Islamic venture capital

A critical examination

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Abstract *The well-known modes of raising and mobilizing venture capital in Islam known as* mudarabah *and* musharakah *(m&m) in Islamic economics are critically examined. In the form as m&m presently exist, they are pointed out to be pre-Islamic financing instruments that came into usage in the Islamic economic literature. The inability to realise the extensively relational perspectives of Islamic socio-economic co-operation with extensive participation across agents, firms and sectors by means of these instruments, which are essential requirements for the Islamic political economy, is shown to make the instruments fraught with many technical and ethical problems of development financing. The alternative to transform m&m into a more integrated financing instrument of Islamic venture capital is formalised. Empirical evidences are given. Institutional issues are examined in the light of Islamic joint venture financing.*

It is well known from the literature in Islamic economics that raising and mobilising financial resources in an Islamic economy must be guided by interest-free instruments. This is a requirement that stems from the moral injunctions of *Qur'an* and *Sunnah* (Guidance of Prophet Muhammad) as these become the epistemological sources of Islamic law, *shari'ah*. *Shari'ah* invokes an extensively participatory form of profit-sharing system that in turn can replace interest-based financial instruments. Such instruments are traditionally termed as profit sharing, called *mudarabah*, and equity participation with both profit and loss sharing, called *musharakah*. The fact that an extensively participatory enterprise is in the essence of *shari'ah* pertaining to economic and financial matters (*muamalat*) can be deduced from the universally unified, diversified and knowledge-centred cosmology of *Qur'an*. See for instance the *Qur'anic* verses (XVI:1-22). Besides, co-operation and unity across diversity of systems and their entities is throughout a central note of the *Qur'an*. See for instance the *Qur'anic* verse (XLIX:13). These epistemological grounds make the criterion of pervasively participatory, co-operative and co-ordinated enterprise under m&m as a *shari'ah* requirement with respect to Islamic joint venture.

Despite the claimed Islamic implications of raising and mobilising venture capital through m&m for attaining co-operative participation, there has appeared a serious impediment in realising this goal through such instruments. Problems have arisen because of the restrictive and dichotomous ways in which these two instruments are used, causing the non-participatory nature of sharing profits through them, as agents remain in sleeping partnership between being owners of capital who are not entrepeneurs, and workers who

References to translations of *Qur'anic* verses are taken from Ali, A.Y. (1942)

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provide effort in producing profits. The sharing question then effectively devolves into one of bond holding or shareholding with no extensive participation in them. The essence of extensively active participation, economic co-operation and co-ordination among agents, so much needed in an environment of co-determined decision making in the Islamic order, is not to be found. Thus, as traditionally understood in pre-Islamic literature and as they continued to be used by Islamic economists, the m&m instruments fail to qualify as truly Islamic ones when the participatory nature of these instruments, that could otherwise provide equity, entitlement and empowerment as developmental effects connected with sheer profit-sharing financial instruments, ceases to exist. An Islamic transformation of such instruments in the light of *shari'ah* is thus required.

Objective

Our objectives in this paper are several. First, we will explain the nature of the problem inherent in the prevailing Islamic joint venture financing instruments called *mudarabah* and *musharakah* (m&m). Mudarabah is a profit-sharing arrangement between owners and workers or between owners of capital. *Musharakah* is equity participation. In this paper, while we will critically examine each of these separately we will also importantly consider the compound joint venture financing instrument between the two and call it *mudarabah-musharakah*, henceforth referred to as m&m.

This inherent problem in the existing m&m joint venture financing instruments results in their lack of precision in capitalising the value of time or wages that workers and similar participants contribute in a joint venture, along with financial capital contributions from owners of capital. Thus, the profit-sharing ratios remain poorly determined. This problem of imprecision in measurement of profit sharing leads to other problems as well. These are the development of entitlement, empowerment, and the possibility of continuous re-contracting between labour and capital owners, all of which are linked with developmental issues on the side of equitable distribution of resources among participants.

Our second objective in this paper is to show that the presence of the above nature of financial and distributive problems has posed a problem of inequity in the light of the purpose of Islamic law (*maqasid as-shari'ah*). Islamic banks are found to have pursued the goals of capital accumulation, that is raising of financial resources, rather than resource mobilisation. The latter is embedded in the issue of distributive equity as well as capital accumulation.

Our third objective in this paper is to point out that in contradistinction to the usual view regarding m&m, in an Islamic political economy, which is an extensively participatory system, joint ventures with the m&m instruments logically invoke significant organisational issues involving institutional decision making. Now participation and interactions are necessarily promoted. This kind of participatory nature of the m&m contract will be shown to span across agents, firms, sectors and interrelationships among these entities. In terms of Islamic terminology, we will refer to the embedded interactive and integrative followed by evolutionary decision making as the process of *shura* (extensive consultation, i.e. pervasive interactions). This sequence of relations is thereby termed as the *shuratic* process in this paper.

The main focus of this paper in view of the above three objectives is to point out the limitations of the existing joint venture financing instruments of m&m. We will therefore transform these instruments into a more cogent compound index of the m&m instruments. Such a new joint venture financing instrument will be shown to be capable of eliminating the problems of imprecision and inequity that arise from a lack of extensively co-operative and co-ordinated participation and the absence of a method that could otherwise capitalise the value of effort contributed by labour in generating entrepreneurial profits. We thereby claim that the existing problems of m&m can be replaced by a more exact representation of the intent of Islamic law (*maqasid as-shari'ah*) in an Islamic joint venture enterprise.

Review of literature

A critique of mudarabah *contract, as perceived in Islamic economics*

In the literature of Islamic economics *mudarabah* is treated as a sharing of resources for doing business in an enterprise in which one set of partners supplies capital and the other set of partners supplies expertise, management or work effort (Siddiqi, 1985). The sharing of profits at the end of a contractual time period is carried out in proportion to the capital invested by the owners of money capital in the first place. The other partners (labour, expertise, management) receive either wages or agreed upon profit shares. But the basis of determining the individual profit shares among the non-capital partners is not a precise one, other than being a mutually agreed upon financial contract, in which the share of capital is well-determined but the valuation of non-capital factor shares remains vague. Now only if a value can be imputed for the work-effort that goes into production and profit generation, then this value, which is foregone by the participating labour wholly or in part, with the other part being made up of wages, can be treated as a form of capitalised investment done by workers in the enterprise. This capitalised value of work effort can now well-determine the share of profits for non-capital owning partners as well. Siddiqi (1985) attempts this distributive question of *mudarabah*, mentioning that it remains an unexplored issue among Islamic economists.

The literature in Islamic economics has paid only marginal attention to this case of imputing capitalised values to work effort so as to make the wages and profit shares foregone by labour in a *mudarabah* contract (Choudhury, 1992) a true investment share in the joint venture. Consequently, the sharing issue among factors of production has remained a problem of a technical nature in respect to how a fair contract can be established in a situation where wages and profit-shares emerge as dual methods of payments to labour and expertise. While the capital owner takes his well determined share of profits according to the ratio of his initial capital investment, the share to labour remains vaguely determined.

Let us make the assumption that non-capital factors of production enter a pure *mudarabah* contract as if they are owning no equipment. This would be particularly true of the assetless workers in developing micro-enterprises. Hence there exists no well determined basis for measuring the share of profit at the end of a contract period. Also there does not exist the opportunity to re-negotiate contracts which could otherwise emerge from increasing levels of ownership by the non-capital owning factor even before the end of a given contract period. The capital-labour relationship in a financial contract, that should otherwise be generating empowerment and increasing entitlement through ownership, is not realised in such a fixed wage-profit contractual relationship without the required financial capitalisation of work effort.

This situation with the existing m&m financial instruments is no different from the one that is encountered in the critique of capitalism according to Marxist arguments (Phelps, 1985). The m&m is simply a financial contract between owners or between workers and owners regarding the sharing of profits *ex-post* according to predetermined sharing ratios.

Two problems at once arise. First, the profit-sharing ratio remains an agreed upon ratio but not a precise basis for capitalising the value of work effort. This ignores the distributive issues of entitlement, empowerment, participation and re-contracting among participants. Second, owners of capital pass on the productive enterprise to labour. Alternatively, the m&m is given up for management to a third party, such as an Islamic bank. In either of these two cases, there comes about a sleeping partnership between owners of capital and labour. Such a sleeping partnership devolves into a dominant decision-making power for owners of capital at the expense of empowerment and continuously changing ownership by workers in the enterprise.

Marx criticised the capitalist mode of accumulation of capital on similar grounds. He saw that by entering into a wage contract with labour, owners of capital cease to be productive factors, while they earn the economic surplus. The surplus is the capitalist's profit in excess of the marginal productivity of labour. According to Marxist argument, the assignment of a value to marginal productivity of labour rests with the employer alone to the detriment of workers.

We now find that in the existing case of sleeping partnership between owners and workers in m&m contracts, the emphasis on capital accumulation rather than on distribution results in dominant interest for the owners at the expense of entitlement, empowerment and ownership for labour. Thereby, the existing m&m instruments of joint venture financing turn out to be simply like the capitalist instrument for capital accumulation.

It has been argued elsewhere that, as long as the wage economy remains the focus of Islamic economics, no real ownership would be attained (Choudhury and Malik, 1992). This of course is not to imply that an Islamic economy would turn into a purely profit-sharing one. That scope would be limited even by the very fact that the transformation process in a wage economy will always involve those who must be paid wages in combination with profit shares over a period of time. Wage payment in such circumstances is an established Islamic practice. But the dynamic nature of enterprise in Islam has always aimed at ameliorating labour. This was exemplified by the classical event of the Madinah Charter that was signed under the directions of Prophet Muhammad between the Makkan emigrants (*muhajirs*) and the Madinan Muslims (*Ansars*) (Umari, 1991). Even in the Ottoman World we find that state property was treated as a distributive resource by the Sultans to the landless in the newly conquered areas (Garraty and Gay, 1972). Property and hence ownership, entitlement and the resulting empowerment, have always been given higher status in Islam than wage payment, despite the fact that a concept of just wages always existed. Given these observations, *mudarabah* contract, as treated in Islamic economics without a precise method of valuation of work effort or expertise, cannot help in realising a transformation process from dependency to ownership for labour.

Critique of musharakah *contract*

In the case of *musharakah* contract the partners are all capital owners who can pool their financial capital in a joint venture and thus share the profits and losses at the end of the contract period according to their initial shares of capital investments. Other variations of *musharakah* are co-financing and equity participation that can proceed on the basis of various forms of capital investments – real, financial and a combination of these.

As in the case of m&m, yields earned by the contracting partners are influenced by two compounding factors. The first factor is the productivity of capital yielding profit. This causes capital accumulation to occur. The second factor is the profit-sharing ratio that distributes the profits. Such a compound effect becomes more effective the more frequent are the re-negotiated contracts. Re-contracting possibility is causally linked with varying profit-sharing ratios that can emerge by virtue of the increasing levels of ownership gained in the enterprise by the partners, especially labour. Re-contracting is also causally related with increasing risk diversification and product diversification in the enterprise. This causes diverse opportunities to open up as capital accumulates. The reverse relationship is also true.

Musharakah venture capital management faces the same problems of asymmetrical ownership and income/wealth distribution as in the case of *mudarabah*. The fact of the matter is that any truly co-operative and well co-ordinated enterprise must be extensively participatory in nature. We would then expect labour relations from a *mudarabah* contract to intertwine with *musharakah* contracts. Such an interrelationship between the instruments would re-create the same kinds of problems that we noticed in the case of the *mudarabah*.

The implications here are that the absence of a common participatory basis between the two contracts makes m&m become dichotomous. Hence the decision making as well as the institutional organisation of the two contracts remain independent of each other. On the other hand, it is the jointly owned active partnership between capital owners and labour that turns out to be the more interesting enterprise to consider.

An important labour relation of this type that now appears in the USA is industrial democracy, wherein capitalists and workers are required to collaborate in management and production. Good examples of industrial workplace democracy are employee savings and ownership plans (ESOPs) and universal savings and ownership plans (USOPs) (Ellerman, 1991). Workers can buy shares in enterprises with the hope of buying back failing companies. In this kind of a re-contracting situation ownership can increase even though wage-payment remains extant. The same kind of co-determination and re-negotiations is not available in *mudarabah* and *musharakah* enterprises as long as these contracts remain dichotomous and de-linked from the productive factors and outlets.

Problems arising from interlinking mudarabah *and* mudarabah

Whereas in the case of *musharakah* the distribution of profit shares is well determined as a function of the contracted proportions of initial investments, the same is not straightforward in the case of *mudarabah*. Yet despite this fact, when wages are mixed with profit shares as modes of factor payments, then to the determination of profit shares is not straightforward. This case of interlinking m&m contracts is not possible in the profit-sharing and loss-sharing framework within the existing dichotomous nature of the two contracts. On the contrary, however, such and other financial and ownership relationships are liable to increase further with the frequency of re-negotiated contracts.

In the case of either the two instruments for raising and mobilising Islamic venture capital we find that democratic decision making and participation are not explicitly built into the financial and distributive nature of the contracts. In the case of *mudarabah*, after a negotiated contract is initially established, subsequent management of the enterprise does not rest on the joint decision-making powers of the two sets of partners. Rather it devolves on the major controlling powers of owners of capital or on the externally arranged management employed by the owners, such as an Islamic bank. Thereby, in case of financial loss the capital owner and not labour becomes liable to bear the loss. The resulting higher risk borne by the capital owner puts him or his appointed management at the helm of decision making.

In the case of *musharakah* too it is quite possible for any of the partners to remain in sleeping partnership after they have allayed their capital shares in the enterprise. This is particularly the case with financial *musharakah*, wherein a corporation may act as an investment firm to look after the shares of depositors. The Islamic bank is an instance. Yet no portfolio of Islamic banks is so far known to have been influenced by voting rights of common shareholders and stakeholders *en mass*. The common stockholders are found to reserve the sole right of deciding how to direct and raise funds in the interest of the enterprise.

We therefore find that in both cases of m&m, active co-operative and co-ordinated participation among owners, managers, shareholders and factors of production does not exist either explicitly or through financial intermediation. The result then is that a truly dynamic nature of shareholding, one that could provide both active participation at the level of decision making and entrepreneurial contributions remains absent, once the powers of decision making are vested with those in authority. With this kind of sleeping partnership, enterprises lose their capability of enhancing empowerment and entitlement, learning and participation among factors of production. An industrial workplace democracy fails to exist (Wisman, 1991). Such a situation in turn adversely affects the possibility of growing out of dependency toward active re-contracting and dynamic ownership of assets in the enterprise. At the end, the development perspectives of enterprises financed or managed by m&m contracts remain unrealised in the midst of sleeping partnership among partners.

Because the partnership implied in these modes of venture capital financing is not of an active type, the shares act simply as a technical method of distributing profits in interest-free financing. But in essence the nature of such shares is no different from that of bonds in which no active two-sided participation is required. Islamic economists have thus modelled profit sharing on the basis of bond-holding behaviour while the m&m treatment devolved into one of sleeping partnership (Bashir, 1983; Bashir and Darrat, 1992; Ebrahim and Bashir, 1998).

Siddiqi tried to bring out the co-operative and dynamic nature of *mudarabah* contracts by referring to the associated financial securities as *mudarabah* shares (Siddiqi, 1983). Yet nowhere in his book one finds explicit rules for co-determination and participatory decision making between workers and capital owners. Likewise, the portfolio of such shares held by m&m savers in Islamic banks is shown to be vested fully with management, without clientele representation. There is no mention in Siddiqi's book about a financial valuation of work effort as a capitalised profit-sharing measure along with the value of wages paid.

A technical problem thus arises, first in failing to make the management practice responsive to co-operative participation among all business partners; second, in failing to introduce a wel determined method of m&m profit sharing in which value imputation of work effort would become a positive sharing measure along with wages and the shares of capital owners. The empowerment and ownership interests of productive factors are thus left out in such financial contracts. As long as m&m fail to incorporate a positive transformation into profit sharing by ownership on the part of labour, such contracts face the problem of industrial unemployment and distributive inequity associated with wage-paying production menus.

One is to note the intrinsic difference between wage contract and a pure m&m contract. Wage contract is based on a fixed payment to labour by capitalists (or owners of capital), whereas m&m offers *ex post* payment of shares of profits. However, it is perfectly permissible under Islamic law to combine wage payment with m&m contracts. These contracts then interact with each other when wages forgone or proportionately invested in the enterprise, enable a new m&m contract to emerge. This is the mechanism of m&m re-contracting that we referred to in this paper as the proper medium of developing entitlement and empowerment for labour.

Identifying the points for reformulation of participatory instruments in Islamic financial ventures

The technical problems of m&m arise first, due to their restrictive terminological usage among Islamic economists, and second, because of their peculiar financial definitions that fail to realise co-operative partnership among capital owners and non-capital partners including labour. It is true that the desired intent is to attain co-operative and participatory goals by using the instruments. Yet no methodology has been developed to manifest the desired goal of co-operative participation in a technical understanding of the financing methods. Consequently, the objectives of socio-economic development that must promote entitlement, ownership and decision making by participation on the one hand, and on the other hand bring about financial risk diversification through re-negotiated contracts, are not found to emerge from these two financial instruments as they presently exist.

In order to transform these financial instruments to realise the ameliorative goals of *shari'ah*, extensively co-operative participation must be explicitly introduced in the m&m instruments. Such rules must reflect the organisational and management processes involved in such extensively co-operative and co-ordinated participatory enterprises. In the absence of this key factor, both the conceptual as well as the applied aspects of participatory financing spelled out by m&m, and as understood by Islamic economists, would fail to be truly Islamic instruments. As we have argued, they devolve into bond holding or managed shareholding among sleeping partners.

The technical aspect of managerial decision making in managed shareholding is well known as the principal agent utility-maximisation problem (Shy, 1995). Such a management model can also be shown to characterise sleeping partnership in the existing form of the m&m instruments wherein, as we have noted, owners of capital give away the management of the enterprise to a third party, such as the Islamic bank, while participation by labour remains absent in enterprise decision making. The appointed management then plays the dominant role of maximising the welfare of the preferred shareholders and common stockholders, instead of workers' welfare as well. In the literature on managerial economics there is no theory of principal-agent game that maximises the welfare of labour in the enterprise. In search of any such theory we need to turn to industrial management and thereby study unions *vis-á-vis* management. This observation is universally true of all managerial approaches that take place in capitalistic financial environments.

Hence there remains no particular challenge in the existing m&m model toward invoking exclusively Islamic financing practices. Consequently, any difference in decision making between an m&m enterprise and other ones is not a relevant issue anymore. The complete adoption of the basic methodology of the principal-agent problem, now repeated for m&m, imitates the usual risk-aversion behaviour solely premised on the assumption of economic rationality and equilibrium-optimal allocation of resources.

The above-mentioned axioms of any principal-agent problem are known to emanate from the neoclassical background of economic reasoning (Khan, 1985). But it is well known that in neoclassical economic methodology issues of ethics and morality remain exogenously neutral preferences of agents. Neoclassical methodology must necessarily treat ethical issues in conflict with purely economic issues, as, for instance, the problem of economic efficiency versus distributive equity. It is this intrinsic rule of marginal substitution among alternatives that gives rise to the discount factor for valuation of assets. Discounting simply measures the opportunity cost of capital, which is the interest rate. In the face of such methodological conditions prevailing in the application of a neoclassical theory to m&m, it would become impossible to phase out the elimination of the interest rate from an Islamic economic system. Thereby, a pure theory of raising and mobilising financial capital through an interest-free system remains impossible in the prevailing neoclassical approach to m&m instruments. Contrarily, interest abolition is fundamentally an ethical issue in Islam that endogenously affects preference formation and subsequently market exchanges and transactions at all levels.

A critique of *mudarabah* and *musharakah* in reference to the classical Islamic period

It is no wonder that m&m, as understood in their present form, fall short of having a true grounding in either the *Qur'an* or *Sunnah* (Prophetic Guidance). The acceptance of these pre-Islamic instruments came about by implication, not by a direct reference to either *Qur'an* or *Sunnah* (Siddiqi, 1991).

We can examine how these pre-Islamic practices entered the Muslim ways of doing business during the Prophet's time in Madinah and why it was allowed to exist. Ismail (1989) makes a good study of this issue and finds that there exists no evidence as to whether the Prophet categorically approved of these modes of financing, although he did not ban them. The closest that the practice of *mudarabah* came to be endorsed is said to be found in the works of the jurist, Imam Malik, who lived many years after Prophet Muhammad. But here too it is Imam Malik's opinion, not a clear Prophetic guidance, that is the basis of the endorsement for *mudarabah*. Subsequently, it is found that those Companions of the Prophet who practised *mudarabah* during the prophet's time did so in view of putting orphans' properties in trust with partners in such ventures. Now there is no real possibility for orphans to interact with financial managers in co-operative decision making. Consequently, sleeping partnership could be accepted in such a case, and the orphans' property could be placed in trust with the *mudarabah* partners.

Even the meaning of *mudarabah* varies among different schools of Islamic jurisprudence. Our definition provided thus far complies with the Hanafi School of Islamic jurisprudence. But among the Hanbali and Shafyi Schools of Islamic jurisprudence *mudarabah* means loaning a certain amount of capital to a partner(s) between whom business can be conducted and profits shared in proportions agreed upon by the capital owner in the first place. In the case of loss there would be no return to the non-capital partner and the capital owner would bear all the loss. Since there does not exist any clear saying and practice of the Prophet with regard to *mudarabah* financing of venture capital, and all cases wherein the companions of the Prophet participated in such a business remain circumstantial rather than precise rules of business ethics, therefore, the pre-Islamic character of *mudarabah* bears little essence of the truly Islamic mode of conducting extensively co-operative and co-ordinated participatory business practice under *shari'ah*.

Instead, in the *Qur'an* and *ahadith* (Prophetic sayings) there appears the central role of economic co-operation and active participation for purposes of generating productive yields that bring about wellbeing to society. This is a goal of *shari'ah* (*maqasid as-shari'ah*). Such an affirmative approach was exemplified in the organisation of the City State of Madinah by the Prophet himself. Many *Qur'anic* verses and important *ahadith Qudsi* (most reliable Prophetic sayings) emphasise the complementary relationship between avoidance of interest and act of charity. God blesses all acts of charity many folds and prohibits the evils of interest-based financing (*Qur'an* Chap. 2, p. 276; al-Shurawardy, 1990).

Islamic participatory instruments of venture capital have, thereby, no grounds for relying on the pre-Islamic nature of m&m instruments. Instead, the accepted generalised instrument of Islamic financing, raising and mobilisation of venture capital can be any mode of financing that promotes explicit rules of extensive participation among co-operative agents, businesses, sectors, variables and relations in the entire Islamic socio-economic order. Through such participatory rules and co-operative relationships an extensive web of socio-economic complementarity among possibilities can be established. The result is a realisation of community social wellbeing, wherein the ethics of elimination of interest is endogenously realised, put into effect and then re-generated within the system.

The endogeneity between money as a contravention for valuation of real assets and real economic relations can then be established by such a generalised participatory instrument. The result would be a realisation of both financial profitability in terms of the productivity of capital and its developmental impact in terms of increasing empowerment, entitlement and ownership among partners including labour.

A critique of *mudarabah* and *musharakah* in relation to interest-free financing

The theory of endogenous money in Islam and its effectiveness in eliminating interest is an area of voluminous proportion (Choudhury, 1998a). Here we will simply state the basic arguments as to why the m&m instruments cannot contribute towards attaining the goal of eliminating financial interest as an unethical and unwanted economic variable in Islam.

Money in Islam is neither a commodity nor a medium of exchange. Money is not a medium of exchange because, in the absence of interest rate as the price of money, there exists no money market where exchange in this commodity can be realised. On the other hand, the value of money is derived from the quantity of money in demand and thus in supply for transacting on "real" economic activities. Promissory notes are excluded as they do not tie down "real" economic activities to money demand and supply. The quantity of money now values the actual exchange and transactions in "real" economic activities.

In the intertemporal case, too, there exists no "real" and realised exchange of goods and services in time, hence there can be no time value of money. The intertemporal case of resource allocation on realised economic activities is thereby non-existent. Consequently, there can be no intertemporal price to measure the time value of money, as neoclassical economics will have us believe.

In the end, in both the atemporal and intertemporal cases, we find that money acquires its value from the value of real exchanges and transactions. Money in Islam has no intrinsic value of its own. That is to say, money in Islam is not a medium of exchange either in its own right or in the case of intertemporal allocation of resources.

When money in Islam values the real economic transactions by means of bullion, such bullion or currencies acquire a store of value reflecting the valuation of real economic exchange. Commercial banks cannot supply promissory notes for transaction on speculative grounds, for only real goods and services are to be exchanged. Deferred exchange, if any, must show strong possibility of delivery of the exchangeables in the immediate future. Despite the fact that future expectations of prospects may be capitalised in terms of expected prices, yet such a valuation is acceptable only for reasons of economic planning. It cannot be indicative of actual exchange and financial policy making, since no actual, but merely notional concept of future prices and contingencies exist in the present time period.

Now if we take these arguments at the level of the pre-Islamic definitions of m&m we find no participatory role of these instruments in decision making between the central monetary authority and the Islamic financial institutions. Consequently, there can exist neither policies enacted by the monetary authority nor discourse among the financial intermediaries, the monetary authority and entrepreneurial partners (*mudarib*) in the productive sectors, in order to ascertain what would be the real demand for money for valuing real economic transactions. It is this lack of interrelationship among partners as mentioned here, caused by the absence of explicit and active participation among the monetary authority, the financial intermediaries and participating factors of production, that leaves void the intrinsically endogenous interrelationships which must otherwise exist between real economic transactions and the quantity of money.

The elimination of interest from the economy can be realised by the above kind of money-goods causality in the midst of a banking transformation to 100 per cent reserve requirement. Such a transformation would require a systemic understanding of inter-firm, inter-agent and inter-sectoral participation in raising and mobilising financial requirements across productive enterprises. Contrarily, m&m financial instruments, as used in their pre-Islamic meaning, are not found to be premised on such a general systems outlook of extensively co-operative and co-ordinated participation.

A simple formalism on Islamic participatory venture capital

The Islamic financial instrument for extensively co-operative and co-ordinated participation must attain two results. First, it must yield prospective returns from resource mobilisation into *shari'ah*-approved possibilities. These would then be causally related with the productivity of capital and risk diversification. Second, the ethical recommendations and productivity of financial resources in possibilities acceptable to *shari'ah* must generate developmental effects.

From the joint effects of these two expectations, Islamic participatory financing would generate extensively co-operative and co-ordinated interrelationships among agents, systems and variables. This conveys the essence of universal complementarity among *shari'ah*-approved possibilities. The enjoyment of all such complementary prospects together yield the social wellbeing of an Islamic community. A communitarian outlook of social wellbeing is thus established through the medium of Islamic participatory instrument in terms of pervasive complementarity among *shari'ah*-approved possibilities. Such a characterisation of the participatory instrument of Islamic venture capital is in close agreement with all the injunctions of the *Qur'an* and *Sunnah* with respect to the idea of social wellbeing. In this way, the cumbersome and restrictive categorisation of m&m as dichotomous financial instruments is avoided. Sleeping partnership between partners is removed. Bond holding is replaced by shareholding and stakeholding with active participatory rules. Empowerment, entitlement and ownership become developmental goals with the increasing possibility of re-contracting profit and loss sharing within capital-labour participatory relations (Tahir, 1997).

Inter-firm or inter-sectoral flow of participatory venture capital and profit sharing

To formalise now, we define the following variables.

Let, I_i denote the venture capital contributed by investor i, say, $i = 1, 2$.

Let V denote the value of work by the non-capital contracting partner (labour), with,

$$V = \sum\nolimits_{T=1}^{n} w_t.t + \sum\nolimits_{t=1}^{n'} n' > n \qquad (1)$$

Here, t denotes the time period over which wages w_t are foregone or proportionately reinvested as investment in the enterprise. Reinvestment of this type helps in developing ownership for labour over the time-periods, $t = 1, 2, \ldots, n$.

I_t denotes the capital investments progressively made by workers while re-contracting during the time-period $t = 1, 2 \ldots, n'$. This may denote increased volumes of shares purchased and hence workplace rights earned by labour.

Now total venture capital amounts to $I_1 + I_2 + V$. This amount of venture capital generates inter-sectoral or inter-firm linkages due to its co-operative nature. We denote the inter-firm or inter-sectoral flows of venture capital by K_{jk}, $j,k = 1, 2, \ldots, n$ sectors or firms.

Since all such venture capital across sectors or firms are participatory in nature in the sense of extensive linkages, therefore, the total venture capital of the co-operative economy is given by, $K = \sum_{m=1}^{m} \sum_{k=1}^{m} K_{jk}$. An economy-wide co-operative participation is thus extended across firms and sectors. We note that a matrix of input-output flows of venture capital is thus generated as in Table I (Lange, 1966; Vanek, 1977; Weitzman, 1984).

In the above expressions, K_{jk} denotes the total capitalised value of resources that flow from sector (or firm) j to sector (or firm) k in the midst of the unified and co-ordinated m&m contract, as defined in our case and sustained between these co-operating sectors (firms), $j,k = 1, 2, \ldots, m$.

We are assuming here that the economy has m sectors (firms). In a more detailed analysis of the matrix (2) we can further subscript these entries to give a distinct attention to firms within sectors. The analysis would then turn out to be more complex.

K_j denotes the total capitalised value of all kinds of capital formation arising from investment flows as mentioned above, for the jth sector (firm), incorporating

		Industries					
Industries		1	2	3	$\ldots$	m	
1	K_1	K_{11}	K_{12}	K_{13}	$\ldots$	K_{1m}	
2	K_2	K_{21}	K_{22}	K_{23}	$\ldots$	K_{2m}	(2)
3	K_3	K_{31}	K_{32}	K_{33}	$\ldots$	K_{3m}	
m	K_m	K_{m1}	K_{m2}	K_{m3}	$\ldots$	K_{mm}	

with, $K_j = \sum_{k=1}^{m} K_{jk}, j = 1, 2 \ldots m; K = \sum_{j=1}{}^{m} K_j = \sum_{j=1}{}^{m} \sum_{k=1}{}^{m} \sum_{jk}$ (3)

Table I. Inter-sectoral flows of venture capital all contributions through the co-operative arrangement among linked markets in m-m contracts, $j = 1, 2, \ldots, m$.

Finally, $I_1 + I_2 + \mathrm{V} = \sum_{j=1}^{m} \sum_{k=1}^{m} K_{jk} = \sum_{j=1}^{m} K_j = K$.

In a similar way we construct the inter-sectoral matrix of outputs that are then turned into profits, say, $[\pi_{jk}]$. Now the profit shares are obtained by $[(K_{jk}/K).\pi_{jk}]$. For a given sector, in relation to inter-sectoral flows of resources and profits, we obtain the sectoral profit share, $(K_j/K).(\pi_j)$, where $\pi_j = \sum_{k=1}^{m} \pi_{jk}, j = 1, 2, \ldots m$.

The share of each partner's profits in the total firm-specific or industry-specific profits is given by,

$$\rho_i = (I_i/K_j)(K_j/K).(\pi_j) = (I_i/K).\pi_j = (I_i/\sum_{j=1}^{m}\sum_{k=1}^{m} K_{jk}).\pi_j, i = 1, 2. \quad (4)$$

The sharing ratio is given by,

$$s_i = (I_i/K_j)((K_j/K) = (I_i/K) = (I_i/\sum_{j=1}^{m}\sum_{k=1}^{m} K_{jk}), i = 1, 2. \quad (5)$$

Likewise, the share for labour during the wage earning and re-contracting period is,

$$\rho_v = (V/\sum_{j=1}^{m}\sum_{k=1}^{m} K_{jk}).\pi_j. \quad (6)$$

The sharing ratio for labour is,

$$s_v = (V/\sum_{j=1}^{m}\sum_{k=1}^{m} K_{jk}). \quad (7)$$

Obviously now, $s_1 + s_2 + s_v = 1$. (8)

The important difference between the expressions (1)-(8) and the existing m&m sharing method used in the Islamic economic literature is the appearance of the V-valuation and its associated profit-sharing rate for labour in an extensively participatory Islamic joint venture. In any other case of m&m contract in the literature of Islamic economics, V is not capitalised to make it play the important role in profit sharing between owners of capital and labour. V valuation essentially removes the imprecision encountered in the determination of the true profit-sharing ratios, especially that between labour and capital owners.

The above results also point out that profit-sharing in an Islamic political economy is a wide spread phenomenon of inter-firm and inter-sectorial linkages, where the venture capital of the three partners, namely, the capital owner (whose investment is I_1), Islamic bank (whose investment is I_2), and the non-capital factor, e.g. labour (whose investment is the capitalised value of effort and capital, V). The implication here is that each of these partners can engage the others in various sectors and firms in which they outlay their venture capital. Consequently, the capitalised value of venture capital denoted by K_{jk} is contributed by the partners across firms or sectors in the form of inter-firm or inter-sectoral linkages, respectively. The above results can be generalised for any finite number of partners in the inter-firm and inter-sectoral participatory sense.

Explicit rule of decision making in participatory contracts.
As we have mentioned earlier, our third objective of this paper is to link up an Islamic participatory enterprise with the extensively co-operative and co-ordinated decision making that is necessary. This involves specific rules and a particular form of approach. In the Islamic system the approach is through an embryonic system of *shuras* (interactive organisations), not simply restricted to the political process. The underlying process associated with the *shura* form of organisational decision making is referred to here as the *shuratic* process.

The next step then is to build the explicit rules of participatory negotiations and re-contracting in the above -mentioned flows of venture capital. This is done first, by establishing what is known as the moral purpose of Islamic Law (*maqasid as-shari'ah*) with regards to the specific issues at hand. The attributes of *maqasid as-shari'ah* are justice, fairness, certainty, wellbeing and dynamic change along these same directions (Choudhury, 1998b). Thus a fair distribution of profits and the possibility of re-negotiating contracts as a result of and for the purpose of developing ownership and empowerment in labour within the enterprise are reflected in *maqasid as-shari'ah*.

The rule so set is the result of discourse among the partners with the objective of arriving at a consensus on the set rules and their operational features. The rules of interactive and consensual participation in enterprise combined with an evolutionary learning-by-doing process are realised from the occasion of continuously re-negotiated contracts. This is based on the feature that new rules emerge along the lines of *maqasid as-shari'ah* through agent-specific inter-systemic discourse with the intent of attaining consensus, which in turn is evolved into better rules. This shuratic process continues indefinitely.

The re-contracting process progresses on the basis of the emerging new rules of participation, which in turn are determined on the basis of the attained values of the socio-economic variables. In the present case, for simplicity, we can restrict the socio-economic variables to profit sharing and inter-firm linkages. Thus, two sequences of values emerge and evolve simultaneously, namely the discoursed knowledge in the light of the *shari'ah*-based rule set at the beginning of a process of discourse, and the socio-economic variables that are causally interrelated with and augmented by the evolutionary knowledge values.

Let, θ^s_{jk} denote the knowledge variable arising from discourse at each level of production inter-firms or inter-sectors, j, k = 1, 2, . . ., m.; s = 1, 2, 3 denote capital owners and non-capital factors (e.g. workers). Such knowledge flows may be understood as assigned ordinal values evolved by discourse and consensus among co-operating participants in decision making and are premised on *shari'ah* rules pertaining to the issues at hand.

Each inter-firm profit-sharing ratio is now qualified by θ^s_{jk} . We then obtain the knowledge-induced profit-shares as,

$$\rho_s(\theta^s_{jk}) = ((I_i/\sum_{j=1}^{m}\sum_{k=1}^{m} K_{jk}).\pi_j)\theta^s_{jk}] \tag{9}$$

The profit-sharing ratios are given by,

$$s_s(\theta^s_{jk}) = (I_i/\sum_{j=1}^{m}\sum_{k=1}^{m} Kjk)[\theta^s_{jk}]; (\sum_s\sum_j\sum_k s_s(\theta^s_{jk}) = 1 \\ j,k = 1,2,..,m; s = 1,2,3. \tag{10}$$

The appearance of $[\theta^s_{jk}]$ outside the bracket (.) means that these knowledge values augment all the variables within the bracketed term (.). Also since θ^s_{jk} qualifies π_j, it at the same time must also qualify π_{jk} in the equation,

$$\pi_j = \sum_{k=1}^{m} \pi_{jk} \text{ and } \pi = \sum_{j=1}^{m} \pi_j. \tag{11}$$

The process-oriented interrelationships between the evolutionary knowledge flows, $\{\theta^s_{jk}\}$, generated by organisational discourse among partners in the light of *shari'ah* rules and in the co-operative institution of the organisational *shura*, set the rules of a truly participatory joint venture in Islam. These are the shares shown in equation (9) and the sharing ratios shown in equation (10).

In particular, the appearance of θ^s_{jk}-values in $I_s(\theta^s_{jk})$ signifies raising of venture capital through extensively participatory processes. $K_{jk}(\theta^s_{jk})$ signifies direction of the capitalised value of venture capital with extensive participation into productive directions permissible under *shari'ah*. $\pi_j(\theta^s_{jk})$ signifies distribution of profits in the extensively participatory sense. The evolutionary nature of the knowledge-induced processes with discourse and consensus denote the possibilities of re-contracting in the extensively participatory framework of co-operative and co-ordinated decision making.

In our *shuratic* process model of co-operative participation and inter-firm linkages it is implied that there are micro-*shuras* and thus micro-*shuratic* processes at each of the (*s,j,k*) levels. Each such linked *shur*a can elect its own representatives for higher echelons of interactive *shuras*. Once the initial rule of *shari'ah* on distribution of profits and re-contracting are set and accepted by the participants on the premise of the *maqasid as-shari'ah*, the micro-processes interconnect through their feedback in the $(\theta^s_{jk}, I_s(\theta^s_{jk}), K_{jk}(\theta^s_{jk}), \pi_{jk}(\theta^s_{jk}))$ vector. An organisational planning is thus generated through continuous recursion of such feedback.

The elements of novelty, search, discovery and complementarity among diverse possibilities are thereby causally enriched in such a co-operative and co-ordinated participatory system. The *shuratic* process of institutional organisation shows characteristics similar to Simon's model of managerial decision making (Simon, 1987).

Inferences drawn

We have now formalised a complete system of profit sharing, invoking in it extensive participation by means of the endogenous ethical values of co-operative and co-ordinated decision making guided by *shari'ah* rules. In this, we have argued that the pre-Islamic character of sleeping partnership found in m&m instruments can be removed by introducing extensive participation and in which the value of wages forgone or reinvested in the enterprise can be capitalised in a new m&m sharing mechanism. In this kind of a profit-sharing system there remains no need to make any dichotomous reference to *mudarabah* and *musharakah* separately. All that matters is extensively co-operative and co-ordinated participation as guided by *shari'ah* rules in a purely Islamic venue of treating m&m jointly, while removing the ethically benign pre-Islamic flavour from them.

Based on our above formalism, a unified Islamic m&m profit- and loss-sharing contract can be developed, as shown in equations (9) and (10).

A financial loss-sharing aspect is built into the above-mentioned expressions by the fact that wages foregone or the imputation of labour time in re-negotiated participatory contracts cannot be returned to the contracting partner. For this reason (risk) it is always advisable for nascent participatory enterprises to be a combination of wage-paying and profit-sharing types with increasing possibility for re-negotiated contracts.

Some empirical observations

Despite the overwhelming emphasis given to m&m modes of financing in Islamic economics, recent empirical evidence of Islamic venture capital shows that only marginal importance has been given to these instruments. This is further proof of the fact that not much capital can be raised and mobilised from these pre-Islamic modes of joint venture financing. I will consider a few of these evidences here.

Islamic Development Bank and Islamic banks

Over the 20-year period 1976 to 1996, the Islamic Development Bank (IDB) had only three projects in profit sharing, one in Somalia and two in the United Arab Emirates. In monetary amount these comprised a mere 0.15 per cent of the total project financing (Islamic Development Bank, 1996).

Recently, IDB has established a number of co-operative projects with Islamic banks in several of her member countries. This Islamic Banks' Portfolio for Investment and Development, as it is called, is a fund jointly established by IDB and the Islamic banks along with other participants. On a cumulative basis between 1988 and 1996, the share components were as follows: of the total of 100 million US dollars allayed in syndicated operations, IDB's participation was 24.5 per cent; Islamic Banks' Portfolio participation was 8.7 per cent; IDB Unit Investment Fund was 5.8 per cent; Pension Fund's participation was 3.5 per cent; other Islamic banks' participation was 57.5 per cent. The syndicated operations have been opened up in two countries only, namely Pakistan and

Egypt. They comprise mainly lease and trade operations, indicating that much of the subscribed capital in this portfolio revolves around foreign trade financing operations. The kind of participation in Islamic Banks' Portfolio is based on a *mudarib* type, whereby IDB acts as the manager of the Islamic Banks' Portfolio.

Because of IDB's fixed rule over the inherent m&m participation in these ventures, the management of the fund proceeds in the sense of a classical *mudarabah*. We have shown such a mode of financing to be of the pre-Islamic nature, in which neither active participation among all partners exists nor is there extensive participation in the sense we have explained it.

Islamic Bank Malaysia

The financing of clientele financial needs by the Islamic Bank Malaysia (Bank Islam Malaysia Berhad, 1994), one of the most progressive Islamic banks in the Muslim world today, quoted the following percentage proportions in m&m funds: *mudarabah* financing stood at 0.21 per cent in 1993, and 0.34 per cent in 1994 of the total financing made to customers. For the same time period, *musharakah* financing stood at 1.85 per cent and 1.81 per cent, respectively.

The m&m funds so held by customers did not involve any active participation as shareholders and stakeholders, for the bank acts as the management *mudarib* (partner) and thus involves itself in the kind of principal-agent contract that we have discussed before, in which only sleeping partnership exists. No active participation of shareholding and stakeholding is invoked except to allow major shareholders decision-making privileges.

The above two cases of m&m financing hardly bring out any significant effect of these modes of financing, in an economy-wide sense, toward generating productive and participatory economic linkages. The picture one derives from this kind of management is that the rules governing the sharing of profits are determined solely among capital owners (shareholders) and financial managers. There is no question of participation by labour as shareholders and stakeholders in the enterprise. Such a nature of sleeping partnership between the two modes of financing makes the m&m contracts no different from any of the profit-participating contracts found to exist in other kinds of financial enterprises, except that the investment outlets are governed by *shari'ah* rules.

Conclusion

We have shown in this paper that the proper instrument for raising and mobilising Islamic venture capital is centrally premised on a single unified or interactive principle between m&m. This would be capable of bringing about extensively co-operative and co-ordinated participation among agents, firms and sectors in view of the socio-economic relations that interactions generate and by the increase in entitlement, empowerment and ownership that results. Such extensively participatory enterprises were studied elaborately by Vanek (1971). In this context, it may be possible to retain the integrated m&m

terminology only if this is understood as a unified financial instrument of extensively co-operative and co-ordinated participation, as we have explained in this paper.

Since the central goal of Islamic development financing is to integrate the profitability and developmental perspectives in accordance with the goal of Islamic law (*maqasid as-shari'ah*), resource allocation in such a system follows the rule of developing complementarity across diverse possibilities. The way towards this end is through knowledge-inducing discourse and its results, as we have explained, by means of the *shuratic* process of organisation behaviour. In this case a substantively new rule of m&m financial sharing emerges. Such an instrument takes along with it the essential ameliorative goal and purpose of *shari'ah*

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