Olson calls “public-good human capital” and al Mawardi calls “public ordaining of the good and forbidding of the bad”. Its effects on income come through shaping, creating and implementing public policies and institutions.

Observing that “the fastest growing countries are never the countries with highest per capita income but always a subset of the lower income countries.” Olson concluded that all countries actually perform below their potential production frontiers and the fastest growing countries are those that “adopt better economic policies and institutions” that “enable” them to narrow the huge gap between their actual and potential income.” <sup>14</sup>

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<sup>13</sup> Olson, Op Cit.

<sup>14</sup> Ibid.

### **Section Three** **CHANGING POLICIES AND INSTITUTIONS**

The Qur'an reads "Verily never will Allah change the condition of a people until they change that which is inside them".<sup>15</sup>

The process of changing institutions and policies is discussed by Henry J. Aaron.<sup>16</sup> In a nut-shell: ***changing the embodied "values"***. Values that are formed through lessons taken from families, friends and communities and that are themselves, in a feedback process, influenced by policies, institutions and environment. Aaron, as well as North, places great emphasis on the process of learning that shapes the embodied values. For Aaron, learning is an endogenous factor. He argues that "the assertion that values are stable (stagnant) at any level more closely resembles an axiom of religious (metaphysical) faith than it does a defensible scientific hypothesis."<sup>17</sup>

In other word, taking learning as a process to change embodied values, and realizing that values are an indigenous variable in economic development make us reach the conclusion that: public ordaining of the good and forbidding the bad (public-goods human capital), through the formulation of public policies and institutions, influences the performance of an economy by affecting the shape and direction of embodied values, that in turn is siphoned through a Max Weber type of human capital.

In brief, **"the social learning pressures may be a slow poison or**

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<sup>15</sup> Surah 13, Verse 11.

<sup>16</sup> Henry J. Aaron, "Public Policy, Values and Consciousness", Journal of Economic Perspective, Vol.8, No.2, Spring 1994, pp. 3-22.

**the lost-found cure”** as Aaron puts it.<sup>18</sup> Codes of conduct are created within an inseparable econo-ideological process of learning; and the reconstruction of such a process makes a **prerequisite for economic development**.

The change of condition mentioned in the Qur’an can take either direction. It can be from “Jahiliyah” to rationalism or from Islam to irrationalism or to agnosticism. Ideally, Islam provides a framework of rationalism based on Divine revelation. But the actual perception of Islam by people, individually and in groups, is subject to many factors that may end up, very often, creating versions of Islam which are not reflective of its ideal teachings. Hence, all that is needed is “to wise up to be able to inculcate a version of the Islamic values that is most conducive to development”.

This “necessary wisdom” cannot be found in either old or new theories of economic development. They require an ideology that goes beyond the existing economic dogmas. Olson observes that “none of the familiar ideologies is sufficient to provide the needed wisdom.” The needed ideology should be able to provide a coherence of actions on the social level that is based on productive co-operation among the “many” and that allows institutions such as contracts, private ownership, public interest, and market to function properly without being handicapped or misguided.

### **Examples of Policy Shifts**

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<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

Three areas may be taken as examples of evolution of theories that result in shifts in public policies; that is policy recommendation derived from a new breed of economic development view points. These relate to population, foreign trade and education.

1) Dasgupta<sup>19</sup> studied the population problem and the factors that shape it across borders and under different cultural axioms and social institutions including inheritance systems, patterns of personal and family conduct, parental values, etc. He concluded his study with a recommendation that population policies should concentrate on political and civil liberties, incentives to employment, fighting illiteracy and increasing labor force participation, a lot more than on the traditional family planning and contraceptive education.

2) Traditional theory on foreign trade and development is based on a few “stylized premises” of the following kind : (A) The production structure of low income countries is heavily dependent on primary goods with an ever deteriorating terms of trade that do not provide them with sufficient resources that can be assigned for development. (B) There is a need for an exception from the comparative advantage theory in order to protect the “infant industries” of those countries, otherwise foreign trade will keep them in the closed cell of primary commodity production where their comparative advantage lies and will cost them high rate of mortality of unprotected “infant industries.”

Based on such stylized facts, economic research in the 60s through

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<sup>19</sup> Partha Dasgupta, the Population Problem Theory and Evidence, Journal of Economic Literature, Vol.XXXIII, No.4, December 1995, pp. 1879-1902.

the 80s emphasized policy recommendations encouraging import substitution industries and protection in order to provide conditions for an industrial take off in the developing countries. Economic developmental policy stemming out of these theories resulted in long lists of goods under very high tariffs and heavy procedures of licensing in almost all developing countries.

Anne O. Krueger<sup>20</sup> points out to both misapplication of theories and assuming counter-situations as main reasons why economic research and economists went wrong. The challenging performance of the four tigers of East and South East Asia and the recent performance of several other countries in Asia (Indonesia, Malaysia, China and India) and in Latin America (including Brazil and Argentina) indicate that outer economies can succeed in achieving high rates of growth even with “over population and middle-of-the-road technology.” The terms of trade pessimism and foreign exchange shortages subsided ... giving way to export orientation, privatization and less protectionism.

3) Finally, it is only recently realized that improving skills through education and reorientation of the educational system to create a skill pool amenable to be used in middle-of-the road technologies proved to be an important policy tool in speeding up the rate of development. This is witnessed in several Asian and Latin American countries. Recognizing learning as an indigenous factor and drawing suitable educational policies raised both the labour force participation rates and the intensity of work per hour. All that increases the efficiency of the human engine in

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<sup>20</sup> Trade Policy and Economic Development: How We Learn, The AER, Vol.87, No.1, March 1997, pp. 1-22.

converting a mix of inputs into outputs. Fogel's study of long term development confirms this prescription. The experience of the British economic growth since 1790 indicates that 50% of the increase in output is accounted for by this latter kind of increase in human efficiency.<sup>21</sup>

### **What Contemporary Muslim Governments Need to Do?**

Although history doesn't always repeat itself, the most recent development in economic policies in the fast growing economies support the view that policies and institutions matter most in the process of economic development. In his 1995 article on *Economics in Action*,<sup>22</sup> George Shultz argues that both technological and political changes in the 90s suggest the presence of a tremendous opportunity for economic development and "rapid rates of growth in many less developed countries"; such opportunities can be grabbed through "the validation and acceptance of ideas about what it takes for economic development to take off".

A new common denominator is emerging consisting of policies and institutions that believe in, and depend on, the functions of the "market place", "incentives" and "entrepreneurship". The stories of both economic failures and economic successes over the past three decades emphasize this trio of "market", "incentives" and "workmanship". Shultz calls for protecting the expansion of the world trade by "even more expansion of the world trade".

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<sup>21</sup> Robert W. Fogel, "Economic Growth, Population Theory, and Physiology : The Bearing of Long Term Process on the Making of Economic Policy", AER, Vol.84, No.3, June 1994, p.388.

<sup>22</sup> George P. Shultz, "Economics in Action: Ideas, Institutions, Policies", AER, V.85, No.2, May 1995.

He emphasizes that threshold of economic development of the 21<sup>st</sup> century requires more emphasis on market expansion through privatization, adjustment of international financial institutions including the World Bank and the IMF, and more faith in the floating exchange rate in spite of the bubbling crises that repeat themselves in one part or another of the world.

Emerging Futurist economic policies need to emphasize the role of the government in laying the **ground rules** for the operation of the market. This is what Arnold C. Harberger calls “enabling policy”.<sup>23</sup> Inter alia, this requires an integration of political and economic objectives in such a way that satisfies the necessary conditions for enhancing the supply of savings, both internally and externally, and the demand for investment within a given country. Corruption and favoritism are pointed out as particularly important impediments to attracting capital in addition to political risk and laxity on contract enforcement.

### **Institutional and Policy Recommendation for Muslim Countries**

Development is a comprehensive process. It must tackle the formation of an appropriate level of human capital, both embodied in individuals and embodied in institutions and policies, as an indigenous and essential process of economic Development. Seven areas of government functions can be determined as objectives of policies and institution building, all of them center around a basic concept of “let people work” or the enabling policy that provides the right environment

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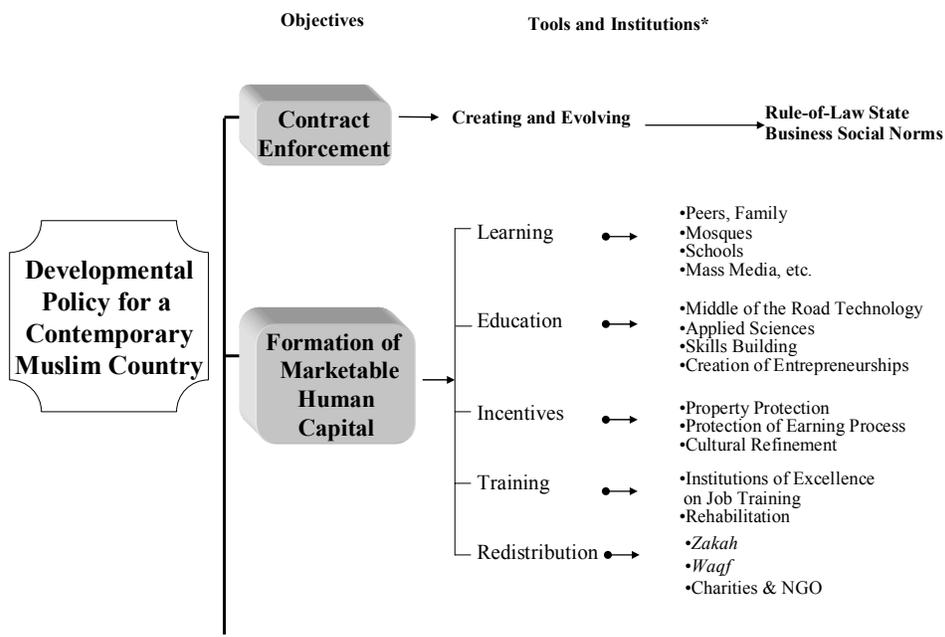
<sup>23</sup> A.C. Harberger, “A Vision of the Growth Process” Op Cit.

and incentives for the individual private efforts to fruitalize.

These seven objectives are obviously inter-linked. Therefore, each of the policy tools and necessary institutions has repercussions on more than one area of objectives. The main objectives of an Islamic development policy are: contract enforcement, formation of marketable human capital, formation of public-good human capital, poverty eradication, improvement of market functioning, enhancing output growth, and increasing labor force participation.

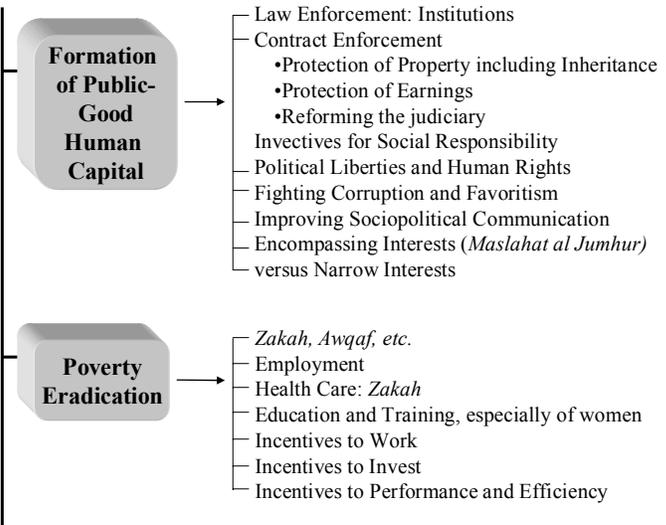
The following chart gives the tools and institutions for each of these objectives.

**CHART DEVELOPMENTAL POLICY RECOMMENDATION FOR A CONTEMPORARY ISLAMIC GOVERNMENT**

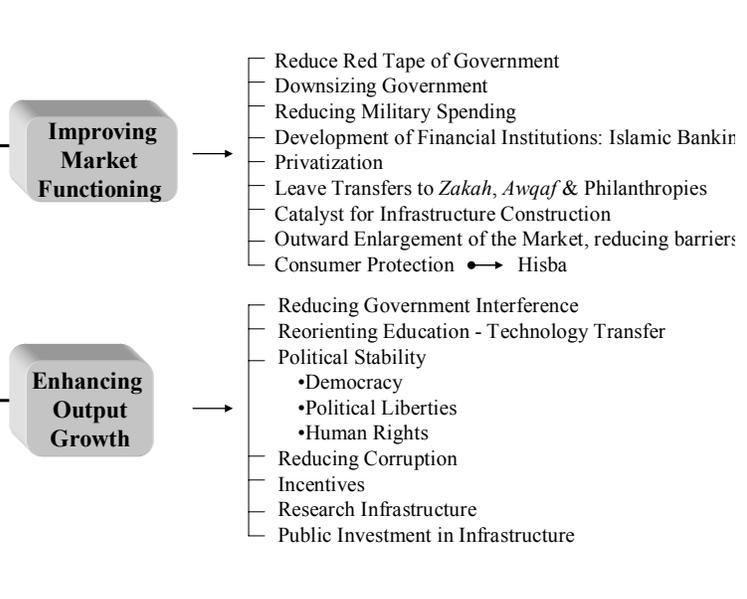


\*Taken loosely

**Developmental Policy for a Contemporary Muslim Country**  
(continue)



**Developmental Policy for a Contemporary Muslim Country**  
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**Developmental Policy for a Contemporary Muslim Country**  
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**Increasing Labor Force Participation**

- Woman Education
- *Zakah* and Awqaf Role in improving ability to work:
  - Poverty Alleviation and nutrition
  - Illiteracy Eradication
  - Health Improvement
  - Rehabilitation and skills
  - Provision of Capital
- Employment Incentives
- Labor Efficiency Incentives

