Why interest-free banking and finance movement failed in Pakistan

Mohammad Mansoor Khan
Buisness and Regional Enterprise, Centre for Regional Engagement, University of South Australia, Whyalla Norrie, Australia, and
M. Ishaq Bhatti
Department of Economics and Finance, School of Business, La Trobe University, Melbourne, Victoria, Australia

Abstract

Purpose – The main objective of the paper is to understand the reasons why Islamic banking failed in Pakistan despite lots of efforts being made to implement in contrast to its success in other parts of the world.

Design/methodology/approach – The paper is based on a debatable conceptual approach. It provides a longitudinal view of the issue of replacing the interest-based financial system in Pakistan with an interest-free system by taking the religious, socio-economic and political factors of the country.

Findings – The findings of the paper hold that piecemeal solutions to eliminate interest from the financial sector of Pakistan could never succeed. It concludes that all intellectual, practical, political, constitutional and legal efforts undertaken in Pakistan to enforce an interest-free system were not meant in earnest and therefore they inflicted serious damage to the cause of Islam as well as Islamic banking. Interest is prohibited in Islam for its exploitative nature. In case of Pakistan, interest institution is not only deep-rooted, but also strongly interlinked with other exploitative tools that are prevalent in the hands of some selected people to keep their control over political, economic and social spheres of Pakistan. There is an indispensable need to eradicate interest along with its allied forces from the polity of Pakistan. The practical success of interest-free banking and finance movement in Pakistan could not be materialized unless the state and polity of Pakistan are not convinced seriously to discover the paradigm of their personal and state institutions based on Islamic guidance and principles.

Research limitations/implications – The contents of the paper woven around normative and social disciplines and therefore, it is not possible to devise any statistical model to empirically test the contribution of these socio-economic factors in a failure of interest-free banking and finance movement for future research and any identified limitations in the research process.

Originality/value – The paper provides a broarder perspective over the issue of eliminating interest from the national economy and financial sector of Pakistan. The paper figures out some serious political, social and micro and macro economic constraints that should be first sorted out to pave the way for any viable strategy to succeed in replacing the existing system with risk-sharing and alternative interest-free mechanisms. The findings of this paper may be useful for the policy makers, researchers, academicians, financial experts, Islamic Shariah scholars, bankers, regulators, Islamic financial institutions and those Muslim countries who wish to undertake a similar kind of experiment as was attempted in Pakistan. This paper may also help the Western economist to think and debate about an alternative interest-free economic and financial system of Islam.

Keywords Interest, Banking, Finance, Pakistan

Paper type Research paper

1. Introduction

The interest-free banking and finance movement has almost lost its case to succeed in Pakistan after the Supreme Court (SC) judgement on the 2002 *riba* (interest) case

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Review. It has essentially happened due to the fact that the interest-free financial institutions cannot function without full support from other state institutions. This very precondition was hardly taken into account in Pakistan at the time of policy making on interest-free banking and its implementation. This paper takes stocks of those socio-economic variables that acted as barriers and eventually caused failure to the interest-free banking practice in Pakistan.

This paper is composed of six sections, including introduction and summary and conclusions. The first section contains introduction. The second section contrasts the top authorities of Pakistan's claims with their real intentions and efforts undertaken to enforce interest-free banking order in Pakistan. The third section highlights the prevailing features of the financial sector of Pakistan that strongly oppose the Islamic interest-free banking to take practical shape in Pakistan. The fourth section depicts the general business scenario and deals with other socio-economic issues that stand to defeat the interest-free banking practice in Pakistan. The fifth section explains the implications of the rapid globalization of business and financial markets on the interest-free banking movement in Pakistan. The sixth section presents the summary and conclusions. The very theme of this paper is captured in Figure 1, which explains that interest-free financial institutions are integral part of overall institutional set up of the country.

2. The Government machinery

The importance of government's support for establishing any new institution in the country cannot be overemphasized. Though the government of Pakistan took the initiative of institutionalizing the interest-free banking, but it never pursued it seriously. This section accounts for the role of successive governments and bureaucrats in the failure of interest-free banking and finance movement in Pakistan.

2.1 Lack of a genuine political support

It is the constitutional and legal responsibility of the Pakistan government and its people to implement the interest-free economy and financial system in the country. The first effort in this matter was registered when the Council of Islamic Ideology (CII) produced the blueprint of an interest-free economy in 1980 to comply with the directions of the President of Pakistan Mohammad Ziaul Haq. The CII warned the

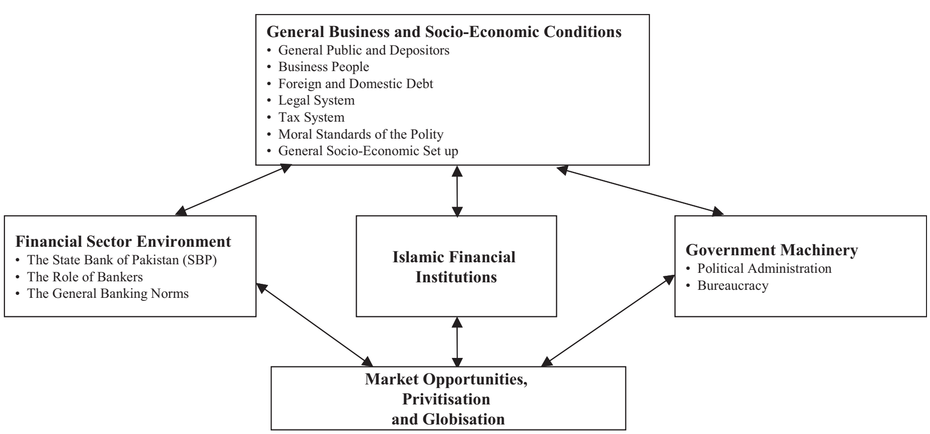

Figure 1. Interdependent relationship between interest-free financial institutions and other state instructions

government that interest-free economy could not be truly established unless personal and state institutions are also restructured on Islamic lines (The 1980 CII Report). However, the government did not devise any comprehensive strategy for Islamization and tried to enforce the Islamic order in the economic arena only (Nomani and Rahnema, 1994).

On one hand, Ziaul Haq vowed to eliminate interest from the economy but on the other, he put a ten-year ban (1980-1990) on the Federal Shariat Court (FSC) to issue any verdict against the interest-based government transactions (The Presidential Order No. 14, 1985; The 1991 FSC Judgement on *Riba*, 1991). Under his government, the State Bank of Pakistan (SBP) allowed financial institutions to invest their interest-free (profit and loss sharing (PLS)) funds in interest-bearing government securities (Tanzilur-Rahman, 1994; Asir, 1994); Zailul-Haq, 1995). The deposits were accepted on the PLS basis, but the mainstream of banking activities were allowed to function on the old interest-based lines in the disguise of mark-up financing (Tanzilur-Rahman, 1994). In fact Ziaul Haq introduced these half-baked measures to achieve some political ends. He was trying to clinch support from the religio-political parties of the country to transform his military regime into some kind of democratic regime (Gardezi and Rashid, 1983; Kennedy, 1996; Tanzil-ur-Rahman, 1997).

The governments that came after the departure of Ziaul Haq also did not take any serious interest in enforcing interest-free banking system. In 1990, the "Islami Jamhoori Itehad (IJI)" government put the agenda of transforming the economy on Islamic lines as its priority number one. It established the "Commission for Isalmization of Economy (CIE)" in June 1991 to promote the interest-free banking and finance practice in Pakistan. However, it challenged the 1991 FSC judgement on *riba* in the SC of Pakistan that had ordered the government to clean interest from the national economy within six months. The government contended that bank interest is not *riba* and it is utterly impossible in the present day circumstances to divorce the economy of Pakistan from the international economy by abolishing interest (The Muslim, 1992). It did not consider the recommendations of the 1992 CIE Report to restructure the financial sector of Pakistan on Islamic lines (Ahmad, 1997). It also delayed the appointment of a full quorum of the SC's judges for hearing on the appeals against the 1991 FSC judgement on *riba* (Ahmad, 1997). These contradictions in the sayings and actions of the IJI government revealed that it took the so-called Islamic measures to win the support of Islamic elements in its coalition government.

The military government that came into power in October 1999 showed serious intentions to transform the economy on interest-free lines under the defined parameters of the 1999 SC judgement on *riba*. But then it went on supporting the petition of the United Bank Limited in the SC, requesting for the suspension of its judgement on *riba*. Afterwards, it manipulated the SC bench of judges, who gave a verdict on *riba* case review in June 2002 that sabotaged the case of interest-free banking and finance in Pakistan (The News, 2001; The Nation, 2001; Dawn, 2002).

The present government's claim that it has been promoting the interest-free banking practice under a dual system is neither feasible nor realistic. The success of this kind of banking practice definitely looks for enforcing Islamic reforms in the overall system, which is not possible (The Nation, 1999; Dawn, 1999). In fact, the conventional banking system have been acting very convenient source of funding for the government, but the interest-free banking order was supposed to be not. Therefore, the government did not make any sincere efforts to enforce the interest-free economy in

Pakistan. It may be stated that the government is primarily responsible for defeating the Islamic banking and finance scheme in Pakistan.

2.2 The noncommittal attitude of the bureaucrats

In early 1970s, the private banking institutions in Pakistan were nationalized. The bureaucrats got key positions in the Ministry of Finance. Having a little understanding of the financial affairs, they followed conservative economic policies and also manipulated market fundamentals for their vested interests. They caused serious damage to healthy market environment, flow of domestic and foreign investments and proper economic growth (Tanzi, 1996). The bureaucratic financial management obliged the government to emerge as the biggest borrower of the banking sector of Pakistan (Yaqoob, 1995; see, The Prime Minister's Committee Report on Self-Reliance of 1991, p. 15).

The main objective of enforcing the interest-free financial system was to infuse free-market efficiency and reduce the bureaucratic influence over the financial sector of Pakistan. The bureaucrats were hardly supposed to adopt any plan that may loosen their grip over the financial sector of Pakistan. So, they complicated the whole affair and adopted round ways to practice the conventional banking system under the interest-free label (Mahmud, 1995). The CII also criticized the bureaucrats of the Ministry of Finance and the SBP for undertaking such measures that were directly opposed to the CII's recommendations for devising the interest-free banking practice in Pakistan (The CII Meeting, 1981). It may be argued that bureaucrats deliberately acted to cause failure to the interest-free banking and finance movement in Pakistan.

3. The banking and financial sector environments

The SBP and financial institutions resisted to allow radical changes in their functional and operational frameworks that were required to lay the foundation for the interest-free banking practice in Pakistan. The overall financial sector conditions were not also conducive for adopting the interest-free banking system in Pakistan. The following discussion further highlights these issues.

3.1 Lack of professionalism in the SBP's management

The SBP is constitutionally responsible to regulate monetary and credit system of Pakistan and foster its growth in the best national interest. However, the political and administrative managers of the country hardly allowed the SBP to assert its autonomous character (Saleem, 1993; Ahmad, 1993, 1994a, b). In practical terms, it acted as a backroom office of the Ministry of Finance of Pakistan. The hostile political parties used the SBP as a major domain of their party politics (Ghausi, 1993; Zahur-ul-Haq, 1993; Tahir, 1994). These considerations have seriously affected the professional integrity of the SBP. Most often the performance of the SBP remained far from satisfactory in managing savings and investments, securing monetary stability and fiscal discipline of the country (Yaqoob, 1995). In 1997, however, the increasing demand from international financial agencies obliged the Pakistan government to introduce some reforms in the financial sector to restore the real autonomy of the SBP (Business Recorder, 2002; The 2002 Task Force Report of Ministry of Finance, Pakistan, 2002, p. 38).

Having seen no genuine interest from the government, the SBP did not take pains to devise any prudent policy for adopting the interest-free financial system. The transformation task was also creating some serious institutional and functional problems for the SBP. The SBP found that under the interest-free financial system, the monetary tool of discount rate would cease to exist and that would make its task of maintaining price stability and exchange rate control much more difficult (Akram, 1994). Therefore, the SBP remained very casual in progressing towards the full-fledged interest-free banking operations. It did not establish any internal Islamic Shariah board for seeking guidance on its Islamization policies. It did not take any serious measures for providing proper training to bankers on adopting the interest-free banking and finance system. It did not furnish banks with all relevant documents and guidance for practising the approved interest-free modes of financing. It rather extended a freehand to the bankers for exclusively using the interest-like mark-up financing system (Tanzil-ur-Rahman, 1997). Thus, for the sake of its own convenience, as well as earning appreciation from the government's camp, the SBP opted to maintain a status quo in the existing financial system of Pakistan.

3.2 Lack of the Islamic vision and training of the bankers

The Pakistani Bankers are well trained in the conventional banking and capitalist environments. They have no real vision about the theory and practice of interest-free finance. They were not given any training to handle the interest-free modes of financing (CII's Consolidated Recommendations, 1983). They were of the view that they could not perform the lending and borrowing operations on risk-sharing basis because the declaration of loss may cause a run of depositors on banks (The 2002 Task Force Report of Ministry of Finance, Pakistan, 2002). Therefore, they almost relied on the same policies of lending, investment and profit distribution under the garb of interest-free banking system. They adopted the practice of showing a pure financial transaction as a trade-based activity on paper only for the sake of satisfying the Islamic Shariah requirements (The 1991 FSC Judgement on Interest; The CII Meeting, 1983; Tanzil-ur-Rahman, 1997). Thus bankers did not let the interest-free banking practice to have a fair go in Pakistan.

3.3 Inefficient and unjust features of the financial sector of Pakistan

The interest-free banking practice failed in Pakistan because the existing financial sector of Pakistan lacks proper documentation, transparency, accountability, adequate prudential regulations and supervision (Business Recorder, 2002; see also The 2002 Task Force Report of the Ministry of Finance, Pakistan, 2002, Chapter V1). The forthcoming discussion may reveal that the characteristics of the banking and financial sector of Pakistan are not only unhealthy from the market perspective, but also strongly opposed to the basic tenants of Islamic economics. These features mainly include non-performing loans and write-offs, control of a handful people on bank credit and high cost of banking services for a common person. The following discussion provides a brief account of these matters to ascertain their negative impacts on the interest-free banking and finance movement in Pakistan.

3.3.1 Non-performing loans, write-offs and cooperative scandals. The financial sector of Pakistan has been plagued with high level of non-performing loans. Table I provides a full picture of loan defaults in the financial sector of Pakistan from 1985 to 2002.

Table I shows loan defaults in the main sectors of the Pakistan's economy. During the period from 1985 to 1993, bank defaults increased from Rs. 23.4 billion to Rs. 95.7 billion. They increased from Rs. 130.7 billion (25.7 per cent of total loans) to Rs. 279 billion (26.6 per cent) between 1994 to June 2002. The amount of write-offs of non-performing loans for the period 1985-1998 was Rs. 16.60 billion. The banking

Year	Industry	Amount of defaults (outstanding) Agriculture	Others	Total	Amount of write-offs
1985	12.1	1.9	9.5	23.4	0.09
1986	15.1	2.3	10.1	27.5	0.14
1987	17.4	3.2	10.9	31.4	0.20
1988	19.6	4.0	12.9	36.5	0.16
1989	21.8	5.8	14.5	42.1	0.11
1990	22.2	8.9	14.6	45.8	0.33
1991	26.5	8.4	21.2	56.1	0.48
1992	39.3	10.2	28.8	78.4	1.37
1993	50.8	7.7	37.4	95.7	0.98
1994	71.9	9.9	48.9	130.7	1.12
1995	73.3	10.4	61.8	145.4	1.44
1996	92.0	15.1	64.7	171.9	2.27
1997	93.7	17.6	71.3	182.6	7.15
1998	96.3	21.8	66.4	184.4	0.78
2002	NA	NA	NA	279[a]	NA
Total					16.60

Notes: NA: Not available, [a]Business Recorder, 2002
Source:

Table I.
Amount of loan defaults and write-offs in the financial sector of Pakistan for the period 1985-2002 (Rs. in billion)

sector allocated Rs. 30 billion out of its profit as a provision for non-recoverable loans since 1985 to 1993. In 1998, the governor of the SBP pointed out that on average at least 30 per cent loans at financial institutions of Pakistan had been found non-performing during the 1990s (The SBP Policy Issues, 1998).

The political misuse of the financial sector is a major cause of the increasing level of bank defaults (Yaqoob, 1998). In 1993, an inquiry of the SBP pointed out that bank defaults incurred mostly in such cases where the presidents of banks got instructions from the Prime Minister's House to grant loans to chosen individuals without worrying about their projects' credentials and other collateral requirements (Mullick, 1993). In 1997, the published list of the loan defaulters in the Pakistani newspapers showed that there were as many as 5,300 names of top politicians, powerful business tycoons, army generals and other influential people of the country (Dawn, January 22, 1997). The close scrutiny of the list revealed that many defaulters after making defaults in the repayment of their advances with one bank were able to secure loans from another bank. The banks granted huge loans to many undeserving individuals under fictitious names (Business Week, 27 January 1997). The Pakistani news media called the loan defaulters as "artful dodgers" (The Nation, 3 September 1993).

Furthermore, in the period of 1986-1994, the financial sector of Pakistan registered three major cooperative scandals that deprived 250,000 depositors of about Rs. 37 billion (Yaqoob, 1995). The poor corporate governance of the SBP and its weak regulatory frameworks were major reasons of these financial irregularities and political misuse of the financial sector of Pakistan (Khan, 1997a, b; Masud, 1997).

3.3.2 Monopoly of the selected people on bank credit. The financial institutions of Pakistan usually discourage an easy access of the small investors to the bank credit. They lend huge sums to big industrialists and influential borrowers. In 1997, the official statistics of the SBP revealed that 4,327 privileged borrowers utilized Rs. 184.8 billion (56 per cent) of the total funds of Rs. 330 billion deposited by 28.4 million depositors. Further, 26,877 borrowers obtained advances amounting to Rs. 72.484 billion. It means that about 31,000 borrowers obtained Rs. 257.284 billion or 83 per cent of the total deposits of Rs. 330 billion. While, 42 per cent depositors of less than Rs. 100,000 got only 4 per cent of the banking funds (The State Bank News, 16 June 1997). These figures give some idea about the control of a small group of influential politicians, feudal lords, army officials and business people over the bank credit in Pakistan.

Furthermore, the banks' concessionary borrowings and subsidies that are supposed to be granted only to the weak economic groups were clinched by the handful superiors of Pakistan (Khan, 1993). In 1993, the governor of the SBP pointed out that the subsidy of Rs. 10 billion was provided on concessionary loans basis to the undeserving borrowers (The Business Recorder, 17 August 1994). Similarly, in early 1990s, three government-run banks, namely National Bank Limited of Pakistan, Habib Bank Limited of Pakistan and United Bank Limited of Pakistan approved the loans of Rs. 16 billion at below market rate under the "Prime Minister's Yellow Cab Scheme" of self-employment (The Muslim, 28 November 1993). Later, the SBP revealed that 87 per cent of these loans were made on political basis to the nominees of the ruling party (The Nation, 22 January 1994).

3.3.3 Expensive and unpopular banking services. The banking services in Pakistan are very expensive and unpopular because of high level of bank defaults, large provisions for bad debt, concessionary borrowings, subsidies and extravagant spending by bank officials (Yaqoob, 1995). During 1990s, the average spread between the rate of return on deposits and lending has been ranged as wide as 10-11 per cent at the banking sector of Pakistan (Yaqub, 1993). It is quite contrary to the internationally acceptable level of 2 to 4 per cent. Most often, if the rate of return on deposits were to be adjusted to the prevailing inflation rate, the real rate of return may come out as negative. As a result, general depositors do not find any real incentive to save and invest (Saleem, 1993; Sheikh, 1994). A large component of the financial savings in Pakistan comes from small savers who commit their funds to banks under such compulsions as for the education of their children and as a provision of old age (The Nation, 1993; Yaqub, 1998). The expensive and unpopular banking services of Pakistan have aggravated the existing micro–macro problems such as low level of capital formation and investment, sick industries, non-performing loans and unsustainable economic growth.

The discussion in section 3 reveals that the basic structure of financial sector of Pakistan is designed in such a way that it cannot make any real contribution in the communal welfare. Therefore, it was not possible to put the prevalent system into full conformity with the etho-social objectives of Islam by merely changing the interest-based lending and borrowing mechanism with the interest-free one. In fact, there was a need to develop just and equitable infrastructure and Islamic norms within banking sector to ensure the successful adoption of the interest-free financial system in Pakistan.

4. General business scenario and socio-economic factors of Pakistan

The general business scenario and socio-economic factors of Pakistan were not in favour of interest-free banking practice. General depositors were risk-averse and they did not show any readiness to bear the risk involved in committing their funds under the interest-free banking system. The business community cannot afford to do business with banks on the basis of risk-sharing and thereby share their true profitability and business privacy with banks. The huge burden of internal and foreign loans on Pakistan economy was another formidable hurdle in transforming the economy on interest-free lines. The legal system, the tax system and the existing socio-economic and moral infrastructures of Pakistan were against the basic tenets of Islamic economics. The following discussion sheds lights on these issues to envision their role in the failure of interest-free banking movement in Pakistan.

4.1 The risk-averse attitude of general depositors

General depositors hold risk-averse attitude based on their experience with the banking sector of Pakistan. As explained in section 3, the banking sector of Pakistan has been involved in some malpractices and mostly serving the people at higher echelon of the society. Therefore, general depositors hold a little confidence in banks, and they adopt a risk-averse attitude in their dealings with banks. This is the main reason that over the years, debt has been rapidly increasing in the existing banking and market structure of Pakistan. The national saving schemes offering a fixed rate of return have outnumbered the equity investments in the financial market of Pakistan (Hook, 1997; Sheikh, 1994; Saleem, 1994a; Siddiqi, 1994; Yaqub, n.d.). The risk-averse attitude of general depositors is also because of the fact that most of them are small savers. In 2001, small depositors accounted over 60 per cent of the total deposits of Rs. 1,276 billion of the banking sector of Pakistan. More than 87 per cent investors in the interest-based government schemes who invested less than Rs. 0.5 million were retired government and private sector functionaries, widows and orphans. They used to rely on the fixed and guaranteed rates of return on their investments for their livelihood, and therefore they wanted to have a full surety about the repayment of their principal together with a fixed return (The 2002 Task Force Report of Ministry of Finance, Pakistan, 2002, p. 17).

The Ministry of Finance and SBP pointed out that the risk-averse attitude of general depositors is the main hurdle in transforming the economy of Pakistan on Islamic lines. They warned that any attempt to switch over from the interest-based modes of deposit taking to the interest-free ones might impose a binding constraint on the investment and growth capacity of the economy of Pakistan. It may jolt the entire system of financial intermediation in Pakistan (The 2002 Task Force Report of the Ministry of Finance, Pakistan, 2002, p. 27). In sum, the risk-averse attitude of depositors did not allow the interest-free banking practice to flourish in Pakistan on PLS basis.

4.2 Little cooperation from business community

Most of the business people in Pakistan are engaged in keeping double sets of accounts. They are in practice of understating their real income or shifting funds from their profit-making ventures to the loss-making ventures so as to avoid huge tax payments. They did not enter into PLS relationship with banks because they could not afford to share their business privacy and true profitability with banks. In the given context, banks found a little demand from the business people to lend them money on PLS basis (Akram, 1994). Thus, the non-co-operative attitude of business people played a significant role in bringing failure to the interest-free movement in Pakistan.

4.3 Foreign and domestic debt burden on Pakistan economy

The unsustainable volume of interest-based domestic and foreign loans has been found the most serious hurdle in transforming the economy of Pakistan on interest-free basis. Table II provides a full picture of the mounting foreign debt on the economy of Pakistan from 1955 to 2002.

Table II.
The outstanding foreign debt on the economy of Pakistan for the period 1955-2002: long and medium term (US$ million)

Year	Amount of debt	Repayment of principal	Payment of interest	Debt servicing
1955-1956	40	1.00	1.00	2.00
1959-1960	145	6.00	5.00	11.00
1964-1965	1,021	37	25	62
1969-1970	2,959	105	71	176
1974-1975	4,796	144	104	248
1979-1980	8,658	350	234	584
1984-1985	9,732	513	275	788
1989-1990	15,094	741	491	1,232
1994-1995	22,117	1,294	748	2,042
1999-2000	38,500	1,950	990	2,940
2002	36,000	NA	NA	2,835

Note: NA: Not available
Sources: Kemal (1997), *The 2002 Task Force Report Ministry of Finance, Pakistan*, 2002, p. 12

Table II provides details about foreign debt from the year they were first contracted to 2002. The economy of Pakistan started to take heavy long-term foreign loans in early 1960s to bring the industrial revolution in the country. In 1955, foreign loans amounted to US$40 million, but they rose to US$1,021 million and US$4,796 million in 1965 and 1975, respectively. They spiraled up to US$8,658 million in 1980, and to US$22,117 million in 1994. They further climbed up to US$38,500 million in 1999 (Kemal, 1997). However they declined to US$36,000 million in June 2002 (The 2002 Task Force Report of Ministry of Pakistan, 2002, p. 11). The debt servicing liability (repayment of the principal amount together with interest) also increased with accumulating debt. The debt servicing liability rose from US$2 million in 1956 to US$584 million in 1980 and to US$2,940 million in 1999. However, it decreased to US$2,689 million by June 2002 (The 2002 Task Force Report Ministry of Finance, Pakistan, 2002, p. 12).

The government of Pakistan has also been constantly relying on internal public borrowings. Table III describes the trends of fiscal deficit of the Pakistan economy.

The features of the Table III are self-explanatory. It is revealed that the economy of Pakistan sustained a large fiscal deficit of average 8.8 per cent of gross domestic product (GDP) in 1970s and 7 per cent of GDP during the period from 1980 to 1996 (see Khan, 1997a, b; Haque and Peter, 1994; Chaudery, 1997; Naqvi, 1998). However, during the period 1997-2001, the fiscal deficit has averaged 6.4 per cent of GDP, amounting to Rs. 180.5 billion or 5.2 per cent of GDP in the fiscal year 2001. The interest payments (both domestic and foreign debt) amounted to Rs. 17.9 billion in 1991. They spiraled up to Rs. 235 billion in 2001, which were equal to 36 per cent of current expenditures and 32.2 per cent of total expenditures of Pakistan (The 2002 Task Force Report of the Ministry of Finance, Pakistan, 2002, p. 12).

The government of Pakistan failed to make productive use of foreign loans due to financial mis-management and other micro–macro economic imbalances (Rasool, 1994). Most often, it discharged old loans and interest payments from the proceeds of new loans or rescheduling of old loans (Malik, 1997). It used the banking sector as a captive source to meet its financing needs. It often financed budgetary deficit by printing money against fictitious assets. This practice aggravated the problems of abject poverty, unemployment and high inflationary pressures (Naseem, 1995).

Table III.
The expenditure and budget deficit of the economy of Pakistan for the period of 1981-2001 (Rs. billion)

Fiscal year	Tax revenue	Total revenue	Total expenditure	Current expenditure	Development expenditure	Interest payments	Fiscal deficit	Primary balance
1981	38.8	49.0	63.6	37.8	25.8	5.9	14.6	−8.7
1982	43.0	53.8	71.0	44.5	26.5	7.7	17.2	−9.5
1983	49.0	61.5	87.1	57.7	29.4	11.1	25.7	−14.5
1984	53.6	74.8	100.0	71.9	28.1	14.1	25.1	−11.1
1985	61.4	80.0	116.8	83.8	33.0	16.5	36.8	−20.3
1986	72.4	92.8	134.5	94.7	39.8	19.7	41.6	−22.0
1987	83.0	105.7	152.4	116.2	36.2	24.0	46.7	−22.7
1988	93.5	122.8	180.4	133.6	46.7	33.2	57.6	−24.4
1989	110.3	144.3	201.2	153.1	48.1	38.1	56.9	−18.8
1990	119.4	158.8	221.6	165.6	56.1	46.7	56.1	−16.1
1991	129.6	171.8	261.0	195.7	65.3	50.0	89.2	−39.1
1992	164.3	231.5	321.5	230.1	91.3	62.4	89.9	−27.6
1993	178.4	241.1	348.7	272.5	76.2	78.8	107.5	−28.7
1994	208.4	272.7	364.9	293.5	71.5	90.9	92.2	−1.3
1995	257.9	322.9	428.3	345.9	82.3	97.2	105.4	−8.1
1996	305.6	380.3	518.1	423.9	94.2	132.5	137.8	−5.3
1997	324.6	384.3	540.9	455.4	85.5	161.2	156.6	4.6
1998	354.8	429.5	634.0	529.9	104.1	202.4	205.0	−2.1
1999	390.7	468.6	647.8	547.3	100.5	220.1	179.2	40.9
2000	406.8	525.4	733.6	645.1	87.7	243.3	208.2	35.1
2001	444.8	546.4	726.9	650.7	92.5	234.7	180.5	54.2

Source: *The 2002 Task Force Report of the Ministry of Finance, Pakistan*, 2002, p. 12

The mounting debt adversely affected the net inflow of capital, monetary policy and sustainable economic growth of Pakistan (Haque and Peter, 1994; Khan, 1997a, b; Naqvi, 1998).

The government of Pakistan did not make any serious attempt for restructuring the economy and its borrowings on interest-free basis. In 1990, the government appointed the "Prime Minister's Committee on Self-Reliance" that produced a report, titled, *The Prime Minister's Committee Report on Self-Reliance* in 1991. The report contained a strategy for the elimination of interest from the domestic and international government borrowings by using debt-equity swap methods and other interest-free instruments. The government did not take any action on the report because it suggested a strict financial discipline on the government's expenditures as a first step towards achieving the goal of self-reliance (see for example, The Prime Minister's Committee Report on Self-Reliance of 1991, pp. 15-22; Ahmad, 1997).

During the hearing of *riba* case review at the SC of Pakistan in June 2002, the government informed the SC that the non-availability of a viable interest-free alternative to foreign debt is a stumbling block in transforming the economy on interest-free basis (The 2002 Task Force Report of Ministry of Finance, Pakistan, 2002, p. 36). The government further argued that it is its unavoidable need to mobilize resources through the conventional system of borrowing to meet its financial obligations to domestic and international creditors. Therefore, the switch over to such interest-free arrangements that may not ensure the government to mobilize funds for paying its outstanding debt would seriously handicap the economic and financial set up of Pakistan (The 2002 Task Force Report of Ministry of Finance, Pakistan, 2002,

p. 38). The foregoing discussion holds that the debt problem seriously undermined the scope of transforming the economy and financial sector of Pakistan on Islamic lines.

4.4 Weak and tardy legal system of Pakistan

The legal framework of Pakistan for recovery of loans is weak and tardy. The banks need to wait for about three to six years to get initial court decisions against defaulters. In the cases of appeal, the banks wait for another five to ten years to receive final decisions. Sometimes, banks find it more feasible to waive off non-performing or bad loans than wasting their time for their recovery through legal means (Akram, 1997; The 1999 SC Judgement on *Riba*, p. 65).

The government of Pakistan did not devise any efficient legal system to safeguard the interest-free banking practice against any misuse. Under the 1984 Banking Tribunals Ordinance, the government established ten Special Banking Tribunals in the country with special powers to decide the banking cases within 90 days (Akhtar, 1988). However, after some time, the government ceased its support for these Tribunals and resultantly, they faced the staffing problem and became almost defunct. Furthermore, the political and bureaucratic influence over these Tribunals did not let them to deal with banking cases on impartial and just basis (Akhtar, 1988). On 30 September 1992, more than 33,000 cases were pending before these Tribunals that involved recovery of Rs. 2.5 billion. At the same time 600 cases were pending in the High Court of Pakistan that involved bank loans of Rs. 5 billion (Dawn, 12 October 1992). Due to weak legal system, banks adopted highly conservative conventional lending policies, which hardly leave any scope for the interest-free banking practice to succeed in Pakistan.

4.5 Rigid and narrowly based tax system of Pakistan

There is a lack of width, elasticity and bouncy in tax laws of Pakistan. The tax to GDP ratio (fiscal effort) has averaged around 12 to 14 per cent against the average of 18 per cent for the countries at similar levels of development and income brackets (The 2002 Task Force Report of Ministry of Finance, Pakistan, 2002, p. 11). The government's total revenues (tax, non-tax and surcharges) have been insufficient to finance the current expenditures. The fiscal efforts in Pakistan have been stagnant or even declining over the last three decades. In year 2001, there were 1.4 million taxpayers against the population of 133 million (1.05 per cent), whereas the potential was estimated about 5 to 10 million (Saeed, 2000). The agriculture sector has not ever been properly taxed and that deprived the government's exchequer of revenue about Rs. 20 billion per annum (The 1986 Report of Working Group on Tax System of Pakistan, p. 5).

A study conducted by "Pakistan Institute of Development Economics" observed that on average Rs. 88 billion have been evaded in tax revenues annually due to the alliance between tax collectors and tax evaders (Haq, 1995). There is a strong influence of powerful lobby over the tax administration. A large number of powerful politicians, bureaucrats, industrialists and army officials evade tax payments. The tax department always grants billion of worth fiscal incentives, such as tax deductions, relief, tax holiday and exemptions to the influential people (Haq, 1999). Consequently, the tax base has been constantly eroded and tax rates have gone up. The government has mostly remained aloof to the dire need of devising efficient and just revenue collecting system for meeting its fund needs. Rather, it went on increasing its reliance on borrowings from the internal and external sources (Khan, 1997a, b; The 2002 Task Force Report of Ministry of Finance, Pakistan, 2002, p. 12).

It is a general impression that tax officials harass honest business people to meet their mandatory tax targets that appear more unrealistic and oppressive after the exclusion of the social superiors from the tax bracket. A large number of business people keep double sets of accounts to avoid high tax payments (*New Horizon*, 1998). In the given context, banking sector alone cannot persuade business people to maintain a true record of their business operations and profitability so as to procure bank credit under the PLS arrangement. The underlying discussion implies that the tax system tends to evolve such business conditions that are directly opposed to the basic tenets of Islam and act as a deterrent to the interest-free banking practice in Pakistan.

4.6 Malpractices in the polity of Pakistan

Malpractices that are prevalent in the society of Pakistan include: bribery, perversion of rules and procedures, nepotism, misuse of funds, abuse of power, illegal appointments, hoarding, black marketing, smuggling, etc. Regular media reports and enquiring results show that a significant number of politicians, top officials and bank executives have been involved in financial scams and misuse of power. A large number of business people have been engaged in hoarding, adulteration, bribery and tax evasion (Nadeem, 1993). A research-based institute, "Gallup Institute of Pakistan" conducted a survey in 1992, which revealed that corruption level in Pakistan was increased by 50 per cent from 1970s to 1980s. It was further noted that more than one-third of the population attached no stigma to corrupt individuals in society (Haq, 1995; Nadeem, 1993). These malpractices have adversely affected the just and efficient functioning of the economy and financial sector of Pakistan. A study conducted by "Pakistan Institute of Development Economics" showed that the size of underground economy during 1991-1996 was on average equivalent to 41 per cent of total GDP (Business Recorder, 2002). Dr Mahbub-ul-Haq, the former Minster of Finance of Pakistan estimated that corruption accounted for about 2 per cent of GNP in 1988, and it shot up to 5 per cent in 1993.

The SC of Pakistan, during its hearing on *riba* case in 1999 recorded that the interest-free banking practice cannot seek roots in Pakistan unless the government take serious measures to eradicate the malpractices from the polity of Pakistan (The News, 26 March 1999). In sum, interest-free banking did not prosper in Pakistan because its prerequisites such as fairness, honesty, mutual cooperation and trust were not met by the polity of Pakistan.

4.7 The exploitative socio-economic set up of Pakistan

The socio-economic set up of Pakistan benefits powerful people at the cost of weak and poor. The government failed to eradicate the control of a handful people over the power and wealth of Pakistan, which always remained a major hurdle in ensuring broad and sustainable economic development within social welfare context. In 1973, the Chief of the "Planning Commission of Pakistan" pointed out that only 22 family groups have controlled 75 per cent of the industrial assets, 80 per cent of banking and 70 per cent of insurance in Pakistan. He further added: "Pakistan's capitalist system is still one of the most primitive in the world. It is a system in which economic feudalism prevails. A handful of people, landlords, industrialists or bureaucrats, make all basic decisions. That is because there is an alliance between various vested interests. What Pakistan badly needs today is to broaden the base of its economic and political power" (Haq, 1973).

In early 1970s, the government nationalized the banking and industrial sector of Pakistan to eliminate monopoly of a few people over the country's resources. However, such measures were not accompanied by rigorous reforms to revamp the entire system of the country (Haque, 1994). After nationalization, financial and industrial institutions came under the control of bureaucrats and politicians who were mostly belonging to the same privileged groups. Since there was no system in place to make political managers and bureaucrats accountable to public for their deeds, they tended to become corrupt. Resultantly, the nationalization process failed to deliver any good to public and national economy (Gardezi and Rashid, 1983; Mahmud, 1995; The Prime Minister's Committee Report on Self-Reliance of 1991, p. 17).

In early 1990s, the government undertook the privatization and deregulation of the economy and financial sector of Pakistan. It claimed that this move would ensure competitiveness and fair dealings in the business sphere of Pakistan (Kherti, 1993, 1994a, b). However, a few powerful people came up to purchase the state-owned industrial units, precipitating the risk of replacing the public monopolies with the private sector monopolies (Ibrahim, 1992; Amjad, 1993; Saleem, 1994b; Ahmad, 1994a, c). In 1992, the Chairman of the "Privatisation Commission of Pakistan" warned that without completely revamping the prevalent socio-economic set up of the country, the process of privatisation would further encourage the concentration of wealth in the hands of a few (The Nation, 12 December 1992).

Whenever the government of Pakistan went for adopting any half-baked plans under the great apparent urge to establish a just and efficient socio-economic order in the country, they ended up to benefiting only the powerful minority of Pakistan, one way or the other. The foregoing discussion reveals that the economic exploitation is a very complex phenomenon in Pakistan. It does not involve interest, but also other gross inequalities in the distribution and production, which are strongly interlinked together and reinforce each other. To say the least, the socio-economic environments in Pakistan were highly unsuitable to sow the seeds of interest-free banking practice.

5. Market opportunities, privatisation and globalisation of the economy of Pakistan

In 1980s, the financial sector of Pakistan was mostly comprised of five government-run banks and a few Development Financial Institutions. In early 1990s, the financial market of Pakistan experienced deregulation and expansion to attract foreign capital and investments and reap other benefits of privatisation and globalisation. The government privatised two nationalized banks and some non-banking financial institutions of Pakistan. It also granted license to ten new private sector banks, more than 90 *mudarabah* companies, cooperatives and other investment companies to function for enhancing the competitiveness of the financial market of Pakistan (Business Recorder, 19 June 2001).

The policy makers contended that due to the globalization of Pakistan's financial market, any move towards Islamization of the economy could cause massive flight of foreign investment and capital from the country. Consequently, Pakistan could face serious difficulties to honour its financial obligations to the foreign governments, financial institutions and other business parties. It appeared as a core reason for the failure of interest-free banking movement in Pakistan that the government did not show any willingness to take the risk of losing foreign trade, investments and capital inflow by abolishing the interest from the economy of Pakistan.

6. Summary and conclusions

Paramount in successful functioning of interest-free financial institution is the presence of Islamically imbued socio-economic and political environments. The so-called interest-free banking experiment failed in Pakistan because of ignoring these core prerequisites. The polity of Pakistan lacks Islamic virtues to strive as a "single entity" for establishing the Islamic order in all walks of life. Overwhelmed by their materialistic considerations, different sections of the Pakistan society dealt with the interest-free banking in the context of their "self-interest" and thereby it was not given much needed public support to prosper in Pakistan.

The government may be held responsible to ruin any chance of success of the interest-free banking practice in Pakistan. Despite the fact that the government was put under strict judicial and constitutional bindings to enforce Islamic order in Pakistan, it exploited the cause of interest-free banking for meeting its political ends. The government always acted as a patron of the conventional financial system because of its virtue of providing a captive source of funding for meeting its expenditures.

The bureaucrats sitting in the Ministry of Finance did not show any real enthusiasm to implement the interest-free system as it was posing a threat to their control over the financial sector of Pakistan. The SBP also did not find any incentive or compulsion to establish the interest-free banking practice in Pakistan. It showed gross negligence in providing proper training, documentation and other technical assistance to banks for practising the approved interest-free modes of financing. Consequently, banks excessively relied on mark-up financing that was almost akin to the conventional banking practice. Banks did not find it feasible to enter into the PLS relationship with business people whose majority maintain double sets of accounts for the sake of avoiding exorbitant tax payments. The absence of a just and speedy judicial system also discouraged banks from adopting the PLS system or even those interest-free modes of financing which hold a nominal risk of non-payment and default. Business people also showed high reluctance to enter into the PLS relationship with banks because of their rule of keeping high privacy of their business operations from an outsider. General depositors remained highly reluctant to bear any real risk on their so-called PLS deposits at the banking sector of Pakistan. The increasing globalisation effects and privatisation of the economy of Pakistan also strengthened the case against the interest-free banking practice in Pakistan.

The fragile economy of Pakistan did not provide favourable grounds for the institutional development of interest-free banking. The huge burden of domestic and international loans on the economy and other socio-economic and political constraints, such as non-performing loans, unsatisfactory level of investment and saving, mounting budgetary deficits, in-efficient tax system, extravagance style of living of politicians and bureaucrats, lack of proper infra-structure, abject poverty, unsatisfactory level of literacy and the deteriorating moral standards of the polity did not allow the interest-free banking to take its roots in Pakistan.

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Corresponding author
M. Ishaq Bhatti can be contacted at: i.bhatti@latrobe.edu.au