b) Capital markets

The capital market is the major area of intervention for the proposed model. Interventions in the capital market are required to correct the elements that create a bias against self-employing entrepreneurial activities and in favor of fixed wage-paying job opportunities. The corrections would aim at the following:

i) Eliminating the need for collateral, in general, and for physical collateral, in particular, while accommodating the capital requirements for self-employing productive activities.

ii) Linking the return on capital with the performance and outcome of the enterprise into which capital has been put.

It is in this context of the capital markets that the Islamic financial system and its role in human resources mobilization is presented in the next section.

The following section evaluates the Islamic financial system vis-à-vis the prevailing financial system in Muslim countries from the point of view of its relevance for human resources mobilization programs.

Before going into a discussion of the Islamic financial system, it may be clarified at the outset that the above conclusion does not mean that the reforms of the financial system are a magic cure for the problem. The significance of education and occupational training for the mobilization of human resources cannot be overemphasized. Corrections in the financial system can help mobilize human resources to utilize their capacity to the greatest possible extent but their capacity remains constrained by their education level. With mass illiteracy in most developing countries, the productive capacity of the masses remains at extremely low levels. But the point is that even this capacity will remain unutilized because of the financial system. This paper, therefore, emphasizes the correction of the financial system at least as a source of mobilizing human resources to exploit their existing capacities, irrespective of how low they are.

5. ISLAMIC FINANCIAL SYSTEM AND ITS RELEVANCE FOR HUMAN RESOURCES MOBILIZATION

The Islamic Financial System is described in the Appendix. The following features are to be noted with specific reference to the mobilization of human resources.

1. The system has a provision for *Qard Hasan* for needy people. Under *Qard Hasan,* there is no return on capital and repayment is subject to the ability of the borrower to pay. *Qard Hasan* is highly encouraged in Islam and state institutions and the private voluntary sector are supposed to raise funds to meet the *Qard Hasan* needs of the members of society.

2. The system entitles the capital to earn a return only by bearing some of the risk associated with the activity. There are various Islamic modes of financing. Some modes of financing may not mean risk bearing to the full extent or for the entire period of financing (as in leasing-based or trade-based modes of financing). Some modes of financing, however, imply risk bearing for the entire period of financing. Participatory forms of financing, which include *Mudaraba* and *Musharakah* participate in the risk bearing to the full extent of the invested capital and for the entire period of risk bearing. Islamic economy, in its financial and economic features will truely be distinguished from the participatory modes of financing than on the leasing or trading-based modes of financing.

3. There is a system of social insurance (in the form of Zakah and charities) that is meant to meet the subsistence needs of those whose subsistence is threatened for any reason. Although it is not directly a part of the financial system, it has significant implications for supplementing the role of the Islamic financial system in mobilizing human resources. State institutions as well as the private voluntary sector are supposed to organize Zakah and charity funds and make arrangements to meet the survival needs of the less privileged members of society.

Introduction of the participatory modes of financing (*Mudaraba* and *Musharakah*) as a core of the financial system in the economy allows, the following features also to emerge and prevail in the economy.

i) Profitability of the project becomes the primary consideration for the financial accommodation. Credit-worthiness becomes the secondary consideration, because the return on the project is not fixed but depends on the profitability of the project. (In the interest-based system which guarantees the principal with interest, credit-worthiness is the primary consideration and the profitability of the project is of secondary importance).

ii) Financial institutions may not be as inclined to finance large enterprises as they are in the interest-based system. Neutrality to the size of the enterprise is more likely to prevail. Profitability has generally been found, empirically, to be independent of the size of the enterprise. (The interest-based system has a clear bias towards large enterprises as the credit worthiness of large enterprises is generally more easily establishable than that of small enterprises).

iii) Finances have a chance to be more widely spread and distributed in the economy. Since the return on financial capital is associated with risk bearing, the diversity of the portfolio is a key to minimizing risk. The interest-based system has no compulsion to diversify because with the credit-worthiness feature, diversity will not help reduce risk and may be more likely to increase it.

iv) As a logical conclusion, when profitability and diversity are the primary considerations and there is nothing to suggest that these two elements are positively related with the size of an enterprise, smaller enterprises will get more encouragement from financial institutions. Smaller enterprises require smaller financial accommodation and, hence, diversity and the spread of risk become less by dealing with smaller enterprises.

v) There is more likelihood of the efficient utilization of capital under the Islamic financial system, which forces financial institutions to look for the most profitable and feasible projects. Under the interest-based system, there is no such compulsion as the return on capital is fixed and guaranteed by collateral.

We shall now look at how the Islamic financial system caters to the needs of a human resource mobilization program. The discussion will be confined to the needs pointed out earlier while taking into consideration the existing models of employment which were summarized in sections 3.1 to 3.5.

5.1 FACTOR-PROPORTION-BIAS

It was argued that the existing financial structure has a bias towards investment in capital-ntensive (labour saving) technology. This is because:

a) The fixed rate of interest (usually determined by the monetary authority of a country) causes the relative price of capital to go down, particularly when there is inflation in the economy. This (price incentive) creates a tendency to use more capital-intensive production processes.

b) Since credit-worthiness and collateral requirements are easily established by those who already own capital, capital becomes concentrated in fewer hands. This promotes capital intensity as it becomes easier to control a large capital intensive enterprise than to control a large labour intensive enterprise. Although credit-worthiness may still exist in some form in the Islamic system, its strength is not likely to be as great as in the interest-based system where guarantees and a fixed return are required for capital as well as ensuring credit-worthiness.

The Islamic financial system implies the following:

a) The institution of *Qard Hasan* will only provide capital to people with little means which, by definition, means the promotion of labour-intensive activities.

b) Islamic financing is on a participatory basis. (*Mudaraba* by *Musharakah* has no built-in incentive towards capital intensity). The return on capital is not fixed and it will increase with inflation and, hence, there is no unplanned decline in the relative price of capital. Also, there is no built-in mechanism to allow the concentration of capital in a few hands. Credit-worthiness and collateral needs, though they may still exist, will be of secondary significance; the primary significance being given to the profitability of the project in which the investment is being made. Furthermore, participatory finance yields a risk-bearing return and risk can be minimized by distributing capital on several projects. The concentration of capital and, hence, capital intensity is likely to decline with the introduction of participatory finance.

Although the leasing-based and trading-based modes of Islamic financing may have a tendency towards concentration and capital intensity "survival" syndrome, which was described earlier as having two elements:

1. A fear of the loss of capital
2. A fear of starvation

These two fears prevent the human resources with little means from being enterprising and innovative in improving their economic condition. Most of the Islamic modes of finance relieve the user of capital from the risk of its loss. In addition there is the institution of Zakah and charities which also have the potential for taking care of the subsistence needs of the less privileged members of society. These institutions can be organized at state or society level in such a way that they can also be used to motivate and mobilize human resources involvement in an enterprising activity, if a wage paid job is not available. By guaranteeing the subsistence of new entrepreneurs (in case they fail) and/or in guaranteeing the principal amount of the loans that the new entrepreneurs may need to borrow, these institutions can further supplement the Islamic financial system's potential for mobilizing human resources.

5.4 SYNCHRONIZATION OF AGGREGATE EFFECTIVE DEMAND WITH THE HUMAN RESOURCES MOBILIZATION PROGRAM

At the macro level, the policies creating an effective demand may not, to the same extent, simultaneously generate human resources mobilization. Fiscal policy or the injection of money supply through interest-based institutions may generate effective demand, which may be met from imports or from capital intensive production. On the other hand, no supply at all may be generated, and the end result may be the creation of inflation. The Islamic financial system provides opportunities where effective demand as well as supply through human resources mobilization can be generated simultaneously. The expansion of the finance supply through Islamic financial institutions generates a productive capacity as well as generating effective demand, because all of the finance supply will be meant for productive purposes and, as already mentioned, the Islamic financial system has a clear bias towards smaller enterprises which are more labour-intensive. Therefore, the simultaneous generation of effective demand and supply by an Islamic financial system mutually reinforces the employment and absorption of unutilized human resources in more productive activities. The magnitude of the problem that was identified in the discussion of the Keynesian model with respect to the possibility of a mismatch of demand and supply and, hence, an inability to mobilize resources is considerably reduced by the features of the Islamic financial system.

6. SOME INSTITUTIONAL PROVISIONS

Besides modifying the approach towards human resources mobilization and making corrections in the financial system, some additional institutional provisions also need to be identified in order to reinforce the strategy described earlier. Particularly in need of attention are the following.

6.1 COMPLETE ELIMINATION OF INTEREST FROM THE ECONOMY

The introduction of the Islamic financial system based on participatory financing is a key to the successful implementation of the proposed strategy. The Islamic financial system, however, will not be able to show its full effectiveness for the human resources mobilization program described in this paper unless the option of interest-based financing is completely eliminated from the economy. If this is not done, then those who own capital are likely to favour the interest-based option and are unlikely to provide capital for participatory finance which could be used by human resources to become more productive. On the other hand, potential capital users will only bring forth projects for participatory financing in which the income is low or the risks and uncertainties are high. Capital owners, however, will not be interested in financing such projects. For higher income and less risky projects capital users are likely to opt for interest-based financing. Hence, participatory finance will be driven out of the economy, if the interest option is allowed to exist. This will be the same phenomenon as Grasham's Law of "Bad Money Driving Good Money Out". In such a case, only government financed institutions will be able to provide the necessary financing along the lines proposed by the strategy. The financial constraints faced by most of the labour in developing countries in the Muslim World will, however, not permit government financial institutions to work on a large enough scale to implement the human resources mobilization program as outlined in the paper.

6.2 DECENTRALIZATION OF THE BANKING SYSTEM

Most developing countries have a centralized banking system. The centralization occurs at the level of the distribution of finances collected from small savers. This centralized distribution of finances has resulted in the concentration of capital in a few hands which, from the point of view of human resources mobilization, is counter-productive. The strategy described in earlier sections requires the decentralization of the investment decisions of financial institutions. This may require some groundwork in the form of giving adequate training to local bank managers for making investment decisions, but this is essential for an effective human resources mobilization program in the framework described in this paper. The spread of the banking system to rural areas with powers given to local managers to make investment decisions and to distribute funds accordingly will have to be an important part of the entire strategy particularly in those countries where more than 75 per cent of the population of working age is located in rural areas. The practicality and cost effectiveness of decentralization in connection with the proposed model can be seen in the experiences of the Federal Business Development Bank of Canada and of the Grameen Bank, Bangladesh.

6.3 ESTABLISHMENT OF A DEVELOPMENT BANK FOR HUMAN RESOURCES MOBILIZATION

There have been several development banks for capital formation, but development banks for human resources mobilization are almost non-existent in the Muslim world. Development banks for the specific purpose of human resources mobilization must be established to provide risk bearing capital to mobilize low-income human resources, who may not be able to compete with the higher income groups in offering a better rate of return. These institutions will be particularly required in countries which have an abundant supply of labour, the substantial part of which is extremely poor, illiterate and unskilled.

7. COMPARISON OF THE PROPOSED MODEL

There have already been some experiences in the developing world as well as in the developed world in the field of mobilizing human resources (particularly in promoting self employment) through the development of appropriate financial arrangements.

These experiences succeeded in proving the following :

1. Human resources can be mobilized through the availability of finances by giving them opportunities for self-employment activities.
2. Even illiterate workers have the capacity to utilize financial capital to substantially improve their productivity and income through self-employment.
3. Self-employment results in a high marginal propensity to save and a propensity to invest and, hence, leads to an accelerated improvement in economic conditions.
4. The availability of finances can convert even housewives into traders or manufacturers.
5. The financial capital required for mobilizing human resources into self- employment activities is extremely low.

The existing experiences, however, suffered from the following problems. Firstly, these institutions have always been short of funds. If human resources are to be mobilized only through specialized institutions then they require exclusive funds for this purpose which can only come through the public treasury or through donations. Both these sources can only generate insignificant amounts for countries where labour is abundant. In countries such as Indonesia, Bangladesh, Pakistan and Malaysia, most of the economic resources are already committed to various development efforts which leaves very little to be assigned to such institutions.

The private sector cannot supplement public efforts in this field in an interest-based economy, because specialized institutions can only provide poor people with an easy access to cheap capital. Capital is only cheapened by reducing the rate of interest.

The private sector will not be interested in such an activity when the rest of the economy is offering a better rate of interest.

Secondly, even if these institutions are provided with enough funds, their ability to mobilize a sufficient portion of the available stock of human resources is doubtful simply because of their interest-based philosophy. These institutions provide interest-based loans, where both the principal and the interest is guaranteed and is required to be paid irrespective of the outcome of the activity for which the loan has been taken. It has already been shown that this basis of financing kills the motivation to seek financing for an entrepreneurial activity because uncertainties are too costly. There are six types of potential borrower. They are those with projects which have :

1. Low return with no or negligible risk.
2. High return with no or negligible risk
3. Low return with low risk
4. High return with low risk
5. Low return with high risk
6. High return with high risk

Specialized development financial institutions even with very low interest rates motivate only the first two types of client. Since these specialized institutions only operate on a limited scale, they can always find enough clients within the type 1 and type 2 categories. When they do have enough funds to look for clients in other categories, those in categories 4 and 6 may hesitate to avail themselves at this facility because of factors already highlighted in earlier sections. Categories 3 to 6 may also generally remain unmobilized even if the specialized institutions' finance is available to them.

On the other hand, the Islamic financial system motivates all six categories. The financing needs in some of the cases (such as for categories 2, 4 and 6) can be taken care of by the market, whereas for the remaining cases (such as categories 1, 3 and 5), specialized institutions can be designed, if the funds are available.

The fundamental difference between the two approaches is that the interest-based financial system aims at providing small entrepreneurs in a particular section of the population with cheap access to capital, whereas the Islamic financial system aims at providing all sections of the population with an equal opportunity to have access to risk bearing capital in the economy.