



ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

INSTRUMENTS OF MEETING

BUDGET DEFICIT IN ISLAMIC ECONOMY

Research Paper
No. 42

ISLAMIC DEVELOPMENT BANK (IDB)

Establishment of the Bank

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent by a Conference of Finance Ministers of Muslim countries held in Jeddah in Dhul Qa'da 1393H (December 1973). The Inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the Bank formally opened on 15 Shawwal 1395H (20 October 1975).

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The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah.

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**ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE**

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MONZER KAHF

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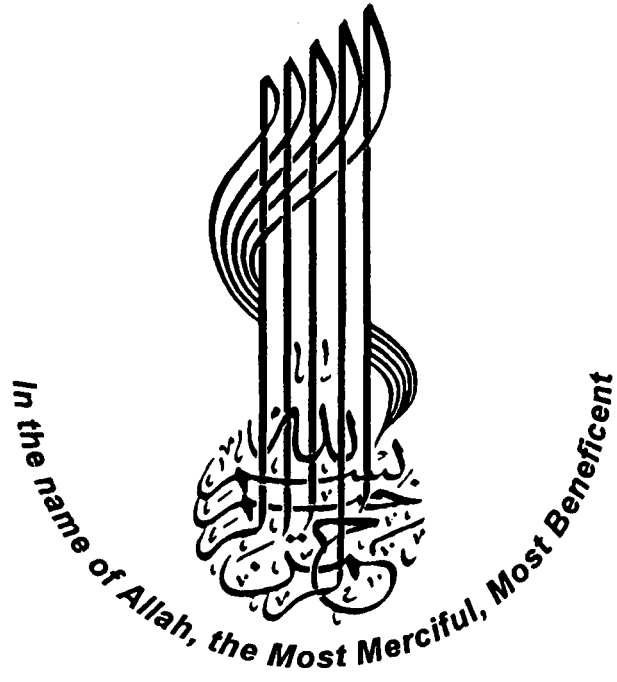
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FOREWORD

The Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) has been established in 1401H (1981) "to undertake research for enabling the economic, financial and banking activities in Muslim countries to conform to *Shari 'ah*". In order to discharge its responsibilities, IRTI pays special attention to research in the areas of Islamic economics, banking and finance. The present monograph on " Instruments of Meeting Budget Deficit in Islamic Economy" was undertaken as a part of IRTI's program of research on various aspects of Islamic economy.

In many Muslim countries, the ratio of public expenditures to gross domestic product exceeds its respective level in industrial countries. Meanwhile, public revenue as a ratio to GDP is below its level in industrial countries. A tendency to have sometimes high albeit persistent deficits is common, hence. Notably, deficits are generally accompanied by a large measure of monetary expansion, giving rise to inflationary pressures. When deficits are financed through borrowing from the public, including commercial banks, the crowding out of the private sector takes place. To make things worse, deficits are generally accompanied by imbalances in the external sector.

Since government borrowing seems to be the culprit in all cases, it is therefore logical to think of "non-debt creating" means to bridge the gap between public revenues and expenditures. The ideal environment of that alternative would be an economy where borrowing is given a rather subordinate role. This applies specifically to an Islamic economy.

Budget deficits are mostly covered by increasing revenue, reducing expenditure, internal borrowing from public, commercial banks and central banks and external borrowing. Since there is only a limited scope either for reducing expenditure or for increasing the tax revenue,

only borrowing from internal and external sources remains a viable alternative. The government in Muslim countries, like many developing countries have taken this option and this has led to mounting internal and external debts.

The present research sheds new light on instruments for public resource mobilization that are based on Islamic principles of financing, rather than on principles of taxation. The author has shown that several Islamic contracts like *Murabaha* , *Salam* , *Ijarah*, *Istisna*, etc., maybe used as a basis to evolve new instruments to mobilize resources for the public sector. In this connection, the author has advanced proposals for devising certain new Islamic financial instruments such as *Ijarah* bonds, *Salam* certificates and *Istisna* coupons etc. These proposals merit serious consideration as they are capable of fulfilling the resource requirements of the public sector in a way that avoids imbalances which are usually accompanied by misallocation of resources.

It is hoped that publication of this research monograph would encourage enlightened discussion on the subject and lead to further research into such a novel, yet promising area.

Mabid Ali Al-Jarhi
Director, IRTI.

INTRODUCTION*
STATEMENT OF THE PROBLEM AND OBJECTIVE OF THE PAPER

Budget deficit is the gap between public revenues and expenditures. Revenues normally come from taxation and public property while expenditures may cover development projects as well as current expenses of running the government. Budget deficit is usually bridged by increasing revenues, reducing expenditures, internal borrowing from the public, commercial banks and/or the central bank, and by external borrowing. This paper examines Islamic economics' means of meeting needs that are usually met through public borrowing in conventional economics.

Public borrowing have become a major feature of contemporary economies in both developed and developing countries. In the past, Governments used to borrow from their rich citizens only to face financial needs of wars and natural calamities. However the era, which followed the second world war has witnessed a tremendous increase in public borrowing especially that financing development and meeting regular budgetary deficit are added to the list of reasons which justify resorting to public borrowing.

Islamic literature on public debt is very little. Only after the blow of international debt crisis in the 1980's, Muslim economists started talking about the problem. A workshop was organized by the International Institute of Islamic Economics of the IIU, Islamabad on the elimination of interest from government transactions in 1984 dealt partially with public debts and a symposium on public debt and budget deficit was held during the seminar on fiscal policy and development planning in Islam in 1986 which was organized by the same institution.

With only a few exceptions, what is written focusses on the causes of debt crisis and suggests that international debt of Muslim countries could have

The author like to express indebtedness and gratitude to three unanimous reviewers for many valuable correction and comments on an earlier draft. However, any mistakes still existing are solely his.

been avoided', rather than tackling needs, forms and alternatives of public borrowing in Islamic economy. This paper does not deal with the needs nor causes of budget deficit in an Islamic economy. It rather concentrates on suggesting instruments for meeting the deficit that are compatible with *Shari'ah*, i.e., it deals with Islamic substitutes of public borrowing. Therefore, issues related to the causes and circumstances of external and internal public debts, as well as the issue of the size of public sector and what goods are to be provided by the government, are all outside its scope.

RELEVANCE AND SIGNIFICANCE OF THE STUDY

Most Muslim countries today have large amounts of public debt, and several of them are increasing their debts by fresh net borrowing year after

year⁽²⁾. These public debts would have to be transformed into Islamically acceptable forms of financing if economic, finance and banking activities are to be re-organized to become compatible with *Shari'ah*.

Furthermore, most Muslim countries still have enormous needs for construction, and expansion of their economic infrastructures, for which they require to mobilize fresh financial resources, both internally and externally. Also unforeseen necessities such as military crises, and natural disasters as well as short and medium term budgetary adjustments should be kept in mind as reasons for public borrowing.

This study, thus deals with an applied issue related to the application of *Shari'ah* in the financial and economic activities of the Muslim countries. It contributes to the studies of Islamization of Muslim economies. Hence it may be of interest to all Muslim countries especially that it helps in the process of mobilizing financial resources for public use in a manner which appeals to the feelings, sentiments and believes of Muslim people in their own countries as well as in the international arena. In other words, this paper contributes to

1. Muhammad Umar Chapra's paper on "Islam and the International Debt Problem" is an example. Unpublished paper and lecture given in the Islamic Foundation, Dhaka, Bangladesh, July 25, 1991.

2 ibid..p.2.

shed some light on Islamic means of private and public funds transfer among the Muslim countries.

The paper consists of four sections. In Section One, I will briefly discuss the principles of financing and public borrowing in Islam as an introduction for the subject. Since the provision of public goods beyond the limits warranted by public revenues is the ultimate reason for budget deficit, Section Two will focus on the provision of public goods and alternative approaches that reduces the role of government and consequently the pressure on the budget in this regards.

In Section Three, I will suggest instruments for public resource mobilization which can be developed on the basis of Islamic principles of financing other than taxation. In this section, I will also make a brief mention of non-market instruments of public borrowing, i.e., borrowing from commercial banks and central bank.

Finally, section four will mention the conclusions and summary of the. paper.

SECTION ONE

PRINCIPLES OF PUBLIC BORROWING AND FINANCING IN ISLAM

There are several cases of public borrowing during the time of the Prophet (pbuh)³. There are also well known cases of borrowing by the Muslim State during the Abbasites⁴ and the Ottomans, and obviously by modern Muslim states since the middle of the nineteenth century. Ottoman's and Egypt's borrowing in the nineteenth century were mainly external, from foreign governments and bankers.

It is noticeable that early borrowing, i.e. the Prophet's and the Abbasites' did not result in issuing any debt instruments. Although it may be understandable that Abbasite Ministers of Treasury who made the borrowing must have issued some "IOU's" to lenders. It is an established fact that transactions of *Bait al mal*, at that time, were always recorded and documented but there are no available reports about the forms of these "IOU's" nor whether they were negotiable.

Additionally, public borrowing was known to the classical writers of *fiqh*. For instance, Al Mawardi (P. 215) talks about resorting to borrowing for payments of dues on the treasury and argues that successive rulers are bound to pay such loans back.

3. M.N. Siddiqi cites seven cases of borrowing by the Prophet (pbuh). In two of them the sums of purposes as well as for personal needs fulfillment for certain people. See M.N. Siddiqi, "Public borrowing in early Islamic history." paper presented in the third International Conference on Islamic loans were relatively large. One loan was in kind and one in cash. He borrowed for defence Economics, Kuala Lumpur, Jan 29-31 1991, pp. 4-14.

4. *Ibid.*, pp. 19-23. According to Siddiqi's sources some of the Abbasite's borrowing was bearing interest.

Table 1

PUBLIC DEBTS IN SOME MUSLIM COUNTRIES (IN BILLION US\$)

Countries	*1970						1980						1988					
	Internal ¹			External			Internal			External			Internal ¹			External		
	Amount*	% of GNP		Amount	% of GNP		Amount	% of GNP		Amount ¹	% of GNP		Amount*	% of GNP		Amount**	% of GNP	
Algeria	2.4	10.5		0.9	19.8		N/A		16.9	41.1		N/A		N/A		24.9	47.6	
Cameroon	N/A	N/A		0.1	12.6		-17.2	-	2.5	36.8		0.2		4.1		4.2	33.7	
Egypt	N/A	N/A		1.7	22.5		0.2(1979)	12.4	21.0	98.0		5.0		9.2		50.0	142.5	
Jordan	0.02	6.7		0.1	22.9		0.2	14.8	2.0	49.6		0.9		42.5		5.5	110.0	
Malaysia	3.1	2.5		0.4	10.8		2.3	4.3	6.6	28.0		7.9		8.6		20.5	66.0	
Morocco	3.4	1.7		0.7	18.6		3.4	4.6	9.7	56.2		3.8		2.4		19.9	105.9	
Pakistan	2.3	4.8		3.1	30.6		3.6	1.5	9.9	42.5		16.6		2.5		17.0	45.6	
Senegal	N/A	N/A		0.1	53.3		0.01	1.6	1.3	45.6		N/A		N/A		3.6	76.6	
Sudan	0.01	1.6		0.3	14.8		0.02	0.4	5.2	78.0		N/A		N/A		11.8	134.3	
Tunisia	0.01(1971)	12.4			-		0.3	8.9	3.5	41.6		1.1		12.3		6.7	70.0	
Turkey	3.2	2.1		1.9	15.0		0.1	3.1	19.1	34.2		1.2(1986)		2.9		39.6	57.7	

* (In billion of local currency)

** In billion US\$)

Sources : 1. IMF : International Financial Statistical Year book 1991.

2. Debt Outstanding of IDB member countries, No. 3, January, 1992.

One had to wait until the late 1960s for a substantial increase in public debts in the Muslim countries. Table 1 shows that while public borrowing reached in 1970 more than 50% of GDP in one of the eleven Muslim countries, in 1988 public borrowing was more than 50% of GDP in almost all eleven countries and more than 100% of GDP in four of them. It also shows the weakness of internal debt in most Muslim countries in contrast with the large size of their public debt. In 1988 external public debt reached more than ten times of the internal debt in three countries. This emphasizes the need for developing resource mobilization instruments which may appeal to Muslim people in order to attract debt from within the country and from individual Muslims abroad whether they are citizens of the borrowing state or not.

The Qur'anic prohibition of *riba* came in terms stronger than any terms used in any other prohibition, and the alternative mentioned in the *Qur'an* for

riba-based financing is sale (Verse II: 275)⁵. The *Sunnah* confirmed this principle and added the principles of Profit and loss sharing and output sharing. Obviously lending/borrowing relationship is also mentioned in the *Sunnah* as a good by practice that is rewarded by Allah. However, since a loan does not generate any return to the lender, lending incentives are primarily non-economic. The rest of this section will be devoted to return-based Islamic principles of financing and conditions of public borrowing will be discussed in Section Three.

1.1 Sale Principle

The sale principle of financing is demonstrated in the provision of physical factors of production, intermediate inputs or consumption goods and services against deferred payment. Hence, the object of sale may be goods or services, whether they are used for production or consumption purposes. This mode of financing can be used by financial intermediaries (such as Islamic

⁵ Verses IL 276 and 280 also mention charity and granting time to the debtor free of any charge, but since both of these are charitable in nature they do not make alternative to *riba*-based financing on the ground that the financier does not expect any material return out of these two practices while there is a return to *riba*. Therefore, a full-fledged *riba* alternative must give a legitimate return to the financier.

banks), owners of factors of production, or other economic agents and intermediaries.'

This principle covers transactions based on sale [*bay*] as well as lease [*ijarah*] since *Sarah* is a sale of usufruct. There are, however, a few differences in the *fiqhi* specifications and conditions for each of these two types of contracts. Sale, as a financing mode, includes deferred payment sale, '*istisna*' and *salam*. Deferred payment sale is usually referred to as sale at mark up to the purchase orderer, or *murabahah li al 'amir bi al shira*'. Lease or *Sarah* is practiced in the form of leasing to the purchase orderer too.

It is argued that, unlike riba based financing, *murabahah* and *ijarah* do not create a situation in which the return to financier is known in advance,' because the seller-cum financier (or lessor-cum-financier) carries certain risks involved in purchasing, owning and selling or renting the object of sale or

lease ⁽⁸⁾ Moreover, in the case of lease the object of the contract remains a property of the financier for the duration of the contract. Like Riba-based financing *Murabahah* creates debtor/creditor relationship between the two parties. On the other hand, unlike interest based financing, sale based financing is committed to a complete or perfect correspondence with the physical or real market transactions and it involves the financier in commodity-based relationships in strictest sense of the term rather than pure financing.

⁶ Monzer Kahf and Tariqullah Khan, "Principles of Islamic Financing: A Survey," unpublished paper, IRTI 1409, pp. 29-31.

⁷M.Fahim Khan, Comparative Economics of some Islamic Financing Techniques, IRTI, 1412, pp 6-7.

⁸ These risks are usually mentioned in *fiqhi* references. They include contract risk, undetected defect risk, etc.

1.2 Profit and Loss sharing principle

The principle of profit and loss sharing covers partnership [*sharikah*] and commendam partnership [*mudarabah*]. The Islamic principle of profit and loss sharing implies that profit may be distributed between partners as per agreement which may differ from their shares in capital, but losses have always to be distributed in accordance with capital shares because *Shari'ah* defines loss as a decrease in principal. Consequently, *mudarabah* may be considered a special case of *sharikah* in which the capital share because of the *Mudarib* is zero therefore he/she has no share in the loss⁽⁹⁾

Partnership requires the financier to share both capital and management i.e., to contribute to the decision making process. *Mudarabah* requires financier or *rabb al mal* to provide capital and remain away from managerial decisions (10).

Mudarabah's inability to allow the banker to participate in the management decisions and to exercise effective checking on truthfulness of its financial reports is probably the main reason behind the little success most Islamic banks find in courageously using this mode of financing on the investment side of their activities. This may call for a reconsideration of the *fiqhi* majority opinion that does not allow any interference from the money owner in *mudarabah*. The lines suggested by the *Hanbalites* who permit a *mudarabah* of two persons and one fund (i.e. *rabb al mal* shares the management with the working partner) may provide a good base for such a reconsideration. Otherwise, the present experience of Islamic banks may suggest that the neat, and theoretically cherished two fold *mudarabah*, did not succeed in attracting Muslim bankers to use *mudarabah* in their financing exercises. This calls for theorizing a model of financial intermediation based

9 See M. Fahim Khan, *ibid.*, pp. 2-5 and table 1 on page 9.

10 This is according to the majority of jurists. The hanbalites, however, accept that *rabb alma'* participates in managerial decisions along with the *mudarib*. See Monier Kahf, *Mafhum al Tamwil fi al Iqtisad al Islami*, IRTI, 1991.

on a formula in which the *mudariib* uses funds of *mudarabah* to provide financing on the basis of the principle of sale which has prevailed in the practices of Islamic banks since 1976.

Lastly, there are two other forms of application of the principle of profit and loss sharing which are not usually given separate names. One is the case mentioned by the Hanbalites in which *rabb al mal* retains the right to share managerial decisions with the *mudariib*, which is described, as mentioned earlier, as: "two persons and one fund. ""

The other form is the case in which the *mudariib* mixes his/her own capital with funds obtained from *rabb al mal*. This form may be preferred over the regular *mudarabah* because it cherishes the personal incentive of the *mudariib*.

1.3 Output sharing principle

A third principle of financing is derived from ancient practices in agriculture which is approved in Islam and re-organized in accordance with the Islamic values. *Muzara'ah* and *musaqah* are crop sharing for cultivable land and fruit trees respectively. In these arrangements, output (not profit) is shared while one party provides land, and trees and the other provides labor. Seeds, fertilizers, pesticides and machinery may be provided by either partner. The *Hanbalites* are the only *fuqaha'* who seem to accept extending the idea of *muzara'ah* and *musaqah*, to non- agricultural sectors.

Consequently, output-sharing financing implies that financier owns durable productive assets which are given to a manager who takes charge of all daily decisions against certain percentage of gross output. The issue of expenses on other inputs seem to be of lesser importance since, as in *muzara'ah*, either party may pay for them provided this is considered in determination of shares of output distribution.

11. Ibn Qudamah, *Al Muglmi*, Dar al Kitab al 'Arabic, 1972, V.5, p.137.

In Practice, output sharing did not make a serious headway among the modes used by Islamic banks today. This may be caused by the fact that output sharing requires the financier to own land and equipment for a long period. It also involves high risk especially in areas where agriculture heavily depends on rain and weather conditions. Moreover, the dust of *fiqhi* discussion on output sharing in business and industry has not yet settled and it may still take sometimes until it is formulated in contractual terms that can readily be used by financiers.

SECTION TWO
SHOULD ISLAMIC ECONOMICS STUDY MEANS
TO FINANCE THE BUDGET DEFICIT?

The straight answer to this question is a plain yes. As shown in Section One, most (or all) Muslim countries have resorted to public borrowing since the time of the Prophet (Pbuh).

However, the contemporary phenomenon of public borrowing in the Muslim countries is not always caused by conditions of necessity similar to those for which the Prophet (pbuh) borrowed. Chapra cites four major areas of excessive public spending that were behind resorting to borrowing in most contemporary Muslim countries: corruption and wasteful spending, price subsidies, inefficient and large public sector, and high defense expenditures.⁽¹²⁾

One may still argue that even if these four problems are curbed, there may still be reasons for public financing in an Islamic economy. Since a budget deficit is an excess of expenditures over revenues, the society's choice of whether certain goods should be provided by the government lies in the heart of budget deficit.

2.1. PROVISIONS OF SOCIAL GOODS -- ISLAMIC PERSPECTIVE

The failure of market to provide efficient mechanism for production and distribution of certain goods raised the issue of social or public goods ⁽¹³⁾. This failure is caused by the well-known non-rivalry and non-excludability

12 Chapra, M. Umer, Islam and the Economic Challenge, Islamic Foundation, Leicester, UK 1992, pp. 290-294.

13 Musgrave and Musgrave, Public Finance in Theory and Practice, 1984 Mc Graw Hill, Inc., New York, pp. 48-51.

nature of certain goods. Both concepts are, however, subject to technological and social influences. A non-rival good may become rival under certain circumstances. For instance the wild-life protection regulations make hunting a rival good where each prospective hunter competes with others for a seasonal hunting license. Similarly, installation of a gate and a toll booth transforms a non-excludable good (driving on the highway) into an excludable one and a price for using the highway can be auctioned.

However, non-rivalry and non-excludability alone are not sufficient to explain what goods are provided by the public sector, and the choice of goods for provision by the public sector is very often political. This means that certain rival and excludable goods may be provided by the public sector by virtue of the society's political choice. Certain rival and excludable goods are selected for provision by the government because they are considered meritorious and should be provided by the government on social welfare, distributive justice or developmental grounds. Some examples are education and public concerts⁽¹⁴⁾. A close look into the public finance of the early Islamic state, especially during the life of the Prophet (Pbuh) when revenues were tight, may indicate that the main services or social goods provided by the government of Madinah were: defense, judiciary and society's management¹⁵.

Therefore, public borrowing made by the Prophet (pbuh) in cash or in kind may be assumed to be for payment of these kinds of services. However, upon the victory of Badr, some public revenues were devoted to children education as very well known.

On the other hand drinking water, Mosque construction, feeding the poor, freeing slaves and some of defense and foreign state guests' expenses were provided by philanthropic action in response to calls by the Prophet (Pbuh).

¹⁴. Education may be considered a mixed good because the benefit of having an educated person as a colleague may be impossible to internalize. However, it may be argued that a conversation with an educated person may be made a rival good and all its cost may be internalized through a 900 charge call number.

¹⁵. Society's management in this context; includes running internal relations between groups and regions within the society and external relations with foreign countries and communities.

When public revenues became abundant during the Second Successor, Umar, the government not only ceased asking for voluntary contributions, but provided rival and excludable goods, such as, food stuff to private consumers.

The historical experience of Muslim society may indicate that the role of individual and institutional philanthropy in providing public goods may be instrumental. For instance, until the introduction of Western system of education in the Muslim countries, education has always been provided free to its users by Islamic Institution of Awqaf. In fact, whenever certain rulers wanted to support education, the help itself would be channeled through Awqaf. This has happened many times and good examples of it are the Ayyubites's and mamluks' Awqaf on schools in Palestine.

2.2 Alternatives to Public Provision of Social Goods

Obviously, there is always a minimum level of social goods below which the government itself either does not exist or is not able to fulfill its essential functions. Such a minimum level should be provided even without revenues at all. Once, the list of public goods expands beyond this minimum level, the budget burden increases and if revenues are not sufficient a deficit arises. Consequently, providing social goods by agents which do not require the use of public funds reduces the financial burden of the budget and may therefore be considered an alternative of public borrowing. Non-government provision of social goods may be either voluntary or profit motivated.

16 Islamic Research Center for History and Arts (IRCICA), The Muslim Pious Foundations (Awqaf) and Estates in Palestine, Istanbul 1982

17 It should be noticed that the Islamic system does not allow the provision of certain of certain social goods by private or voluntary agents. Law enforcement is an example. Additionally, Muslim fuqaha arguer that certain social goods cannot be made subject to market conditions on moral grounds, such as giving religious opinions (fatwa).

A) Voluntary provision of public goods

The provision of public goods by voluntary agents is as old as Islam itself. Upon the arrival of the Prophet (pbuh) in Madinah, the first mosque was built by voluntary labor and material. Defense activities of the newly established city/state were carried out on a voluntary basis too. The Prophet's army consists of people who used to volunteer their labor and use their own weapons. Some social services such as lighting the mosque and providing food to the poor were also performed on voluntary basis. Before the arrival of the Prophet (pbuh), drinking water used by a Jewish owner of Biruha' well. The Prophet called on Muslims to buy the well and give its water free, and Uthman did that. Thus, in the Islamic State, water was also provided free on philanthropic grounds.

Soon after the establishment of the Islamic state, voluntary philanthropic work assumed an institutional shape and the institution of philanthropic waqf came into existence. Early properties of philanthropic waqf included Mukhairiq gardens and Bairuha' well, both in Madinah, and Umar's orchard in Khaibar. These awqaf were used to provide income for the Prophet's families (head of state's expenses), weapons for the army, stipends for the poor and free drinking water for inhabitants of Madinah (18). As time went by, the awqaf institution became the provider of education, health care and mosques' construction and maintenance; and major contributor to financial aid to the poor and building and maintaining border defense posts and forts. The institution of Awqaf is an essential part of the Islamic economic system. It can be received to re-assume an important role in providing social goods and in contributing to the infrastructural development of the Muslim countries.

Additionally, *zakah* as the third pillar of Islam, provides a permanent flow of resources devoted for restoring distributive equity and social welfare.

Zakah is essentially a function of the Islamic government, but it can be carried

18 Hassan Abdallah Al Amin, ed. *Idarat wa Tathmir Mumtalahat al awqaf*, IRTI Jeddah 1989.

out by charitable organizations, so are other *sadaqat*, especially that non-profit voluntary organizations usually have achievement incentives because of the bondage that links their workers to the organizations' objectives. At the same time, they can use free (voluntary) labor and avoid the bureaucratic structure of government⁽¹⁹⁾. Therefore, in many western societies today, the provision of public goods by non-profit organizations has a wide spread application, especially in the area of education, health care and water supply⁽²⁰⁾.

B) Profit-Motivated Provision of Public Goods

The argument for leaving more of the social goods to the private sector is well known in the literature, as the market provides efficiency incentives by means of the profit motive and the conditions of competitions. Consequently, whenever the market mechanism can be activated for the provision of a given good, efficiency ideas do not lend support for its public provision. Therefore, if a smaller government with a smaller scope of social goods' provision means a lesser demand for public borrowing, private provision of public goods makes an alternative of budget deficit. In other words, transferring more goods to the private sector is an important way to reduce the need for public borrowing.

Education, health care, water, communication, electricity, garbage collection, etc. are examples of goods where almost all cost of production can be internalized. Such traditional public goods these can be produced and provided by the private sector, (the thing which reduces the financial burden of the public sector and lessens the needs for budget deficit ⁽²¹⁾).

Lance Liebman, "Political and Economic Markets: the Public, Private and Not-for-Profit Sectors" in Public-Private Partnership, H. Brooks, L. Liebman and C.S., Selling, eds., Ballinger Publishing Co, Cambridge, Mass, USA 1984, p. 354.

Gabriel Roth, The Private Provision of Public Services, EDI of World Bank, Oxford University Press, 1987, pp. 11-12.

Many technological and organizational changes help reduce externalities, allow providers to charge all costs to users, and eliminate non-excludability conditions. However, there remain situations in which the size of the market may be small and economies of scale prevail or characteristics of natural =

However, there are four considerations that *Shari'ah* requires in this regard:

- (1) *Shari'ah* prevents a few goods from being produced on market basis, such as prayer spaces in mosques, exercise of political rights and implementation of law and order⁽²²⁾. Beyond these and similar *Shari'ah-ordained* public goods, most goods and services may be privatized. For instance, you may go to Court to have a judgment on a dispute (public goods) or you may agree with the other party to rely on paid-for services of a private arbitrator or judge⁽²³⁾. In other words, although it may be possible to privatize a given good from technical point of view, this may not be permissible in *Shari'ah*. This prohibition, however, only applies to a very small number of goods.
- (2) The Islamic system distinguishes between two categories of revenues from the point of view of their potential allocation to expenditures. Certain revenues such as *kharaj* may be used for any governmental activity while others are restricted to specific headings of spending. This means that if the government has revenues characterized with flexible usage such as return from public property ⁽²⁴⁾, it can allocate them to any public goods. On the other hand, if the government does not have much of the

monopoly (one source of some factors of production) prevail. These situations may be dealt with through tax/subsidy, pricing and other regulatory means while the provision of social goods is kept in the hands of private sector. Alternatively public sector may provide these goods. Additionally, cases of market failure because it is either impossible or very difficult to avoid the free-rider's problem remain a concern of public sector. So is the case of political/social preferences for public sector's provision of certain goods. For detailed discussion on this issue refer to Gabriel Roth, op. cit.

- 22 Obviously goods and services prohibited in Shari'ah are outside the scope of this discussion because they cannot be provided by either private or public sectors.
- 23 *Qur'an* refers to private arbitrators (judges) in family disputes (4:35) and nothing in *shari'ah* prevents paying for the services of such arbitrators.
- 24 *Kharaj*, *jiziah* and state share of *Ghanimah* are also flexible with regard to their use.

use-flexible revenues and it has to tax citizens for revenues, then only necessary public goods, such as public administration, judiciary and defense can be provided, unless by approval of tax payers as mentioned in (3) below,(i.e., the *Shari'ah* does not allow resorting to taxation in order to finance any public goods.

- (3) The moment one goes beyond those goods whose production by the public sector is absolutely necessary, the choice of what, how and for whom public goods are to be produced should be subject to the Islamic approach of public decision making, i. e., to be taken by means of *Shura*. The same applies to the choice regarding the financing of such public goods. The *Shura* is the body that represents the whole society. Since the Islamic foundation for any tax that is not indispensable to maintain basic public goods is the voluntary consent of tax payers, taxes to finance public goods can only be imposed with *Shura* approval. Additionally, since the production of public goods implies the use of resources owned by the *Ummah* such a use also requires a *Shura* approval. The *Shura* may decide that certain goods should be provided by the public sector and may assign or raise certain revenues for this purpose as long as it is in the best interests of the *Ummah*.
- (4) The Islamic system encourages individuals and raises their morals to undertake social works and produce public goods on voluntary basis. It also links social goods to religious duties by means of *fard al kifayah*. More important, in the present context, is that the Islamic system permits the government to provide incentives to investors for encouraging private provision of social goods. An important incentive in this regard is the government guarantee as a third party. This is discussed in the remaining part of this section.

2.3 Third party guarantee as an incentive for private sector's Provision of public goods.

The nature of *mudharabah* does not allow the *mudharib* (laborer/entrepreneur) to guarantee the principal nor any profit to *rabb al mal* since such a guarantee violates the basic intent of this form of financing. It has been, however, argued that if a guarantee of *mudharabah* principal is given by some other party, not involved in the *mudharabah* contractual relationship, it may become permissible in *Shari'ah*

Third party guarantee is therefore a pledge given by a person who is not part of the *mudharabah* relationship to the financier [*rabb al mal*] assuring him/her that if the *mudharib* fails in returning the principal, and/or producing certain profit, the guarantor will step in and compensate the financier for loss in capital.

The *Shari'ah* permissibility of third party guarantee of the principal of *mudharabah* is beyond doubt. It was approved by the *Fatwa* Committee of the Ministry of *Auqaf* of Jordan in 1977 with regard to the then proposed draft act for the establishment of the Islamic Bank of Jordan.

More important is the opinion of the Islamic *Fiqh* Academy of the Organization of Islamic Conference.

There is nothing in *Shari'ah*, which prevents the inclusion of a statement in the prospectus of the *mudharabah* certificates about a promise made by a third party, totally unrelated to the two parties of the contract, in terms of legal personality or financial status, to donate a specific sum, without any counter benefit, to meet losses in a given project, provided that such commitment is independent of the *mudharabah* contract ... (25)

Third party guarantee, thus, requires that the guarantor must be independent of the two parties of the *mudharabah* both legally and financially.

25 The OIC Islamic *Fiqh* Academy, Resolutions and Recommendations, for the years 1406H-1409H/1985-1989, Resolution No. 5 of its fourth session held in Jeddah, Saudi Arabia, 18-23/5/1408H equivalent to 06-11/21/1988, p. 62.

The government may offer this guarantee to private investors in order to encourage them to offer *Mudarabah* funds for projects that would otherwise be financed from the public funds. Consequently, in as much as losses do not exceed capital requirements of such undertakings, this guarantee saves on the use of public funds and may, therefore, be treated as an alternative to budget deficit. Of course, it is irrational to choose third party guarantee if its cost is more than the cost of the project itself.

However, *Shaikh* Mustafa al Zarqa argues that guaranteeing a profit is different from guaranteeing the principal on the ground that the former contradicts the spirit of *mudarabah* relationship especially that it may negatively affect the instinctive drive to pursue self interest through efficiency and performance⁽²⁶⁾.

This argument deserves attention, if we look at it from the angle of *rabb al mal* who enters into a *mudarabah* upon receiving such guarantees. For *rabb al mal*, seeking (or accepting) a third party guarantee for his/her *mudarabah* is like giving funds for investment without carrying any risk, (knowing that risk bearing, with regard to money invested, is an indispensable feature or implication of ownership which justifies deserving a share of profit.

Moreover, a guaranteed *rabb al mal* would care less about the performance of the project in which he/she invests. Therefore, considerations of disruption in economic efficiency and in the role of profitability in allocation of investable funds become crucial if third party guarantee is applied en mass. Additionally, it may be argued that whoever is going to finally shoulder the cost of a government guarantee is a net loser, so why doing it? And what justifies spending public resources for this purpose?

On the other hand, one may point out to many circumstances which call for the application of a third party guarantee. First, contemporary business involves high levels of risks which justify the existence and expansion of insurance business all over the world. The fact that many risks are today

26 Monzer Kahf; "*sanadat al Muqaradah*" King Abdulaziz University Journal, *Islamic Economics*, v. 1, 1989, pp. 43-78 appendix No. 2.

insurable and actually insured does not lead to the elimination of profit in investment allocation nor necessarily reduces economic efficiency, although commercial risks are not commonly insured. .

Secondly, there are industries which, because of many reasons, cannot stand in the market without additional support. Some industries may be new and small in the market, especially in today's market structure which is far from the neat theoretical model of perfect competition. Some industries may be vital for national security, such as, education, and those related to national defense and food security.

After all, nations collect taxes and spend huge resources for achieving national objectives. Many such undertakings may not be economical in the narrow sense, but the public decision makers find them rewarding from the point of view of national interests.' Hence, to support certain industries by means of encouraging investors through governmental guarantee is at least the lesser of the two evils.

Thirdly, there may be regional considerations which require providing additional incentives to investors in certain regions in order to fulfill national objectives of equity and justice. Even in an Islamic society, it is possible that certain regions may remain neglected if they are left to the normal play of market forces and the Islamic government may find it necessary to encourage the private ' sector to invest in those regions by means of a third party guarantee.

Fourthly, the experience of some Islamic banks in the late seventies and in the eighties indicated the importance of establishing special funds for guaranteeing investment risks. These funds proved of important help to those banks in bad years. (For instance, reserves in these funds were actually resorted to by Islamic banks in Egypt and Jordan).

With the pros and cons of third party guarantee' and reservations against any expanded application of it, it appears that the government may resort to providing private investors with a third party guarantee under certain conditions, but in order to contain its negative effects on efficiency, its use

should be restricted to cases related to national interests at large so that it does not become a predominant phenomenon in the economy.

SECTION THREE

**SUGGESTED FINANCING INSTRUMENTS
FOR THE PUBLIC SECTOR IN ISLAMIC ECONOMY**

In the previous section, alternative approaches to providing public goods were discussed from Islamic point of view. A few points may be derived that have bearing on the present section :

- 1- As public goods may be provided by government, voluntary sector, and/or private sector, the Islamic system encourages the provision of public goods by non-profit organizations and by the private sector. For this purpose, it offers moral enhancement as well as material incentives.
- 2- Whenever it is possible a smaller government seems to be preferred to a big government by Muslim economists.
- 3- Under all circumstances there will remain certain public goods that are to be provided by the public sector. This may be either because of the nature of these goods, *Shari'ah* requirement, or political choice of the *Ummah*.

This section, therefore, takes it for granted that an Islamic government may have a variety of needs for financing. It may need financing for the provision of public goods which may be given free or sold at a subsidized price. Even goods sold at a fair or surcharged price may require financing for certain period of time until accumulated surplus becomes sufficient to pay for capital investment of the project. Alternatively, financing may be needed for developmental projects or for current expenditures. In other words, the discussion in this section covers instruments for all kinds of financing needs of the government which may otherwise cause a budget deficit.

It may, also, be noted at the outset that the analysis in this section does not make any assumption with regard to the size of government. In other words, the instruments of financing public sector and modes of public borrowing which are discussed in this section may be applied by a government which restricts its functions to mere administration and defense. They may equally be applied by a government which believes in expanded degree of interference in the economy.

Additionally, many of the suggested instruments of financing can be used for income generating projects as well as for projects which do not generate income. This means that many of these instruments may suit meeting the deficit in current budget, i.e. they can be used to finance pure administrative expenditures as well as income generating projects and mute infrastructure.

Furthermore, no value judgement is made in this section regarding the objective of the projects for which financing may be needed. Those projects may or may not be developmental. They may be for defense, or education or they may be productive, efficient, luxurious, or otherwise, etc., as all these issues are outside the scope of this paper.

It should also be noticed that as *rabb al mal* in profit and loss sharing and output sharing agreements is not a creditor to the working partner⁽²⁷⁾ and as a lessor in *ijarah* is an owner of leased assets not a creditor to the lessee,⁽²⁸⁾ the application of these principles of financing does not create any public debt. Hence, modes of financing derived from these principles are alternatives to public debt. Government guarantee of private investors in public goods' production is also another alternative. On the other hand, sale-based financing creates debt although it is not a public borrowing in the strict meaning of the term.

27 In fact, as we have seen earlier in this paper, the return to financier in *murabah* sale is based on ownership of goods by the financier. Therefore, although the financier-cum-seller becomes creditor and the beneficiary of financing becomes debtor, financing legalities require the financier to begin the operation as an owner selling goods which he/she owns.

28 In *ijarah*, the lessee is debtor of the rent only not the value of the asset.

Consequently, instruments derived from sale-based financing are instruments of public debt.

Additionally, since *Shari'ah* does not prohibit borrowing by the public sector, instruments and modes of public borrowing which fulfil the *Shari'ah* conditions are also included in the category of public debt creating instruments suggested in this paper. Therefore, public sector financing instruments will be classified in this section under two titles, namely, non-debt financing instruments and public debt modes.

3.1 Non-debt Financing instruments

By non-debt public financing instruments I mean those certificates issued with regard to *Shari'ah* compatible forms of financing which allow the financier certain return and are at the same time negotiable, i.e., can be traded at a secondary market. On the other hand, sub-section 3.2 shall focus on modes of financing which either do not provide income to the financier or are not negotiable.

Undoubtedly, negotiability is a desired feature in any financing instrument because it offers flexibility and reconciles the desire for income with that of liquidity and precaution. From *Shari'ah* point of view a certificate must represent (i.e., be a title of ownership²⁹ physical commodities or property in order to be sold at a price other than its face (purchase) price³⁰). Consequently, from

²⁹ From *Shari'ah* point of view, in addition to avoidance of *riba* there are few injunctions which should be observed. These include that one can only sell a thing that one owns and has in physical or constructive possession. Sale of commodities or property one owns and possesses may be done at any agreeable price. Selling of a debt is usually called *hawalah* [transfer]. In *hawalah*, only the face value of the debt is payable to the transferor. A debt, whether represented by a certificate or not may be in terms of money in terms of or any other physical commodity which can be described in a standard manner to the extent that its identification becomes undisputable. Finally, since an instrument or a certificate is itself just a piece of paper, what matters in all transactions is the commodity, property and/or debt it represents.

³⁰ This is the general case. A special case is also addressed in *Shari'ah*, that is when an instrument represents a mixture of physical assets, usufruct rights, debt and cash. The OIC *Fiqh* Academy ruled that if usufruct rights and physical assets make the majority of the total value of the mixture,

the point of view of the financier, all instruments discussed in this sub-section represent real or physical properties that generate income.

3.1.1 *Ijarah* instruments

There is only one form of negotiable instruments of financing based on the sale principle: *Sarah* [leasing] instrument⁽³¹⁾. The way it works is as follows:

Certificates are issued to the public as titles of ownership of real estates, machinery and equipment, airplanes, ships, or any other long-living assets. These fixed assets are rented to the government. Certificate holders receive their share of the rent.

As owners, certificate holders bear full responsibility of what happen to their property and they are required to keep it in shape suitable for deriving its usufruct by the lessee.

Provided *Shari'ah* permits, arrangement to take charge of these responsibilities may be made by means of Islamic insurance and agency to the lessee or anybody else.

The negotiability of these instruments is unquestionable provided that the issuing body accepts, in the prospectus, that holders may sell the property without any effect on the *ijarah* relationship between lessee and lessor. Moreover, *ijarah* instruments are sold at market prices which obviously reflects the market valuation of the stream of income involved with each instrument. This stream of income includes present contractual rent, expected future rents, and the asset's value at the end of the *ijarah*. Elements such as effect of present and expected inflation on the periodical rent as well as on the value of the asset at the end of contract, choice of relevant discount rate, effect

= the instrument may be sold at a market price. (OIC Fiqh Academy No. 5, of the Fourth Plenary Session, Jeddah, 1408H).

³¹ It will be shown later in sub-section 3.2 that all other sale-based certificates represent debts and are therefore not negotiable.

of technology, alternative opportunities, etc., are all taken in consideration in the market evaluation.

A spectrum of variety of *ijarah* certificates may be suggested subject to *Shari'ah* compatibility. These may include the following :

1. perpetual or renewable *ijarah* instruments, where capital consumption (amortization) or replacement allowance is introduced to preserve the value of the asset and replace it when needed;
2. temporary *ijarah* instruments in which no amortization allowance is made and the instrument gradually loses its value at regular intervals. This kind of instruments is suitable for investments where fast changes in technology are expected such as computer equipment, etc.;
3. declining *ijarah* instruments, where the lessee desires to own the property after a period of time and assigns installments of the value of the property to be paid to the lessor along with the periodical payment of rent.

Additionally, *ijarah* instruments may be used to finance income producing projects such as an electricity plant as well as for projects which do not produce income such as mute infrastructure. For instance, fixed assets and installation of either a commercial or military airport may be financed by *ijarah* certificates.

Ijarah certificates may also be used to bridge the gap in current budget such as renting office furniture instead of buying it. Obviously, there ought to exist some need for fixed assets purchases which may be identified in the budget and substituted by *ijarah*. They can also be used in developmental budgets such as building schools and obtaining machinery and equipment for a university laboratory or a government economic enterprise.

They can be used for construction of infrastructure, productive equipment or even for weaponry (except consumable ammunition), as long as the asset involved has a long life and can be identified for a rental relationship.

They can represent one long living asset or a group of assets put together in one project or in several projects as long as they are covered by one *ijarah* contract. Subject to *Shariah* permissibility, even assets of different life spans may be combined together as long as the certificates are issued against physically existing assets, thus providing this instrument with the ability of having fixed or declining return.

Moreover, *ijarah* certificates may be issued against fixed assets rented by the government itself or any other governmental body with autonomous budget and identity such as local governments, municipalities, government owned economic enterprises, government supervised *awqaf* organizations, etc. They can be issued for assets that have a relatively short, medium or long use life span as long as they are not themselves consumable.

It is important, however, to notice that *ijarah* certificates must always represent well defined physical assets, (and whenever there are different portfolios, corresponding different certificates should be issued.

It should also be noted that *ijarah* certificates financing does not change the provider of public goods. This means that, when we resort to this form of financing, the government keeps the decision making on the provision of goods it supplies in its hand. Therefore, *ijarah* financing can be applied irrespective of the public choice regarding who provides public goods, the issue of privatization, or the size of government, etc.

Finally, because of their above mentioned properties, *ijarah* and *ijarah* certificates may be very convenient for external resource mobilization in addition to their internal fund raising potentials. Take for instance the temporary *ijarah*; it suits external resource mobilization in areas of rapid technological change. By the same token, declining *ijarah* is convenient in cases of long-living assets that the government likes to own in the future. Moreover, permanent, temporary and declining *ijarah* certificates offer international financiers desired degree of liquidity if an international market

Of *ijarah* certificates can be organized, while they preserve the independence of the host country in all relevant decision making . These advantages make *ijarah* certificates a good candidate for debt equity swap especially that it is up to the debtor country to identify physical assets that will be sold to creditors and leased back.

3.1.2 Profit and Loss sharing instruments

As we have seen in section one, this principle of financing covers *sharikah* and *mudharabah* where losses are distributed in accordance with the shares of capital while profits are distributed as per agreement which may differ from the shares in capital. Noticeably, these two modes of financing are fit for profit making projects only. Therefore, unless combined with some other arrangement as will be shown later, they do not suit financing current expenditures deficit.

Financing instruments derived from profit and loss sharing principle may take either *sharikah* or *mudharabah* forms.

Sharikah-based instruments

These instruments are similar to common stocks in almost all aspects provided they do not have any prohibited conditions. For instance, preferred stocks that guarantee a minimum return or less capital risk are prohibited⁽³²⁾.

It should be noticed that *sharikah* mode of financing does not offer much of freedom for the public sector as it gives shareholders corresponding shares of management right. This implies that by selecting *sharikah* instruments as a means of project financing, the government surrenders management rights to shareholders. In this respect, *sharikah* financing is in fact a form of partial privatization of public projects which may be applied to new projects as well as to existing projects.

³² See the Resolutions of the 7th annual meeting of the OIC Islamic *Fiqh* Academy, Jeddah, S h a w l 1412H.

Hence, *sharikah* may suit mixed corporations in which the public sector desires to benefit from the skills of private businessmen in decision making. In such a case private shareholders will provide both finance and management together. The benefit to the government is that it gets its project established and entrusted to skillful management while keeping certain control over it.

Sharikah instruments would be negotiable and the government may increase (decrease) its stake in the corporation through the secondary market, e.g., open market operations. The government may preserve a majority right by holding a large chunk of the stocks.

On the other hand, *mudarabah* makes a very good mode of finance for income earning public-sector projects as it limits the role of the financier to providing money and receiving (+ or -) return, while the management of the project is retained in the hands of the government.

Empirical experience of Islamic banks in the last fifteen years shows that the success of *mudarabah* in mobilizing deposits has been very satisfactory. This success, along with the limited ability of most Islamic banks to exercise this mode of financing on their assets side, may at least partially be attributed to the corporate form of the *mudariib* (Islamic bank) which reduces the moral hazards in addition to other factors related to trust in management, religious zeal which may be higher among Islamic banks' depositors than

businessmen who are usually more pragmatic, etc.⁽³³⁾

Consequently, *mudarabah* has a good chance to succeed in mobilizing resources for public sector income earning projects provided the government takes practical steps to offer managerial skills which nourish confidence among prospective financiers.

³³ See references about studies of these factors in Saudi business and in Pakistan business cited in M. Fahim Khan, "PLS, Finn Behavior and Taxation", IRTI, unpublished, 1412H.

***Mudarabah* instruments**

Mudarabah instruments are shares of ownership in *mudarabah*. They entitle shareholders, who are exposed to losses not to exceed the entire value of their shares, to receive shares of profit as stipulated in the prospectus. They may be offered for a specific investment or project or a group of projects under the management of one *mudarib* provided that this project or projects may be identified accounting-wise in such a way that a profit and loss account may be made for it (them) alone, distinct from other projects the *mudarib* might be running.

Mudarabah instruments may be issued for short, medium or long term investments. They may be issued by the government itself, local executive branches, municipalities, government economic enterprises, etc. They can be sold at market prices because they are fully negotiable.

Additionally, *mudarabah* instruments may be issued by the users of funds themselves so you have *mudarabah* instruments of railway, airlines or

communication companies.⁽³⁴⁾ They may be issued by an intermediary *mudarib* who supplies funds to other users on the basis of *mudarabah* or other modes of financing. This characteristic confers high degree of flexibility on this kind of instruments making it possible to establish private or government institutions

³⁴ According to majority of *fuqaha'*, *mudarabah* can only be used in trade because *mudarabah* implies disposition of the principal itself in buying and selling (al Sharh of Kabir with al Mughni, V 5, P192 and Monzer Kahf. Mufhum al Tamwil, P24). However, some *fuqaha'* approve the inclusion of certain services on the part of the *mudarib* such as sewing the cloth into dresses and weaving the threads into cloth (al Mughni, V 5, P118). Moreover, al Sarakhsi (al Mabsut, V 22, PP 72-73) argues that farming is permissible in *mudarabah*. fanning includes renting land, cultivating it, and buying grain for seeds because "farming work is something merchants do for the purpose of getting a return". Also renting ships, animals, land, and other means of transportation, storage and cultivation is permissible (al Kasani, V 6, P 88). Al Kasani (V 6, PP 91-92) also permits providing the service of tinting by *al Mudarib*. All these, in addition to the fact that there is no text in Sunnah that prevents using *mudarabah* in industry, agriculture and services, have lead several contemporary scholars to argue that in today's world, *mudarabah* may be used in the provision of services such as communication and transportation as well as in other industries.

specialized in issuing *mudarabah* instruments to financiers and allocating mobilized funds to government income generating bodies.

Moreover, specialized institutions may be established to raise funds on *mudarabah* basis and use them to supply goods for deferred payment to the government on *murabahah* basis,(to provide capital goods on *ijarah* basis, or to combine goods and services together and provide financing to the government on the basis of *istisna*.⁽³⁵⁾

These kinds of specialized institutions may work on the basis of *wakalah* [agency] with or without compensation for their services, or they may themselves be profit making similar to Islamic banks. But it should be noticed that there may be certain limitation on negotiability of *mudarabah* instruments which are exclusively used to finance *murabahah* transactions on the ground that these instruments may represent assets consisting mostly of debts and cash since according to rules of *Shari'ah* debts may only be transferred at their face value.⁽³⁶⁾

Furthermore, subject to *Shari'ah* permissibility, *mudarabah* instruments may be perpetual, i.e. issued for an indefinite period of time. They may be timed, i.e., issued for a given period only with or without assets left over for liquidation at the end of the period. They may also be decreasing if the prospectus allocates certain proportion of the *mudarib's* share of profit to buy up the shares of *rabb al mal*. *Mudarabah* instruments may also have decreasing value if assets exploited have no end-of-productive-life value such as an oil well or a fixed term franchise.

Besides, the pool of funds raised through *mudarabah* instruments may make a closed pool as in common stock companies with fixed principal, or

35 *Istisna* contract is similar to manufacturing or construction on order, in which the supplier of manufactured or constructed goods may also provide financing, i.e., payment will be made at, or after, delivery. The nature of the contract, however, gives room for financing to be given by the orderer to the producer, i.e., in the opposite direction, too.

36 *Fiqh* Academy resolution No.5 in the Fourth Annual Meeting, Jeddah 140811.

they may make an open pool similar to that of open capital companies and to the pools of investment deposits in Islamic banks.⁽³⁷⁾

Transfer of ownership of these instruments may be made easy by records in the issuing institutions, endorsement on the certificates, or even by hand over of certificates if they were to bearers.⁽³⁸⁾

Lastly, *mudarabah* instruments may be backed by a guarantee from the government if they are issued by corporations and/or institutions that have legal and financial independence from the government and the government does not own any share in them. Such a guarantee may cover certain kinds of risks especially non-commercial risks but it may also cover commercial risks with regard to capital alone as we have seen in section two above.

Accordingly, a very large variety of *mudarabah* instruments may be issued by government, its branches and/or public or private corporations specialized in financing government projects. These instruments are negotiable and can be circulated in an Islamic financial market. They may have specific or general aims and they may take many name as mentioned in section one of this paper. These instruments offer modes of fund raising which serve income generating government projects and through the introduction of intermediary private or public financing corporations, they can also serve non income generating headings of public expenditures.

Mudarabah instruments provide a viable alternative to public debt for internal as well as external resource mobilization. The experience of Islamic banks indicates that savers in the Muslim countries are willing to take the risk

37 Bahrain introduced an act permitting the establishment of open-end-capital companies in which part of the capital may take the form of non-voting shares based on *mudarabah* principle. See Sami Hamud, "*al Adawat al Maliyyah al Islamiyyah*" [Islamic financial instruments], paper presented at the seminar on the financial markets from Islamic point of view organized jointly by the OIC *Fiqh* Academy and IRTI, Rabat Nov. 1989.

38 A workshop organized in Bahrain, Nov. 25-28,1991, by The OIC Islamic *Fiqh* Academy, IRTI and Islamic Bank of Bahrain recommended that it is permissible in *Shari'ah* to issue bearer shares. This was endorsed by the plenary 7th annual meeting of IFA, Jeddah, 1412.

mudarabah exposes them to if their funds are entrusted to qualified institutional intermediaries. It seems that there is no reason why profitable government enterprises do not enjoy the same advantage. By the same token if *mudarabah* deposits are used by intermediaries to finance government on the basis of *murabahah*, *ijarah* or *istisna'*, they also should have similar appeal to individual savers.

With regard to external resource mobilization, *mudarabah* instruments offer a combination of return and liquidity, which allow them to be a viable alternative to external borrowing especially from international capital markets. Noticeably, the host country keeps the management in its hands. Thus *mudarabah* instruments offer a tool that is worth considering in the debt/equity swap especially if a third party principal guarantee can be arranged at least for a transitory period in order to minimize the risk involved. This may allow *mudarabah* instruments to seriously compete with debt rescheduling.

It should also be noted that *musharakah* instruments share all the characteristics and potentialities of *mudarabah* instruments with the sole difference of participation in management.

3.1.3 Output sharing instruments

This principle permits sharing the output provided no valuation of capital is needed, in similarity with the *muzara'ah* relationship which does not require evaluation of the land. Hence, this principle requires that income generating property be handed over to a manager on the basis of sharing the output.

Forms of output sharing certificates may be suggested as follows:

The government sells an existing income earning fixed asset such as a toll bridge or highway to certificate holders. The proceeds of sale are needed for another governmental project whatever it may be and the purchasers have nothing to do with this matter. Certificate holders may assign an agent or a managing partner, that may be a governmental bridge authority, to run the property on the basis of output sharing while all running expenses are born by the managing

partner. Hence gross toll revenues of the bridge will be divided between the manager and share holders according to the agreed upon percentage of output sharing. Of course, expenses are taken into consideration in determining this percentage.

Alternatively, a private contractor may issue shares and invite investors to construct a toll bridge which will be managed by the governmental bridge authority on the basis of output sharing. The bridge authority may also play the role of the private contractor as deputed by shareholders.

This means that certificates may be offered for an existing or a new project, with or without a gestation period. But in new projects, there will be two forms of relationships, at two consecutive stages, between the bridge authority and certificate holders. In stage one, the authority shall be an agent of certificate holders in constructing the bridge. It may be paid certain fees for services provided, or it may act voluntarily until the construction is complete. In stage two, i.e., once the property is ready for income generation, the authority becomes a managing-cum-working partner as in *muzara'ah*. The risk born by the certificate holders is considerably higher in new projects than in existing projects.

With regard to negotiability, it should be noted that output sharing certificates represent property actually owned and legally possessed. Therefore, they can be sold at market prices. For new projects, there may be certain waiting period until cash funds are exchanged for physical property and/or construction material since the *Fiqh* Academy of the OIC ruled that sale of such instruments at a price other than the purchase price is only permissible after at least majority of property becomes physical commodities and assets.⁽³⁹⁾

It must be noted that output sharing certificates, like common stocks, do not necessarily have any embodied process of redemption or amortization

³⁹ *OIC Islamic Fiqh Academy, Rulings and Recommendations*, Ruling No. 5 of annual meeting No. 4, Jeddah 1408, pp. 66-67.

as they represent fully owned fixed assets. Moreover, like *Sarah* instruments they expose holders to risks resulting from natural calamities as well as commercial risk such as diversion of traffic away from the bridge.

A vast variety of output sharing certificates may be issued to accommodate a multiplicity of output yielding public projects which need financing especially in infrastructure and transportation sectors.

Like *mudarabah* instruments, output sharing certificates may represent projects in which allowance for amortization of capital may or may not be made. In the latter case, periodically distributed share of output represents both the principal and the return and the output sharing instruments would be declining. This approach may be suitable for projects based on exploiting a franchise or when there is a condition of transfer of ownership of the project or its assets to the public sector after certain period.

Lastly, output sharing instruments are also convenient for external resource mobilization especially that they have lesser moral hazards risks than *mudarabah* instruments because the reporting required in output sharing is only about gross rather than net revenue. Therefore, output-sharing instruments are more amenable to external debt swap than *mudarabah* and *sharikhah* instruments.

3.1.4 General remarks on public projects financing instruments

Before concluding this sub-section it may be worthwhile to mention the following few remarks:

1. While *sharikhah*, *mudarabah* and output sharing instruments apply to income generating projects, *ijarah* may be utilized for any kind of public projects regardless of being mute or income generating. Therefore, from the point of view of usage, *arah* certificates may prove to be the most flexible tool of resource mobilization among all the ownership-based instruments.

2. All these instruments are based on holders' ownership of all or a fraction of financed projects, i.e. no public debt is created. This ownership has several implications the most important of which are the following:

- a) These instruments are fully negotiable at market prices because their sale means the sale of the property they represent. Moreover, they can be issued to a specific name or to holder.
- b) In principle, there is no need for repayment (by government) of the principal of these instruments, unless this is so specified in the conditions of financing agreement (as diminishing *ijarah*, *sharakah* or *mudarabah*). Therefore, the issue of inter-generational equity does not seriously arise. Of course, it is not completely ruled out. It can be argued, however, from the point of view of the generation that pays for the property, that unlike public-debt holders, owners are getting a fair return on their investment, of publicly-used property especially that the property pricing is subject to market conditions. Moreover, effect of technological change will also be reflected in the market prices, while it does not *affect* debt holders. On the other hand, each generation that uses the property pays the price of the services it is getting.

After all, the Islamic inheritance system diffuses property ownership throughout the whole society.

- c) Ownership by the public of government projects is in a way a form of privatization. But we noticed that except in *sharakah*, the government can retain the management of projects financed by these instruments if it is desired. This means that the provision of goods produced by these projects is kept public, not private. Therefore, this is only a special form of privatization, not similar to what is usually meant by the term.

In a different paper,⁽⁴⁰⁾ I called this form a "democratization" of public projects. This democratization is strengthened by the strict *Shari'ah* conditions of public borrowing discussed later in this section.

- d) Except in diminishing *ijarah*, the government has to pay the market price if it wants to regain ownership of projects financed by these instruments. In diminishing *ijarah* the paid price may be contractually determined, keeping in mind that although diminishing *ijarah* is practiced by several Islamic banks, the controversy about its *Shari'ah* compatibility is not over yet.
3. The issue of who provides what in public goods is irrelevant to the forms of *financing* discussed above. This implies that these financing instruments are neutral as far as the size of government is concerned. In other words, these instruments can be used by a government which opts to provide larger variety of goods on a public basis, in as much as they can be used by a government which chooses to contain its role to the provision of goods on which the principle of exclusiveness does not operate through the play of market forces.
4. Whether taxes and/or borrowing become inevitable to pay for public financing through these instruments depends on two things: first, whether a financed project produces a surplus sufficient to pay for the financing services (principal plus return). Efficient income generating projects may be able to pay for these services. Therefore, in this case, future taxes may not be inevitable. On the other hand, projects that do not produce income may call for future taxation to pay for their financing services. Second, what forms of financing is applied for the project. In interest based public debt, future taxation is required to pay for the debt services.⁽⁴¹⁾ In all financing instruments discussed in this sub-section, the financing

⁴⁰ Monzer Kahf, "Financial Revenues of the Early Islamic State", IRTI, 1992.

⁴¹ Alternatively rescheduling and fresh public borrowing are the other possibility.

agreement may be formulated in a way that does not require future taxation because there would be no need to pay back the principal financed. In other words, even if *ijarah* instruments are used to finance non-income generating assets, the government is not necessarily required to pay back the principal since it may keep renting them for ever or return them to certificate holders.

As for the financiers, they can always sell their certificates in a secondary market if they need liquidity.

5. These instruments of public financing are related to specific projects and usages. In case of *ijarah*, this implies that the government can only use the fixed assets acquired through lease contracts and in the case of other instruments the government is bound to undertake specified revenue-generating projects. This, is in contrast with interest-based public borrowing which does not necessarily involve such one to one correspondence with acquisition of physical assets or construction of income producing projects. On the one hand, this linkage with physical assets and the profit incentive in such projects reduce the moral hazards on the part of public officers because of the added element of private control. Additionally, the above-mentioned ownership-based public financing instruments enhance efficiency because public projects would have to compete with private sector's projects for financing.
6. Finally, the nature of these instruments allows their use for external and internal resource mobilization. In other words, these instruments are fit for external financial resource mobilization from individuals, international institutions, and foreign governments provided a suitable secondary market is created for them.

3.2 Public debt modes and certificates

All instruments mentioned in sub-section 3.1 are based on ownership. This makes their exchange at market prices permissible because this is one of the implications of the right of ownership. Although, these instruments are essentially structured for long-term financing, some of them, especially *mudarabah* instruments, may also serve short-term public financing.

On the other hand, ownership-based instruments may not fulfill all financing needs of the public sector and governments may prefer resorting to public borrowing under certain circumstances. For instance, seasonal needs to bridge the time gap between revenue collection and expenditure disbursement, (inability to formulate certain financing needs under any of the ownership instruments because of certain legalities, (or failure of these instruments to attract investors. These and similar conditions make debt-based financing an alternative and a supplement to ownership-based financing especially that debt-based modes are more tuned to serve short term needs than long term financing.

However, It must be noted that whenever one moves from the idea of property ownership to the idea of debt, a severe blow to the liquidity of the instruments takes place because of two *Shari'ah* rules: (1) debts may only be exchanged at face value regardless of date of maturity, and (2) debts may not be exchanged for debts, i. e., in a permissible or lawful exchange at least either payment of price or delivery of sale's object must be done at the time of contract.

Consequently, all debt-based instruments of financing that public sector may issue cannot be negotiable. This eliminates the possibility of a secondary market with all its feedback effects on the first market itself. It will make it necessary that an alternative approach for liquidity must be sought. This alternative is redemption.

Redemption, in this context, means buying back the debt before its maturity by the debtor. It is done either at the debt's face value or at a discount. discount in debt redemption is called *wadi'ah*,⁽⁴²⁾ and there are certain

⁴² *Wadi'ah* is a reduction in the amount of the debt given up by the creditor in exchange of early payment. The permissibility of it is based on the Saying of the Prophet (pbuh) which means "reduce the amount of debt and get it before maturity" which he said addressing some jews when they were leaving the country and they wanted to cash their debts before due dates. The fact is that if mark up is acceptable because of delay in payment also a reduction may be acceptable if a payment is done before it is due. Both mark up in sale with deferred payment and discount at redemption before maturity reinforce the argument that time is important with regard to exchange but it must not be separated from real business exchanges to become a pure monetary phenomenon.

Shari'ah conditions for its applications such as it should not be an explicit part of original contract which initiates the debt, nor an implicit condition well established as a regular custom by previous government practices.⁽⁴³⁾

Debt may be acquired from the public voluntarily or by use of legal authority of the government. With regard to sources of the loans, they may be internal or external.

3.2.1. Voluntary public debts ⁽⁴⁴⁾

While forced borrowing is obtained by coercion, voluntary public debts must have certain built-in attractions in order to appeal for the self interest drive of individuals. It must be noticed, however, that *Shari'ah* prohibits attaching any fringe benefits to a loan and considers any such benefits a form of *riba* whether they are called *riba* or not. This is on the basis of the famous *fiqhi* rule that a loan which may bring any benefit is a *riba* tinted loan. *Riba-based* fringe benefits are material benefits which may or may not be calculated at the time of lending. For instance, with regard to government borrowing, some may argue that such prohibited fringe benefits may include a tax reduction, relaxation of deadline condition of tax payment, providing facilities or concessions with regard to sale of debt-holder's products, etc.⁽⁴⁵⁾

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- ⁴³ It must be noted that *wadi'ah* is approved by some *Shari'ah* scholars while others oppose it on the ground that it is a form of *riba*. For a discussion on the issue refer to Rafiq al Misri, *Al Hasn al Zamani* [time discount], Center for Research in Islamic economics, Jeddah. However, the OIC Islamic *Fiqh* Academy considers *wadi'ah* permissible provided it is not made a condition in the contract, and it is done as an arrangement between the debtor and creditor without the interference of a third party. See Resolutions of 7th Annual Meeting, Jeddah, Shawwal 1412. One may add that *wadi'ah* arrangement should not become prevalent to the extent that it becomes a regular custom adopted by the government because this makes it similar to being pre-contracted.
- ⁴⁴ Some ideas of this sub-section derive from M. Fahim Khan and Monzer Kahf, "Financing government deficit through borrowing from the private sector," presented at the sixth annual meeting of experts of Islamic banks held in Bahrain, May 1990.
- ⁴⁵ It may be noted that some scholars believe that a tax rebate or privilege to a public-debt holder may be permissible on the ground that this is not a fringe benefit to a loan but part of tax arrangements similar to variations in rates and taxability on the basis of different conditions of tax payers; especially that a tax is not obligatory from its origin.

Consequently, incentives for public debt must be carefully designed in order to be tailored within the limits of *Shari'ah*. Hence, in this sub-section, I will only discuss such modes of public borrowing in which the appeal to debt holders does not pose any problem from *Shari'ah* point of view. The attractive features may take the form of appealing to the sense of patriotism and religious piety. Alternatively they may take the form of material incentives incorporated on the basis of sale relationships. This may be on the basis of mark up on goods sold to the government for deferred payment, or mark down on future goods and services sold by the government for immediate payment. It may also be at present prices as a protection against expected future inflation.

A) SALE-BASED PUBLIC DEBT

The mark-up and mark-down approaches are based on the sale principle of financing. Protection against inflation may take the form of sale of goods with tomorrow's delivery at today's prices. Mark up may be applied through *murabahah* or *istisna*. Mark down may be applied by means of *salam*, *'istisna'* or *arah*. Hence, we have four kinds of sale-based financing modes which can be used by the public sector: *murabahah*, *'istisna'*, *salam* and *ijarah*. The following few paragraphs will briefly describe these four modes.

Mark-up-based public debt : *murabahah* and *'istisna'*

The concept of mark up comes from raising the price of goods if payment is made at a subsequent date in recognition of a financing compensation.

Public-debt creation may take the form of simple deferred payment sale in which the government gives IOU's for future payment to suppliers of goods. By the same token, *'istisna'* form of sale may be used for construction with payment taking the form of IOU's due at a point of time subsequent to the date of delivery of completed construction. Since these IOU's are transferable at the face price, they do not attract secondary market transactions. A provision may be made that they can be used for tax payment, etc. IOU's, which may be of different denominations and maturities, may be redeemed by the government before their due date. At the time of redemption,

the government may seek a discount (*wadi'ah*) for early payment. *Murabahah* is a version of deferred payment sale in which the seller declares his/her cost and profit or added mark up.

Another form of *murabahah-based* public debt may copy the *murabahah* for the purchase orderer. It works as follows:

The government assign one of its bodies to work as an agent of the public in acquiring goods on order for the government. This government body may work on a voluntary basis if the government provides all its administrative expenses,(or it may work against a given fee collected from *murabahah* bonds' holders.⁽⁴⁶⁾

These goods shall be paid for in cash from funds obtained from the public to finance the operation. Upon completion of sale of goods purchased on order and receipt of small denomination *mudarabah* bonds from the government for the amount of the contract, the agent will distribute these bonds to contributors of funds in proportion of their respective principals.

Murabahah bonds are not transferable to other owners except at face value. They can be redeemed by the government before maturity. A series of *murabahah* bonds may so be issued at different denominations and maturities to suit the financing needs of a stream of supply of goods to government.

Lastly, *murabahah* for the purchase orderer may also be applied through private sector's financial intermediaries as it is practiced by Islamic banks.

⁴⁶ Alternatively, if the agent works as a *mudarib* for the public, funds would then be obtained on *mudarabah* basis as mentioned in Sub-Section 3.1.2 of this paper.

Mark down and fixed in-kind public debt : *salam*, '*istisna*' and *ijarah Salam* certificates and '*istisna*' coupons

Indebtedness in *Salam* is in terms of physical goods rather than money. *Salam* offers a mode of financing public sector if the government is able to provide goods in the future for which it gets immediate payments. For example, government-owned enterprises or farms, which produce consumer

goods, may sell part or all of their output on *salam* basis.⁽⁴⁷⁾

Salam certificates of indebtedness of small denominations of quantities of goods may thus be issued to purchasers. These certificates are not negotiable because according to *Shari'ah* one may not sell purchased goods before physical delivery. But they can be redeemed before maturity by canceling the contract if the parties agree. In this case, the purchaser gets his/her money back without any increment or reduction.

Istisna-based public debt is similar to *salam* with one important difference that relates to the nature of goods. In *istisna*, the object of sale is not necessarily identical or standardized commodities. Rather, it may include construction or manufacturing works of individualized specifications. *Istisna*' may cover both material and labor such as houses, cars, etc.

In *istisna*'-based financing of the public sector, the government sells future housing units with specifications and delivery date, put clearly forward in the prospectus at the price of say 100 *dinar* for each one thousandth of a unit. Whoever accumulates one thousand coupons will get a house. These *istisna*' coupons are also not negotiable, but they can be redeemed before maturity by canceling the *istisna*' contract. In this case, coupon holders get only the amount paid for it to the government at the time of the contract.

⁴⁷ It is to be noted that in addition to normal conditions of a *bay'* contract, there are seven conditions in *salam*: 1) immediate payment of price; 2) postponement of delivery, 3) the commodity sold should be describable in absentia and it becomes a debt on the seller, 4) detailed specification of commodity; 5) determination of quantity, 6) ability of delivery; and 7) exchange of price and commodity should be = permissible from the point of view of prohibition of *riba*. See for instance Abd al Halim Muhammad Umar, *Al Star al Shari wag al Muhasabi li Bay' al Salam*, IRTI, 1992, and other *fiqh* books for details of these conditions.

It should be remembered that in both *Salam* certificates and *istisna* coupons, government acquires funds at present and bears indebtedness in terms of real goods. On the other hand, unlike ownership-based financing, the use of proceeds of these forms of financing is not tied or restricted to specific goods or projects. Consequently, proceeds of *salam* and '*istisna*' may be used to finance another project unrelated to the production of sold goods, current budget deficit, balance of payment deficit and what not.

Moreover, *salam* certificates and *istisna*' coupons may be issued by federal, regional or local branches of government as long as the delivery of object (contracted goods or construction) is feasible for the issuing body.

The incentive in these certificates may be a mark down on current prices or alternatively, if prices are expected to increase because of expected or persistent inflation, pricing at the present level may provide an incentive in the form of protection against inflation.

Public utility warrants

Finally, a special kind of debt-based financing arrangement may be suggested to finance public sector utilities. This arrangement is a combination of a recurrent supply agreement [*istijrar*] combined with some of the features of *salam*. Provided *Shari'ah* permits a utility public-sector corporation may contract its consumers to sell certain quantity of say electricity they draw in the future at a price marked down from current price (it may also be fixed, i.e., protected against inflation) against advance payment for the whole contracted quantity. Obviously, the nature of this commodity is that delivery is combined with consumption, so the consumer is the party who determines the quantity delivered at each period of time.

Like *salam* and *istisna* financing, this financing arrangement creates indebtedness in kind on the part of the public sector corporation that provides the concerned utility for which electricity, water, or telephone warrants may be issued and used for payment of these utilities at locations determined by

warrant holders.⁴⁸ Warrants are not negotiable and their proceeds may be used at the debtor's own discretion. They may be redeemed before receiving the services at face value by mutual agreement, and at partial face value in proportion to the residual of the service unreceived.

Ijarah bonds

Ijarah debt may take the form of bonds which represent a commitment by the government to provide certain service to the bond holder or his family at a future date. It is a contract to sell a future service for advanced payment. Services, that can be an object of this contract, may be provided after a number of years such as university education for children or housing usufruct; they may be provided only after a short span of time such as garbage collection during 4th month of the current year.

Like *salam* and *istisna'* public debt, *ijarah* bonds are not negotiable. They may be priced at a mark down or at present prices as a protection against inflation. They can be issued by central government, a university or a local branch of government as long as the issuing agency can provide the contracted service in the future. Bonds may be redeemed before maturity for their paid price. The proceeds of sale of bonds need not be tied to any specific use, i.e., seller of services may use proceeds at own wish and discretion, e.g., to finance current budget deficit.

B) LOAN BASED FINANCING

Two kinds of public loan bonds may be mentioned:

- 1) foreign currency bonds which invoke the incentive of protection of one's wealth against devaluation and, to a certain extent, inflation (at least in many developing countries where domestic rate of inflation is higher than inflation abroad),(and

⁴⁸ It is worth mentioning that these utility warrants represent a financing arrangement between the producer and the consumer of utilities and can be used by public sector providers of utilities as well as private sector as long as the relationship is between the producer/seller and the consumer. But if the relation is made three way in which the provider/seller is different from the user of finance, it becomes similar to *bay'al inah* which is prohibited by the majority of *fuqaha*

2) bonds issued on the basis of appealing to patriotic and religious sentiments of private citizens.

Foreign currency bonds

These bonds are issued against foreign currency loans to the government. They may be used when local currency is expected to lose value in terms of foreign exchange. The incentive they provide is the guarantee of payment in the foreign currency in which bonds are issued, as it is presumed that this foreign currency is more stable than domestic currency. Thus, foreign-currency bonds give protection against devaluation of domestic currency and against inflation.

In accordance with known rules of *Shari'ah*, foreign-currency bonds can be issued against foreign money received rather than its value in local currency, (they must not yield any return since they are based on the principle of loan which prohibits any return or attached benefit. Moreover, they are not transferable except at face price. Therefore, there is no incentive for their negotiability. They may be demanded by individuals who have no investment opportunities of the foreign currency they hold. This situation arises especially when there are restrictions on holding foreign currencies. They do, however, provide protection against domestic inflation.

Benevolent bonds

It may be possible sometimes to find a reasonable response to the appeal for lending the government by invoking the sentiments of loving one's country and protecting and promoting the religious values and principles it stands for. After all, the Islamic system has a strong built-in mechanism to promote voluntary contributions by tying them to good deed and to appealing to God and saving for one's hereafter. If the Qur'an calls on people to sacrifice their lives and wealth for helping the *ummah*, then giving loans for public cause represents a lesser sacrifice which is implicitly covered by this Qur'anic call.

3.2.2. Involuntary public borrowing

Involuntary loans are acquired by the government on the basis of its authority and responsibility. They are a version of taxation but with a pledge to refund. Forced loans may be sorted according to sources of funds as: loans from individuals and non banking corporations, loans from commercial banks and loans from the central bank. *Shari'ah* permissibility of payment of certain return on public loans has been raised in some quarters⁽⁴⁹⁾ and a debate was carried over about the return of treasury

bonds and other government saving schemes⁽⁵⁰⁾

In this debate both the prohibition of *riba* and its applicability to government transactions were not disputed. The argument for permitting state loans to offer a return to lenders is centered on a few points which apply - in fact - to all transactions, private and public. These points may be summarized as follows:

- 1) Government should be allowed to give (take) *riba* to (from) its subjects in analogy to permissibility of *riba* giving (taking) between a father and his son or between a slave and his master.
- 2) Governments need to raise funds for development, emergencies or to meet budget deficit and interest must be paid to attract such funds.
- 3) It must be fair to compensate savers for the loss they incur because of inflation.
- 4) Interest payment by government to holders of treasury bonds and other governmental loan certificates should be treated like government grants which are permissible.

To answer these points it should be noticed that *riba* is a matter of inter-personal transactions, i.e., whenever there are no transactions between different entities the prohibition of *riba* does not apply. Thus if giving or taking (principal and any increment) is merely an internal arrangement within

⁴⁹ See for example the questions raised by the government of Pakistan in 1984 which caused the International Institute of Islamic Economics to hold a workshop on 15-17 Oct. 1984.

⁵⁰ Like the debate raised in Cairo in 1989/1990 on investment certificates which contravened the publication of many newspapers' articles and several books.

the same financial entity, the question of *riba* does not arise. Hence, the issue that there is no *riba* between a slave and his master falls in its right place because the master owns the slave's wealth.⁽⁵¹⁾

In the same context, some argue that a father has a free hand on the wealth of his son and therefore *riba* prohibition does not apply between them. *riba* does not apply between a father and his son since the father can take (give) any thing from (to) the wealth of his children.⁽⁵²⁾ Here again, the argument is based on the assumption that a father has a free hand on his son's wealth ⁽⁵³⁾, not on the relaxation of the *riba* prohibition.

Consequently, since individuals are legally and financially independent of the government, the prohibition of *riba* arises with regard to transactions between the government and its citizens. Moreover if a government-owned corporation or bank is considered an independent legal entity from *Shari'ah* point of view, *riba* prohibition must also apply between this entity and other governmental entities, but if the government and all corporations it owns represent one single legal entity, the use of any fixed rate in calculation, evaluation, or allocation of funds within the finance of this single entity is not *riba*.⁽⁵⁴⁾

⁵¹ Since the master owns his/her slave along with any property the slave might own.

⁵² See for example, the article of Abd al Mun'im al Nimr, on this issue in al Akhbar, Newspaper, Cairo, 21/10/1989.

⁵³ This argument is based on a saying that "You and your wealth belong to your father", [reported by Ibn Majah].

⁵⁴ Sami Homoud, in Tatwir al A'mal al Masrafyyah, pp 200-205, emphasized the separation of legal entity (*al thimmah al malyyah*) in the prohibition of *riba* between a master and his/her slave, especially that according to Ibn Hasm such separation is what justifies the conclusion of contracts between these parties; otherwise contracts become redundant.

However, it may also be argued that what matter is ownership only, so that as long as the owner of different corporation is one, *riba* prohibition does not apply.

With regard to the second argument, the issue of necessity is discussed at length by jurists. In brief to relax a prohibition, necessity should unequivocally be proven. This is very difficult in the case of public borrowing as Islamic modes of financing provide adequate alternatives to *riba* for mobilization of resources for public use.

The question of compensating savers for losses they incur because of erosion by inflation seem to be reasonable. However, if we accept that inflation is caused by government mishandling of monetary and fiscal policies to the extent that makes it financially responsible for the effects of its action on individuals, compensation must be paid to all those persons who are hurt by government action in terms of erosion of their income or wealth, not only to lenders to the government alone! Singling out lenders to government alone for compensation is not fair and it indicates hidden reasons other than inflation for the compensations.

Additionally, such compensation should be sufficient to redress wealth and income to their levels before inflation or should at least be distributed among those affected in accordance with the inflicted damage. Obviously, this is not the case in interest-based public debt. Consequently, inflation can't be used as a pretext for violating the rule of *riba* prohibition. The OIC Islamic Fiqh Academy issued an opinion on this subject stating that charging the debtor to compensate for inflation-caused damage to creditor is not compatible with *Shari'ah*.⁽⁵⁵⁾

Lastly, government grants are regulated in *Shari'ah* in accordance with the principle of justice and observance of the public interest and Islamic process of public decision making. These principles do not allow using government grants as an alternative to interest.

3.2.3. General remarks on public debt instruments

1. All modes discussed in sub-section 3.2 create public debt. However, while mark-up instruments and voluntary and

⁵⁵ Decision No. 4 of Session No. 5 of the Islamic Fiqh Academy.

involuntary public borrowing create indebtedness in money terms, mark-down instruments create in-kind indebtedness.

2. Both mark-up and mark-down instruments of public indebtedness are tightly related to goods and services exchanged and/or produced on the basis of one to one correspondence -between financing facilities and real transactions.

However, in mark-up modes, (*murabahah* and *'istisna*) public indebtedness occurs only in order to supply the government with goods and services it wants to use for its current and/or developmental activities, regardless of whether financed projects generate income or not.

On the other hands, in mark down modes, government prepares to produce goods and services as payment of its in-kind debt. *Shari'ah* requires that those forms of financing cannot be concluded if the debtor is not able to supply contracted goods and services.

The link with commodities supplied and produced restricts public debt in such a way that prevents the government from expanding it. By this mark-up and mark-down public debts avoid one of the major drawbacks of interest-based debt.⁽⁵⁶⁾

3. With regards to mark-down instruments and voluntary and involuntary borrowing, the public sector has a free hand on the proceeds of financing. It can use them to meet budget deficit regardless of its sources. This is unlike the case of financing instruments examined in sub-section 3.1. In other words, these instruments of public debt provides the government with the flexibility of using the proceeds as desired by budget planners.

56. Al-Qari, Mohammad Ali, "Petroleum bonds as an alternative to treasury bonds", unpublished paper, CRIE, King Abdulaziz University, Jeddah, I412H.

In this respect, these modes bear resemblance to most interest-based public debt.

4. Debts, whether in cash or in kind, have to be paid when they become due. Therefore, all instruments of Islamically acceptable public debt pose the challenge of repayment of debts in the future, especially if the goods and supplies obtained in mark-up modes and/or proceeds of other modes are not used for income generating projects. This means that future generations have to be either taxed or asked for fresh flow of loans to the public sector in order to fulfill the latter's obligations.

Obviously, this calls for a thorough examination of the impact of such instruments on inter generational- equity.

5. Since all modes of public debt discussed in this sub-section provide the government with either cash or goods and services, there is no issue of privatization arising from the application of these modes.
6. As all these modes result in creating public debts, the government may provide any form of guarantee it likes to secure this indebtedness. Such a guarantee may be given by the same body which uses the financing or by another governmental body which may be legally and financially independent from the debtor.
7. Except for involuntary borrowing, all modes mentioned in sub-section 3.2 can be applied to external as well as internal financing. Consequently, a government may obtain foreign governmental or institutional financing on the basis of either marabah, salam, 'istisna' or benevolent foreign lending. It can also mobilize foreign financing from private citizens of other countries or its citizens abroad, on the basis of mark-down instruments and foreign currency bonds.

Consequently, public-debt instruments can be looked at as an easy to use alternative of interest-based loans to bridge the external gap, and to finance the foreign exchange requirement of the current as well as development government budgets.

Furthermore, these instrument may appeal to interest-accustomed and risk-avertor foreign lenders.

8. Although debt-based instruments can be used to fulfill long-term financing needs, they are essentially tuned to short-term needs because of the commodity base of most of them. Therefore, these instruments are useful to finance current budget deficit which is caused by seasonal adjustment, price subsidies, tax reductions aimed to enhance investment, etc.
9. Lastly, although the lack of negotiability of these instruments is their major drawback, the issuance of small denomination instruments of staggering maturities helps instrument's holders and portfolio managers overcome most of the difficulties arising from the instruments' non-negotiability.

3.3 Some important issues in public borrowing

There are several issues related to the forms, procedures, characteristics of different kinds of public borrowing and their pros and ones. These are usually dealt with at length in the classical literature. Therefore, the present paper will select three issues which have peculiarities and special relevance to Islamic Economics. These issues are:

- 1) Conditions of public borrowing in *Shari'ah*;
- 2) The social justice consideration of public borrowing,(and
- 3) Demand deposits and seignorage as a basis for justifying involuntary public loans.

3.3.1 Conditions of Public Borrowing in *Shari'ah*

Resorting to the private sector to cover a deficit in public funds is unquestionably permissible in *Shari'ah*. It has its own tools which include those discussed in this section in addition to taxation. In the Islamic classical literature, jurists debate whether the government can impose taxes or borrow from the public. In other papers, I argued that an Islamic government may impose taxes only as a last resort, i.e., after exhausting all other sources including borrowing." Hence I will concentrate here on the *Shari'ah* conditions of public borrowing.

It is well established that the Prophet (Pbuh), as the head of state, borrowed from individuals on several occasions and took, at least once, *zakah* one year in advance from his uncle al Abbas, who was one of the wealthiest individuals in that society.

Al Mawardi ⁽⁵⁸⁾ and al Juwaini ⁽⁵⁹⁾ discussed public borrowing and taxation. The question is also addressed by several other scholars including al Shatibi, al Nawawi, al Ghazali and Ibn Hazm. From those discussions and from comments on the issue by al Qaradawi and Rifat al Awadi, one may collect the following points emerge:

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- 57 For details, kindly refer to my papers on "Financial resources of the early Islamic state", IRIT 1992; "Economic public sector and its role in mobilizing resources for development", in *Al-Mawarid al Maliyah li al Dawlah al Islamiyyah fi al'Asr al Hadith*, [Financial resources of the Islamic state in modern time], Monzer Kahf, ed., U, Jeddah, 1989; "The Islamic state and the welfare state", in *Islamic Movement Challenges*, Tariq Quraishi, ed., ATP, Indianapolis, Indiana, USA, 1986; "Taxation policy in an Islamic state", paper presented at the *Seminar of Fiscal Policy and Planning Development*, held by IIIIE of the International Islamic University, Islamabad, 1986; and "Financing Public Sector in Islamic Perspective", presented at the *Third International Conference on Islamic Economics* held by AMSS of the USA and Canada, Washington D.C., Dec. 1990.
- 58 Abu al Hasan Ali bin Muhammad al Mawardi (circa 450 h.), *Al Ahkam al Sultaniyyah*, Third ed., Mastiff al Babi al Halabi, Cairo, 1973.
- 59 Imam al Haramain al Juwaini (circa 478 H.), *al Ghiyathi*, published by Directorate of Religious Affairs in Qatar, 1400H.

1. The permissibility of public borrowing in *Shari'ah* depends, on certain conditions and circumstances. That is to say: in principle *Shari'ah* has its own system of raising financial resources for the government. These resources must be sufficient under normal circumstances. There are, however, exceptions. Al Juwaini for instance says "It is not right for us to invent methods in bringing good to servants of God and procuring means of wise action which have no roots in *Shari'ah*, since this bears a great deviation and an enormous danger", p.287.
2. Some scholars, e.g., many Shafi'ites argue that the government may not keep any surplus in the treasury since a surplus in *Bait al Mal* is an exclusive right of present generation of people. It should be given away to them in terms of direct distribution like what 'Umar did, or in terms of governmental projects such as building of dams, mosques and shelters for the poor and needy. People who subscribe to this view argue that should a need arises in the future, the government can always collect from the public amounts sufficient for fulfillment of its responsibility by means of taxes or loans, (al Mawardi, p. 215 and al Juwaini, p.249). Apparently, this is a reference to budget balancing on an annual basis as well as a license to impose taxes and/or loans from the public when a need arises.

However, though himself a Shafi'ite, al Juwaini challenges this opinion on the ground that in case of anticipated needs in the future, saving the surplus may be wiser especially that keeping some reserve in *Bait al Mal* is always beneficial and a sound policy, (p.250). The Hanafites agree with this view especially events are usually unpredictable and some urgent need might arise, (Al Mawardi, p.215). Al Juwaini even questions the wisdom of spending on luxuries like building small dams (!) and beautiful houses while exhausting a reserve fund which could otherwise be saved for future use to be spent on the army, (p.251).

3. While al Mawardi seems to suggest that borrowing comes before taxation in case there is a need for mobilizing funds for the government (p. 215), Al Juwaini appears to prefer taxation though he may sound indifferent. The contention of al Mawardi is that in case of needs, the government should first borrow if it anticipates any future resources. Al Juwaini elaborates his argument on the basis that necessary expenses must be done anyway. It is, therefore, a financial obligation on individuals which is, like physical obligations such as military service for defending the *Ummah*, a responsibility of all those who can discharge of it, (p. 259).

He further adds that as an obligation, funds acquired by the government need not be on loan basis since this obligation is based on ground of *fard al kifayah*, and what is given in fulfillment of an obligation should not be subject to refund,[p.275]. Moreover, giving such funds with the condition of returning them later indicates that payers are not original in discharging of what God ordained unto them, [p.276].

This is not necessarily granted because needs must not be overestimated. If a need can be completely satisfied by taking funds from the public and returning them after a while, why should we then take them without any refund? The analogy of a starving person who needs food is likely to apply here... he/she may take what is necessary on borrowing basis unless he/she is not capable of payment. Only in the latter case he/she may take without the pledge of payment, (p. 278).

In the final analysis, al Juwaini seems flexible. He asserts that the matter must be left to the government in its looking for what is most suitable for each situation (p. 277), he also contends that what the Prophet (pbuh) did in borrowing' instead of taxing merely implies that public borrowing is permissible is *Shari'ah* (p. 279).

Lastly, it seems that al Juwaini was afraid of those who strongly oppose taxation and he wanted to forcefully articulate the argument against them and affirm that taxes are not only permissible but may sometimes be preferable as well. This may be similar to what Ibn Taymiyyah did in his book al Hisbah with those who contested pricing even in case of monopoly.

4. To understand the opinions of al Mawardi and al Juwaini on public borrowing, one must distinguish between loans taken from rich citizens in a forceful manner and voluntary public debt. It appears from their discussion that they have in mind a forced kind of public borrowing. However, permissibility of voluntary public borrowing by means of instruments offered to the public may be implicitly derived from their arguments.
5. Both al Mawardi and al Juwaini seem to agree with most other Muslim scholars and jurists that public borrowing must always be related to the needs of the public sector. However the kind of needs which make it permissible to borrow may vary.

Al Mawardi (p. 214-215) for instance differentiates between three kinds of public expenditures as follows: (A) expenditures due against goods and services contracted or actually bought by the government, the example he gives of this kind is salaries of soldiers and price of weapons, (B) expenditures on the general interests of society and the welfare of people, etc., but which, if neglected, bring general harm such as an indispensable road which has no alternative or a drinking water fountain that has no substitute, and (C) expenditures of the B type except that they have alternatives, even with difficulty such as a road which has a substitute but a bit longer or less convincement.

Al Mawardi believes that coercive public borrowing may be resorted to for the satisfaction of kind (A) of needs provided the government anticipates definite future revenues sufficient to pay for the debt along with future regular expenses. Kind

(C) of needs do not justify borrowing nor imposing taxes. As for kind (B), the choice between taxes and forced loans depends on whether the government anticipates sufficient surplus resources for debt payment from its regular future revenues (p. 215).

On the other hand, reading through al ghiyathi, it seems that al Juwaini also distinguishes between three types of public needs which are: (a) military and other needs for survival of the *Ummah* such as actual defence of the Muslim land and people in case of a foreign attack or to abort and prevent an expected attack (p. 257-258) and satisfaction of basic needs of the deprived (p. 259 and 278), (b) military needs to prepare an army able to carry on the responsibility of *Jihad* and prevent any oppression in the land of unbelievers (p. 258-259), and (c) regular needs such as payment of salaries of soldiers, judiciary, religious teachers and research and *fatwa* scholars and other collective obligations (*fara'id al kifayah*) etc. (p. 245-246, 259 and 280- 282).

Al Juwaini argues that kinds (a) and (c) should be financed by taxes on the rich. Tax revenue should fulfill all the needs of kind (a) and in the case of kind (c) taxes must be regular and moderate because the needs are continuous and require a stream of revenues. For needs that are not so pressing, i.e. kind (b), he suggests that they should be financed from taxes on the "excess of the wealth" of the rich (!).

Interestingly, al Juwaini and al Mawardi both consider construction of dams, improvement of material conditions of living and similar public interests as of marginal importance that may only be carried out if there are surplus funds in the treasury, i.e., they should not be financed by taxes or forced borrowing.

In other words, public needs for which involuntary public borrowing is permissible are the following:

- a) Defence requirement in case of aggression or to prevent an expected aggression.
 - b) Establishment of a minimum government apparatus which maintains safety and security of persons and property and organizes the essentials of religion as a comprehensive way of life.
 - c) Satisfaction of basic needs of the poor and deprived in terms of food, clothing, shelter, indispensable level of health services, marriage if necessary, etc.
 - d) Fulfillment of other collective obligations [*fara'id al kifayah*] such as burying the dead, maintaining skills and scientific knowledge essential for indispensable production and distribution, etc.
6. Al Juwaini mentions voluntary contributions as a major source of public funding at the time of the Prophet (pbuh). This gives room to extend the analysis to include public choice with regard to what needs should be financed by which means, public debt or taxation. According to al Qaradawi, such a decision can only be taken by a *shura* council whose decision is binding on the executive branch of government.⁽⁶⁰⁾ Rifat al Awadi considers this condition one of the essential principles of taxation in Islam.⁽⁶¹⁾

⁶⁰ Yusuf al Qaradawi, *Fiqh al Zakah*. Mu'assasat al Risalah, Amman, Jordan 1972, p. 1085-1088

⁶¹ Rif at al Awadi, "*Al Daribah fi al Nizam al Islami*" [Taxation in Islamic System] *Al Idarah al Maliyyah fi al Islam*, [financial management in Islam]; Mu'assasat 'Aal al Bait, Amman Jordan 1990. V. 3, pp. 1053-1126, p. 1088.

7. Pushing this debate further, one may argue that if it is permissible for a duly elected *shura* council to impose taxes and/or obligatory loans under certain circumstance, it must also be permissible for the *shura* council to decide on financing projects of benefit to the society, though they may not be necessary, by means of voluntary financing obtained from the public through any of the instruments discussed in this paper.⁽⁶²⁾

Al Juwaini, however, warns against extending the permissibility of imposing taxes [or by the same token forced borrowing] beyond its proper limits. In his discussion on whether it is permissible to confiscate wealth of criminals and bandits, he argues that since seizing their wealth is suggested not for a genuine need for public fund but only as an act of punishment, *Shari'ah's* general rules do not allow a measure like this as there is no indication in this religion regarding its permissibility. However, if a genuine need for public funding already existed such individuals may be charged more than others, (p. 287-288).

Consequently, one may argue in favor of voluntary public debt⁽⁶³⁾, if the conditions of necessity are lacking, since offering financing certificates gives the choice to the general public. This is a form of voting on government projects by the public.

Furthermore, mobilizing private sector's resources for financing public projects may be a social choice for accelerating economic development, and the public acceptance of, or attraction to, this kind of investment is itself a form of public voting on governmental development policy. This may

⁶² M. N. Siddiqi, "Public expenditures in Islamic State", paper presented at the seminar on Fiscal Policy and Economic Development in Islam, organized by ME, International Islamic University, Islamabad, 1986.

⁶³ Or alternative instruments as discussed in this section.

be true from Islamic point of view as long as the incentives of this financing are compatible with *Shari'ah*, do not jeopardize private savings and investment and are initiated for the public interest of the *ummah*.

8. Lastly, to complete the conditions of public borrowing, the following should be mentioned:
 - i) Lack or inability to mobilize regular public revenues which are stipulated in *Shari'ah* including revenues from public property, i.e. *Kharaj*.
 - ii) Public loans should avoid *riba* and any other form of transaction prohibited in *Shari'ah*.
 - iii) They must not endanger the internal and external security of the *ummah*. This applies especially to foreign loans.
 - iv) Whether coercive or voluntary, public loans must not be taken from the poor and must, at least, not negatively influence the poor's welfare. Muslim jurists seem to categorically agree that forced public loans can only be taken from the rich and in accordance with the level of their wealth.

3.3.2 Social Justice Considerations of Public Borrowing

The effect of public borrowing on social justice may be inter-generational or between the rich and the poor within same generation.

Inter-generational incidence of public borrowing (and all kinds of debt-based financing) is one of the important issues raised in economic literature. It

is equally important for Islamic economics because of the latter's sensitivity to the question of justice.

Two view points are often offered in answering the following question: who will bear the burden of public debt, present generation or future generation? Some writers claim that since resources used by the public sector represent a chunk of present output of which private sector is deprived, it is the present generation who carries the load of this utilization regardless of its mode of finance, taxes or debts."

However, it can be shown that public expenditures, whether current or developmental, represent real use of resources for which some one must pay. If these expenditures are paid for by borrowing from the public, future generations will have to be taxed for the payment of principal and interest (in interest-loaded economies). This represents a real burden on future generations. On the other hand, bond holders do not gain at the time of settlement of public debt because for them payment of the debt represents an exchange of one asset for another.

As for the present generation, holders of public-debt bonds do not lose in terms of their welfare because they choose to either reduce their consumption for an increase in their income producing assets, i.e., they moved along the same indifference curve, or substitute one asset, e.g., private investment certificates or cash, for the public bonds which are just another asset.

However, payment of principal and interest is not the only consideration which has to be taken into account. For instance, if we assume that public debts are taken out of private savings, interest rate may rise because of a leftward shift in supply of private sector's loanable funds. Other things remain unchanged, this increases the cost of investment for the present generation.

⁶⁴ E.K. and J.M. Browning, Public Finance and Price System, 2nd Ed. Macmillan Pub. Co. Inc., New York, 1983, pp. 405-406.

Additionally, future generations' burden will, in fact, be reduced by inflation, because the real value of public debt declines with inflation unless bonds' holders are compensated by means of certain form of indexation. This may mean that, without indexation, the relative burden of public debt on future tax payers declines too.

Moreover, the kind of public expenditure for which debts are used makes a difference. If public loans are used to pay for current expenses of say administration of government, future generations may not have any increase in income coming along with the burden of debt. Whereas, if debts are spent on construction of a dam which will increase irrigation and expand cultivable acreage, or if they are spent on building of human capital, the increment in income resulting from additional material and human capital also lessens the burden of debts or may outweigh it.

All these considerations relate to public debts subscribed to by individuals from within the economy. If public borrowing is done outside the country, further considerations should be added among which are the following: first, payment for servicing the debts will put a pressure on export and other sources of foreign exchange,(second, domestic inflation, if higher than inflation of the currency of the foreign debt, which is usually the case for developing countries, creates a further increase in the burden of future generations,(and third, the burden of foreign debt will be heavier if debts were not used to increase the production and export capacity of the economy.

With regard to justice within each generation, it has been argued in the previous sub-section that, when permissible, public loans should only be taken from the rich not from the poor⁽⁶⁵⁾. Therefore, any kind of involuntary public borrowing, whether from individuals and private corporations, commercial

65 Al Juwaini argues that other considerations may supplement social justice in determining the payers of taxes and/or forced public borrowing. Specifically, he mentioned two additional considerations: (a) financial penalties may be imposed on the wealth of criminals and bandits if there is a genuine need for funds, and (b) if public funds are needed, the government may charge those who are believed to use their wealth for extravagant and other prohibited usages to the extent which prevents such misdeed. See Al Ghiyathi, op. cit., pp. 273 and 288.

banks or central bank, must be carefully evaluated from the point of view of its impact on social justice. Whether it affects individuals in proportion to their richness or not, keeping in mind that richness in Islam is measured in terms of both stock (wealth) and flow (income) together.

Consequently, if borrowing from the central bank creates an inflationary pressure adverse to the poor, influences the equals differently, or causes any other kind of injustice in the Muslim society, such borrowing transgresses on the principle of justice and should either be avoided or coupled with corrective measures in order to compensate the adversely affected persons. The same kind of rationale applies to borrowing from commercial banks and from the private sector.

Moreover, if the government decides to impose involuntary loans on individuals, such loans should not be implemented by means that would have adverse effect on the poor. For instance, deductions from government employees' salaries may be easy to collect and almost cost free, but they create social injustice because other income earners and wealth owners are not equally charged, and because these employees may not be rich enough to be burdened by taxes or public loans. Public loans should be obtained from individuals in a progressive manner according to their wealth and income whereby, unless for important and overwhelmingly justified reasons, all the equals must be treated equally.

3.3.3 Demand Deposits, Seignorage and Involuntary Public Debt

Two facts are well established about deposits in banks' current accounts. one, that depositors are usually not given any share in the earnings of the banks (Islamic or not) although their funds are used in the bank's profit generating activities,(and two, primary deposits help the banking system create derivative deposits because of partial reserves-cum-multiplier affairs. Both these two facts, together, award banks an opportunity to reap returns unearned by the banks' own property and work but caused by the economic

system and the behavior of people towards it. This gives rise to the seignorage rights regarding this kind of created credit.⁽⁶⁶⁾

Several ideas are put forward by Muslim economists in order to bring justice in this regard.⁽⁶⁷⁾ Some suggests that commercial banks in the Islamic system should maintain 100% reserves of all their demand deposits,⁽⁶⁸⁾ others recommend that banks may be permitted to harvest this benefit but they should be taxed accordingly,⁽⁶⁹⁾ some others yet suggests that derivative deposits should be used for:

- a) broadening the base of borrowers from commercial banks to include fulfilling some of the welfare objectives of the Islamic state in supporting the poor and needy and promoting their productive capacity,(and
- b) whatever is left of created credit should be considered similar to *mudarabah* deposits in the hands of commercial banks the return of which is to be collected by the government and spent on welfare programs for the poor and needy ⁽⁷⁰⁾.

It may also be suggested that commercial banks be asked to maintain say 20% reserves for demand deposits in the usual form of cash and deposits with the central bank and 80% reserves in the form of a combination of short

66 Seignorage is generally caused by the acceptance of the public to use sorts or means of payments which are almost cost free to produce. Hence, it also arises with the use of credit cards in which case consumers get the advantage and with the use of fiat money where the government reaps it.

67 The consideration of justice is usually provoked along with other points related to stability of the banking system, reducing the power of bankers, providing financial resources for the public sector, etc.

68 See for instance, Mabid al Jarihi, "Monetary and Financial Structure of an interest-Free Economy", in Money and Banking in Islam, CRIE, Jeddah, 1983, pp.69-87, and Monzer Kahf, The Islamic Economy, The MSA of the Us and Canada, Indianapolis, Indiana USA, 1978.

69 Munawar Iqbal, "Fiscal Reform in Muslim Countries with Special Reference to Pakistan", IRTI 1993.

70 M. Umar Chapra. Towards a Just Monetary System, Islamic Foundation, Leicester, U.K. 1985, pp. 89-94.

and medium-term *riba* free treasury bonds. Or to put it in general terms, commercial banks may be forced to lend the government, especially short-term lending, in order to, wholly or partially, compensate for the seignorage reaped by them. This kind of public debt particularly helps in seasonal budgetary adjustments and may, additionally, provide a valuable monetary policy tool which can be used to control money supply by the banking system.

SECTION FOUR

CONCLUSIONS AND SUMMARY

After a brief survey of the principles of financing in Islam, the paper reasoned that the prohibition of *riba* applies to the public sector as much as it applies to private individuals. Therefore, the same principles of financing which guide individual Islamic behavior must also guide the behavior of the public sector. That is to say that according to *Shari'ah* all branches of government, service producing public corporations and other economic public enterprises are required to observe the same principles of financing which are applicable to the private sector.

The paper then proceeded to discussing the causes of budget deficit which may be summarized in a level of production of public goods beyond the financing capacity of the public sector's resources. Alternative approaches, to provision of social goods are also discussed. These include provision of social goods on philanthropic basis by individuals and organizations and on profit basis by the private sector.

In section three, I examined the different alternatives of borrowing available to government as Islamically permissible instruments and modes of finance. These include the following:

First, financing instruments which preserve ownership in the hands of the financier. They include *ijarah* instruments which may be used by income generating projects as well as by non income generating branches of the government. They also include instruments of financing derived from the principles of profit and loss sharing and output sharing. All these instruments are negotiable in a secondary market. The principle of private ownership of assets managed by the government creates a form of privatization of property while keeping the management public. This, of course, applies to all but *Sharikah*. In *Sharikah*, all shareholders, government and private individuals have equal right of management.

Secondly, we have financing instruments which are based on a creditor/debtor relationship. These include *murabahah*, *salam*, *istisna'* and *ijarah* public debt. The paper notes that *murabahah* creates a cash public debt, *ijarah* and *salam* result in an in-kind type of public debt, while '*istisna'*' can be used for creating a cash or in-kind debt on the government.

All these instruments of public debt are suitable for projects which produce revenues as well as for non-revenue generating projects and for the current expenditures of administration.

Without going in the details mentioned in the text about the characteristics of each suggested public financing instrument and mode of public debt, four important points are worth be used as concluding remarks. these are:

- 1- Whenever a public debt is created, a future liability also arises,(and unless the government generates sufficient future resources to pay back the debt, taxes and/or expansion of borrowing become inevitable. From the point of view of Islamic financing instruments, it should be noticed that:
 - a. Ownership-based instruments do not necessarily call for redemption as they do not create liability on the public sector.
 - b. In-kind public debt calls for future production of contracted goods and services. This requires financing. Therefore, unless the production capacity of the public sector is expanded sufficiently, fulfillment of contractual obligations becomes difficult. Default of the government in this regard may result in compensatory damages, etc.
 - c. Cash public debt cannot be rescheduled because interest is prohibited.
- 2- Sale of public property is an important source of public revenue that may be tapped to meet budget deficit and pay back public debts. It still deserves a thorough investigation. The economic development in

all producing countries depends on this source. Moreover, the privatization process in the second and third world countries generates huge financial resources which should not be overlooked. However, a *Shari'ah* investigation of privatization of public property deserves to be subject of a future research.

- 3- The modes and instruments discussed in this paper may be utilized for financial resource mobilization from the private sector within the country. They can also be used for external financing. In a different paper, Tariqullah Khan and myself discussed the principles of external financing for the public sector. It may be worthwhile to mention here that from the point of view of external security of a Muslim country, a distinction may have to be drawn on the basis of the sources of external borrowing. This may bring into the analysis the concept of the Muslim *Ummah* and its impact on Muslim/non-Muslim international economic relationships. This is, of course, an area which falls outside the scope of this paper and it may be suggested for future studies.
- 4- A thorough *fiqhi* investigation and elaboration of detailed conditions of some of the modes and instruments suggested in this paper may also make a good subject of a *Shari'ah* oriented future research in this area. This itself may generate new ideas and result in developing more modes and instruments of public financing.

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