Fiscal and Monetary Policies in Islamic Economics: Contours of an Institutional Framework

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This paper summarizes main points in the existing Islamic economics literature on the subject of fiscal and monetary policies. It outlines institutional framework for these policies from the Islamic economics perspective. Some fresh points on the nature and role of government in the light of the Shari’ah principles, are also noted. The general goals for macroeconomic policies are discussed along with separate goals for each of the two policies. The argument is capped with a look at practical considerations in the actual working of both the policies. These are the main points in the paper. (1) Fiscal policy is the policy that works through government budget, and monetary policy is the policy aimed at monetary management. (2) Both the policies may complement each other because the goals for both of them are to be seen in the context of overall objectives at the state level. (3) Thrust of both policies would be different from that presently recognized, due to institutional factors. (4) Fiscal policy is not assigned a proactive role. The main conclusion is: government’s role should be limited to prudent governance, and greater attention be paid to monetary management.

Key Words: Fiscal Policy, Monetary Policy, the Shari’ah, Government

1. INTRODUCTION

Islamic economics project was launched by Muslim economists in 1976 with the holding of the first international conference on the subject in Makkah. The main constituency of this exercise was the Muslims. Speedy development and quick recognition warranted focus on issues of practical significance for Muslim countries at that time. Accordingly, economic development, income distribution, poverty and macroeconomic policies were part of the initial research agenda. Fiscal and monetary policies were thus among the subjects that caught attention of Islamic economists very early. This happened when contour of the subject of Islamic economics were yet to be defined. Two international seminars on monetary and fiscal economics of Islam were held at Jeddah and Islamabad in 1978 and 1981, respectively. Since then history of the discourse on these themes coincides with the development of Islamic economics in general.

Fiscal policy works through government budget in a country. “Government” includes national, provincial/state, county/district and local governments. However, the literature on fiscal policy generally focuses on fiscal action by the central government. Fiscal policy works through expenditures, taxes and subsidies at the government level. Monetary policy is concerned with monetary management by the monetary authority in a country. It revolves around volume of liquidity—purchasing power—in an economy. It works through the volume of money supply (high-powered money) and variations in the rates at which resource-
surplus and resource-short economic agents carry out their exchanges, whether directly with one another or through financial institutions.

Traditionally executing authorities for both the policies are different: government for fiscal policy and the country’s central bank for monetary policy. Linkage between the two policies is recognized in the mainstream economics literature. But that is limited mostly to the case of deficit financing with the government expenditure not being tax–financed. In such an instance, the monetary scene is affected by either injection of fresh money supply into the economy or shift of resources from the private sector to the public sector through public borrowing.

Where do the things stand in this regard from the Islamic economics perspective? And, what is the likely line for further research? This study explores these matters. The organization of argument as follows. State of the existing thinking is briefly reviewed in section 2. Survey of the literature reveals gaps in the area of institutional framework for these policies. Accordingly, the issue of institutional framework is explored in section 3. Among other things, this includes nature and role of government in the light of the Shari’ah principles. In section 4 the goals of macroeconomic policy, in general, and those of fiscal and monetary policies are separately discussed. The argument is capped in section 5 by addressing some practical considerations in the actual working of the two policies. This is followed by some concluding observations in section 6.

2. A SELECTED LITERATURE SURVEY

International conferences and seminars have played defining role in the development of literature on Islamic economics. This is more so in the case of the subject of this paper. The process of these symposia involves issuance of a call of papers along with identification of topics for research, writing of papers on the approved themes and their presentation by the selected authors. It is also pertinent to mention that during the formative years of Islamic economics a select group of Islamic economists was involved, either directly or indirectly, in the organization of the said conferences and seminars. All these factors have had great impact on both the direction and the nature of the research effort. The work done on the subject of monetary and fiscal policies has three broad features:

1. Fiscal and monetary policies have been subjects of separate inquiries. The respective Islamic economics literature has, therefore, developed separately for each policy. This, in turn, has had the following implication. The argument and the conclusions for both the policies do not rest on a common institutional set-up and policy goals.

2. The audience of Islamic economists has been the Muslim countries. They, therefore, kept in view the ground realities and the needs in these countries. They also highlighted importance of zakah, prohibition of riba and role of the voluntary sector in the economy (see below). However, they did not fully spell out the macroeconomic framework from the Shari’ah point of view for these policies. That is, institutional framework of the economy, nature and role of government, the policy framework and the goals of macroeconomic policies.

3. A distinction between state and government is not maintained in the argument.

In fact, the positions actually taken are close to those already taken in the conventional economics. An interesting feature of the existing literature is that in the early stage of development of Islamic economics, fiscal and monetary policies were subjects of separate studies. In the late 1980s and early 1990s that some analytical papers were published with the focus on calculating policy multipliers for either one both the policies.\(^1\) Likewise, there have

been some studies focusing of implications of zakah for an economy. The focus of this short survey is on conceptual matters related to fiscal and monetary policies. Accordingly, the said works are excluded from this survey. With the growing interesting in Islamic banking and finance, trend of most of the works again turned to analysis of monetary policy alone. In what follows, we separately look at the state of thinking on fiscal and monetary policies.

### 2.1 Fiscal Policy

Faridi (1983, p.28) attributes the following socioeconomic goals at the state level for fiscal policy:

1. Justice and equity
2. Provision of socioeconomic needs of the community or socioeconomic welfare
3. Enhancement of the community’s economic resources or economic growth
4. Improvement in the cultural milieu of the society

He contends that Islamic economy would be a three-sector economy consisting of traditional private and public sectors as well as a voluntary sector. He goes on to note that the state (by which he means government) shall perform traditional allocation, stabilization and distribution roles. In his view, zakah and voluntary charity would provide anchors for distributive purposes.

Salama (1983) also assigns stabilization, distribution and regulation goals to fiscal policy. To this extent he is no different from recommendations in the mainstream economics literature. But he also adds a fourth goal: economic growth. He also touches upon revenue and expenditure sides of Islamic state, and what one might expect for the case of the existing Muslims countries.

Metwally (1983) makes no major addition to the above points. He mainly discusses mechanism for fiscal policy in an Islamic economy and effects of zakah levy on selected macroeconomic aggregates.

Kahf (1983) discusses genesis of an Islamic state, goals of fiscal policy and principles for taxation policy in an Islamic economy.

Siddiqi (1986) focused on public expenditure in Islam. According to his argument, heads of public expenditure from the Islamic point of view will be more or less the same as in any economy in the current age. In a separate study, Siddiqi (1994) also presented evidence of public borrowing in the early Islamic state, i.e., during the time of the Prophet SAW and the four rightly-guided Caliphs.

Ahmad (1989, 1992) carried out a detailed analysis of public finance in Islam. The 1992 paper is a survey of the existing thinking in the area. The 1989 paper, more important of the two, contains reviews of basic teachings of Islam with a bearing for public finance and fiscal system in the first Islamic state of Madinah. His conclusion is that many of the issues of public finance had precedence during the time of the Prophet SAW and his able successors. The main paper gives an outline of public finance in Islam in the modern age. The most striking proposal in his paper is that the distribution or welfare budget is to be based on zakah and to be maintained separately from the rest of the government budget. He also argues that transfers could be made from the main budget to the zakah-based budget, but not vice versa.

Hasan and Siddiqui (1994) examine the stability implications of equity-based financing of government expenditure in an interest-free economy. They replicate similar exercises for bond-financed government expenditure in an interest-based economy. Their study offers no breakthrough at the conceptual level.

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2 See, for example, Salama (1982)
This above review captures most, if not all, of the points in the existing literature related to fiscal policy. It is pertinent to mention that when the above writings were penned, advances on in the area of Islamic finance were yet to be made.

2.2 Monetary Policy


Chapra led the discussion on the subject in a series of papers and books published between 1983 and 1996. He initially listed in his 1983 paper the following three goals for monetary policy from the Islamic point of view:

1. Economic well-being with full employment and optimum rate of economic growth,
2. Socioeconomic justice and equitable distribution of income and wealth, and
3. Stability in the value of money

He also discussed sources of money supply and monetary policy instruments. One novel proposal in his paper is earmarking 25% of demand deposits with the banks for advancing interest-free loan to government. This may serve as a sort of proxy for reserve requirements for the respective banks as well as financing government needs in the face of shortage of revenue through taxes or interest-based borrowing. Chapra’s 1985 book *Towards a Just Monetary System* expands on the themes of his 1983 paper.

Chapra (1996) revisited the subject in his paper on monetary management in an Islamic economy, published in *Islamic Economic Studies*. This paper presents the case for monetary management in a comparative perspective. Need fulfillment, optimum growth and full employment and equitable distribution and economic stability are some of the recurring themes in this paper. And, the monetary instruments include, among others, statutory reserve requirements, credit ceilings (in particular, goal-oriented allocation of credit), equity-based instruments, changes in profit-and-loss sharing ratio and moral suasion.

Khan (1986, 1992) focused on the financial side, and presented a macroeconomic model in order to establish that monetary policy would work in an interest-free economy in the same way as in interest-based economy but with better speed of adjustment economy in disequilibrium situations. Non-guarantee of the deposits provided the main ground for his argument.

Khan and Mirakhor (1987) gave a flow-of-funds matrix for an Islamic economy in which the central bank provided equity-based support to banks. However, their analytical model rested on conventional interest rate variable relabeled as an *a priori* variable rate of return. It is, therefore, not surprising that they do not find any difference in the effect of monetary policy in an Islamic versus a traditional one economy.

The papers by Khan and Mirakhor (1994) and Choudhry and Mirakhor (1997) have reflection of the advances made in Islamic banking and finance in the 1990s. Khan and Mirakhor highlight the modarabah mode deposit mobilization, and list financing instruments that might be available in the Islamic financial system. They point out that apart from the Islamic banking system there would also be primary, secondary and money markets. There is great semblance between their thinking and what is available in conventional economics. Of course, the instruments like modarabah and musharakah certificates are expected to have Shari’ah legitimacy. They regard macroeconomic stability, characterized by price stability

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3 During this seminar, Siddiqi (1982) discussed the challenges that Islamic economists face on the financial side and the likely form of Islamic banking. He made only a passing reference to monetary policy.
and viable balance of payments position as the chief goals for monetary policy. As for monetary policy, their conclusion is as follows:

Monetary policy of an Islamic state takes place in a framework in which all conventional tools normally available in a modern economy are at the disposal of the monetary authorities with the exception of the discount rate and other policy tools that involve interest rate. All other tools, namely open market operations (where equity shares rather than bonds are traded) and credit policies, can be as effective in an Islamic system as they are in the conventional Western system. Additionally, the authorities in an Islamic system can utilize reserve requirements and profit-sharing ratios to achieve changes in the stocks of money and credit. . . (Khan and Mirakhor, 1994, p.19)

Choudhry and Mirakhor (1997) focus on the tools for monetary policy. Their main proposal is use of equity-based government securities with rates of returns based on budgetary surplus for the purpose of monetary management. This study, like the others noted above, does not spell out blueprint of Islamic economy and, therefore, remains silent on the role of monetary policy in Islamization of an economy.

This completes our short survey of state of thinking on monetary policy. In passing, it may be noted that some relevant points are also discussed in other studies. For example, Elhiraika (2004). He does draw upon the references noted here. Beyond, this his is mainly an econometric study of determinants of monetary policy in Sudan, a country that opted for elimination of riba from the economy in 1984. His conclusion is that monetary policy in Sudan is closely linked to financing government’s budgetary deficit, and its determinants include government spending and inflation.

It passing, it may be mentioned that good deal has been written on instruments for financing government’s budgetary deficit since the developments in the Islamic finance from the late-1990s and onward. See, for example, Iqbal and Khan (2004). The principal aim of such works is to highlight alternatives for meeting government’s budgetary needs. The focus of the said studies is at variance with the main theme of the present study. Therefore, are, therefore, not covered in here. With these clarifying remarks, we now turn to the main aim of this study: the relevant institutional framework for fiscal and monetary policies and the policies themselves.

3. INSTITUTIONAL FRAMEWORK FOR FISCAL AND MONETARY POLICIES

Islamic economics is about solutions to economic issues in real life on the basis of the Shari’ah principles. The Shari’ah perspective implies that the Islamic economic solutions will give the best results in a Shari’ah-compliant institutional framework. As explained hereunder, this does not limit the applicability of the Islamic economic solutions. These solutions remain applicable in Islamic as well as other settings, whether in Muslim or in other societies. The Shari’ah-perspective helps to draw attention to institutional arrangements that are not often appreciated in the academic discourse.

According to the Islamic worldview, this life is a test for man. For the purpose of test, Allah SWT gave man free will and allowed private ownership. This, in turn, implies that people can own property and exchange property rights. How can millions and millions of economic agents do so with their free will? The answer is “through the institution of market”. It is, therefore, safe to conclude that the Shari’ah prescribes a market-based economy. This conclusion is also confirmed by scores of Ahadith on forms of transactions and the evidence available for the first Islamic economy during the days of the Prophet SAAAWS and his rightly-guided successors.
One may add the following point to the above point about market-based character of Islamic economy. Allah SWT is the Original, the Absolute and the Ultimate Owner of everything that is in the heavens and the earth. This, in turn, implies that when two people enter into exchanges with one another, Allah SWT is always the Third-Party. Thus, His Will also matters in how transactions are to take place. The Divine Will is available to us in the form of general principles governing permissible exchanges as well as detailed rules for the various transactions norms. The former include, among others, free willing consent of all stakeholders, no transaction of a thing on which one does not have a Shari’ah-recognized claim, no vague elements in contracts, no qimar and no riba.—The principle of no qimar implies that all exchanges inspired by economic considerations must involve some quid pro quo. And, the principle of no riba requires that all loans, debts and similar other exchanges must be carried out on an equal basis in terms of the relevant units of exchange. With these main restrictions, people may do trading, leasing, partnership-based exchanges, loaning and a host of other exchanges. The list also extends to more complex cases involving many exchanges among several parties, both at a point in time and across time. The possibilities are virtually unlimited. It is easy to imagine the existence of an economy comparable to a modern economy where individuals, businesses and companies exist, and work in a gainful manner for themselves and the others. Market forms would depend on the existence of substitutes for different products and the number of players on the demand and the supply sides.

On the financial plane, the Islamic principles for exchanges will have the following implications. Institutions like banks may exist for economic reasons, but with the following differences from the contemporary scene. Banks would no more be pure financial intermediaries that borrow short and lend long. They would be economic agents. They would interact with resource-surplus units in two ways. First, they may provide interest-free demand deposits for those seeking security of their money and flexibility in the use of the funds. Second, they would enter into partnership contracts with owners of funds conscious about seeking a return on their money. On the financing side, the restriction of “no interest” will rule out the banks providing credit to their clients who can use it at their discretion. This will force the banks to actually enter into the transaction process at the grassroots level as traders, lessor and partners. To this, one may add that Shari’ah-based divisible and tradable financial instruments will add depth to the Islamic money market. This will remove the dichotomy between financing by the banks and its use at the beneficiaries’ end, and, hence that between financial flows and real flows in the economy. 4

The above recapitulation of Islamic economy would be complete with an addition of its distribution dimension. Islam addresses the problem of distribution at the opportunity, production and inter-temporal stages. Salient features of this scheme are as follows:

1. Everyone has equal right of access to primary means of production like rivers, forests, natural meadows, etc.

2. Contributors to production process are entitled to reward for their respective role. The Shari’ah a step further, and grants the poor and destitute a right in the outcome of the process despite their being unable to make a direct contribution.

3. The Shari’ah also provides a comprehensive social security system in terms of rights of parents, family and neighbors along with institutional framework and comprehensive legal system all provide an effective enforcement mechanism.

4. Annual zakah on wealth and the Islamic law of inheritance provides additional checks on concentration of wealth.

Zakah is the main pillar of the Islamic scheme for distribution. The Shari’ah prescribes detailed guidelines for its management on a self-financing basis. Zakah plus other social

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4 See IIIE (1999), chapter 4 for further details.
safety nets noted at point 3 form an elaborate Islamic social security system. In the Islamic scheme relies on the individual for both the initiative and necessary action in order to solving the problems of poverty and economic inequalities. This is a significant departure from the Western model where the welfare issues are addressed by the government, i.e. at the macro level, with the people contributing through taxes. The fiscal implications of the Islamic approach are enormous. They shift the welfare matters off the government budget.

The last piece of our description of the institutional framework is government, the key element and dominant player in any organized society. In order to keep the argument brief, we list the main points on nature and role of government from the Shari’ah point of view.

First of all, in principle one must distinguish between “government” and “state”. The latter is a geo-legal construct, and is legal person in the international community. The government, on the other hand, is operational arm of the Shari’ah and the state as well as representative of the people. In democratic dispensations, government is elected representative of the people. In other settings, the ruler(s) draw their mandate from acceptance of their position from the masses in one form or another.

In its capacity as operational arm of the Shari’ah and the state, the government is supposed to fulfill all claims of the Shari’ah on the people (such as collection and distribution of zakah) and to discharge the obligations of the Shari’ah in favor of the people (like, for example, fulfillment of critical minimum needs of the people should a problem arise due to systemic failure). In its capacity as representative of the people, the matter becomes quite complex. The following points throw further light on this matter.

All Ahkam of the Shari’ah given in the Qur’an and the Sunnah at the micro level, also apply to government—representative of the individuals. In particular, all prohibitions of the Shari’ah apply to the government without further ado. For example, the government cannot enter into interest-based transactions. However, in the case of the permissibles of the Shari’ah, the matter is somewhat different. The principle of being neutral among all the subjects whom it represents implies the following. The government cannot act like as an economic agent. For example, while the government may buy furniture for its needs, it cannot be either a manufacturer or seller of furniture because in that event it would be competing with its own subjects. This point also implies that public sector enterprises, an important source of pressures on government budget, have no place in the Islamic set-up. In addition to not being an economic agent, the government cannot tax one set of people and against their will transfer the benefits to another group. This limits economic role of government to only the provision of Shari’ah-justified pure public goods. In all other cases, the teachings of the Shari’ah require that the cost of government action to be charged to the respective beneficiaries. Any discussion of macroeconomic policy from the Islamic perspective has to reflect on these points.

4. GOALS OF MACROECONOMIC POLICY FROM ISLAMIC ECONOMICS PERSPECTIVE

This section is concerned with the goals of macroeconomic policy, in general, and those of fiscal and monetary policies, in particular. The approach is to spell out what one may regard as general policy objectives from the Islamic economic perspective. The argument is then narrowed to discuss the roles that might be assigned to fiscal and monetary action in an economy.

The general policy objectives are identified hereunder in the context of an Islamic economy. The reference of Islamic economy helps us to provide the Shari’ah support for these goals. Nevertheless, many of these goals can be policy objectives for any economy in this age.
It is also pertinent to mention that an Islamic state has an ideological context, namely, spreading the message of the God Almighty to everyone, both inside and outside the state. On the practical plane, this ideological perspective also means (1) keeping working of the economy in line with the Shari’ah dictate for economic activity and (2) Islamization of the economy where it is found to be off-tract from the Shari’ah-prescribed course. Elimination of the financial system through conscious policy action is an example of the latter. In what follows, we do not emphasize this dimension of macroeconomic policy, and limit our argument to pure economic side of public policy.

4.1 General Policy Objectives at the State Level

Such objectives may be divided into primary goals and secondary goals for economic policy at the state level. Both kinds of goals are listed hereunder:

Primary Goals/Objectives at the State Level:

1. Development and preservation of institutional framework for supporting economic and distributional activity
2. Fulfillment of critical minimum needs (fundamental economic rights) of the citizens
3. Maintenance of credible deterrence
4. Education

Secondary Goals/Objectives at the State Level:

1. Reduction in interregional disparities
2. Integration of economy into the world economy
3. Development of economic infrastructure such as means for communication and transportation
4. Poverty alleviation

The goals of macroeconomic policy, in general, and those of fiscal and monetary policies are separately listed and explained hereunder.

The rationale for the above goals and their specific meanings can be explained in terms of the Shari’ah as well as over 14-centuries experience on the Muslim community. First of all, we may clarify that this list represents a slight departure from the tradition in Islamic economics. In the past, the scholars based their argument on the Qur’an and the Sunnah, practices during the time of the four rightly-guided Caliphs of the Prophet SAAWS and opinions of reputed fuqaha and Islamic scholars. Most of the Islamic scholars draw their inspiration from the practices during the time of the second Rightly-guided Caliph, Sayyidena Omar, may Allah SWT be pleased with him. A point missed here is that during his time the economy was a resource-surplus economy. Sayyidena Omar took all the initiatives without introducing taxes on the citizenry. In other words, while forming opinion in the modern age, greater reliance is to be placed on ground realities, of course, without in any way sacrificing the dictates of the Qur’an and the Sunnah.

Rationale for most of the goals/objectives listed above is partly or wholly discussed in the context of nature and role of government. We add here a few words by of additional reasons and some necessary clarifications.

The first two goals are absolutely sacrosanct. Development and preservation of the institutional framework and distributional activity fall under the natural role of government. Without security of life and property, law and order and justice the state loses its raison d’etre. It is, therefore, independent of pre-existence of means for doing the needful. In order words, the state’s claim on its subjects for arranging the necessary means hold by default. The

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5 Sayyidena Omar introduced kharaj (land-tax) and ’ushoor. Kharaj can also be seen as a kind of rental on state lands made available to the non-Muslim cultivators. And, ‘ushoor were taxes on foreign traders wishing to sell their merchandise in the Muslim lands.
provision of necessary means remains the obligation of the citizenry through, of course, taxation.

As for meeting critical minimum needs of the people is fulfilled, the Shari’ah provides zakah and other social safety-nets for this purpose. Primary obligation of the state and its operational arm, namely the government, is that the system is in place for doing the needful. Of course, in the event of systemic failure, the society has to bear the costs through the government.

Maintenance of credible deterrence is mandated by Allah SWT for the Muslims. It is also the need of every society. The only debatable issue is the extent of such a deterrent. Given that the goal is to keep the hostile external forces at a distance, armaments quickly becoming obsolete, over-sized armed forces and lavish cantonments do not come on the list.

Basic Shari’ah knowledge is right of an individual and obligation of the state. The scope of “education” extends to all aspects of practical life. That includes knowledge of humanities, arts, culture, law, science and technology. After the experience of the Muslims societies in the field of education during last 14 centuries, there is hardly any room for further argument. Skilled and polished individuals are not only good for themselves but for the others as well. The wide gap between needs of the society and private concerns, only state can shoulder the responsibility for mass education. Effective consultation process between the people, businesses and industry and the government, can help set the priorities and the criteria for meeting financing needs. But, if one is willing to draw a lesson the past experience, the responsibility has to be shouldered by the state.

Among the four secondary goals noted above, several things are noteworthy. Take the case of reduction in inter-regional disparities first. In the present age, most of the countries are like “joint home” of several population groups differing in language, culture and history. Shared interests bring them into one fold but their long-term association also rests on common concerns. Reduction in inter-regional economic disparities is vital for preserving federal structures and unity of state.

As for integration of economy into the world economy, the case may be argued on economic grounds. But, we rest the matter on the Shari’ah grounds. The economy during the time of the Prophet SAAWS was an open economy. The same has been true for Muslim states during the past 14 centuries. International trade and mobility of resources provides a natural avenue for getting into contact with the foreigners and spreading the word of Allah SWT to them. Government can work toward opening of the economy through developing economic protocols and agreements, not necessarily through activist fiscal or monetary policies.

Importance of the two other secondary objectives, namely development of economic infrastructure, hardly needs a comment. The Prophet SAAWS has strongly advised all the believers to seek the refuge of Allah SWT from poverty. Common concern of all citizens automatically qualifies as a policy target. Being policy goals means monitoring and directing or coordinating necessary action in these respects at the government level. It, however, does not necessarily mean action through government budget. Monetary policy instruments may have a role here.

4.2 Goals of Fiscal and Monetary Policies

As noted at the outset, traditionally fiscal policy is seen as the policy that works through the government budget. It reflects on the role that the government is called upon to perform in its own name in the economy. Monetary policy, on the other hand, is associated with monetary management—in particular, the volume of liquidity in the economy—by the central bank. Both policies aim at macroeconomic stabilization through demand management. Fiscal policy is routed through public expenditures and taxes, and monetary through private investment in
the economy. Fiscal policy also acts as channel for distribution agenda assigned to the government. Government carries a welfare agenda whereby economic support is provided to the have-nots through a tax-transfer mechanism. Islamic economists have not challenged this conventional wisdom.

The discussion in section 2 reveals that the goals of both the policies have separately discussed in the Islamic economics literature. Full employment with price stability is deemed as the chief macroeconomic objective. But the argument is open-ended on other pursuits. In what follows, we review some of the goals for both the policies. The basis for our argument is that from the Islamic economics perspective monetary and fiscal authorities may not necessarily work as independent policies. Where necessary, action on both the fronts may be coordinated in the larger interest of the economy and the society.

To the extent that government is not expected to directly take part in economic activity for the Shari’ah reasons, fiscal policy will have minimal proactive role. Two arguments supporting this stance are as follows:

1. Government cannot compromise on its neutrality on the economic plane.
2. Government cannot tax one group, whether the existing taxpayers or future generations, and transfer the benefits to another.

The same principle largely applies to monetary policy with reading “central bank” instead of government in the above points.

The traditional goals assigned to these policies are not defensible for the following reasons:

1. Full employment without inflation. First of all, employment is a means to an end, not the end by itself. Secondly, with constraints emerging from the principles of no riba and no qimar will have two implications. First, real and financial sectors in the economy will be integrated. And, financial bubbles will not be created that are important cause of inflation and business cycles. Second, economic exchanges beneficial to only one party will be pushed into the background. Both these factors will encourage production and employment, and lessen chances of inflation.
2. Economy is unlikely to carry unmanageable deadweight of pensions and welfare payments that are an important cause of fiscal deficits and, hence, inflation.

Government can play defining role in determining the economic course of a country. But, given the Shari’ah constraints, the modus operandi will be short of direct intervention either on the fiscal or the monetary plane.

5. SOME PRACTICAL CONSIDERATIONS IN THE WORKING THE TWO POLICIES

At present in the case of government, the ruling elite makes fiscal decisions, the establishment (or, bureaucracy) implements them and the public (whether present or future generations) pick up the price tag. Social contract (constitution), laws, rules and regulations and binding consultative process (in the form of elected bodies in a democratic set-up) seek to ensure orderly working of the system. However, lack of common concerns at the three tiers of fiscal activity makes the system a recipe for disaster. This problem is partially resolved with the introduction of constraints on the nature and the role of government by the Shari’ah. These factors have been explained in the preceding sections. In what follows, we take note of some practical matters in the working of fiscal and monetary policies.

One thing should be clear at the outset. The welfare or distribution agenda of the society has to be off the government budget. It is to be managed separately with the system of zakah and other social safety-nets provided for the Shari’ah for this purpose.

Taxation warrants specific Shari’ah justification on a case by case basis. One implication of this principle is that taxation will be mostly earmarked. Closure of the option of interest-
free borrowing will bring forth additional constraints on fiscal action. This would result in, for example, curtailment of inessential expenditures under the various heads, such as law and order and national defense. A lot of fat from fiscal side of economy is likely to be shed away.

Economic subsidies for promoting economic activity by producers and exporters are difficult to justify on the Shari’ah grounds. Therefore, they are unlikely to have a place in the Islamic milieu. This ought to remove a big cause of fiscal deficits in a country.

As explained at length in the preceding sections, government’s active role will be brought into line with the natural role for a government. Government may make its economic contribution to the society through off-budget measures.

The following point will merit consideration in the Islamic fiscal set-up. Where government expenditure can be done in mutually exclusive ways, and all the options do not have identical distributive implications, preference may be given to the way with the implications for reduction income inequality.

As for the monetary side, one expects some radical changes. With the “no interest” restriction, banks will have access to demand deposits raised as interest-free loans to the banks as partnership-based deposits. In the former case, banks may use the available deposits in providing financing in their own names because ownership of the said deposits shall be with them. However, joint ownership of deposits generated through partnership-based modes will have far reaching implications. In principle, with the ownership of the funds belonging to both the depositors and the banks, the latter shall not be in position to do financing transactions (with the available funds) in the banks’ own names. This would place a cap on credit creation well-known in the interest-based banking industry. The notion of high-powered money is expected to change.

Notwithstanding the above, monetary authorities may call upon the banks to maintain reserves to back up demand deposits. However, no such requirement may be introduced in lieu of on deposits raised for investment purposes with the prior permission of the monetary authorities. Of course, the goal of limiting (increasing) the banks’ capacity to generate partnership-based deposits may be achieved by increasing (lowering) the contribution by the banks got raising the said deposits. Exogenously introduced restrictions on the ratio of profits shared by the banks with their depositors would violate the Shari’ah principle of no government intervention in bilateral matters.

The foregoing points should not raise alarms. The chief source of increase (decrease) in money supply will be Shari’ah-justified budgetary deficits (surpluses) of foreign trade surpluses (deficits). If capital markets are perfect, the velocity of circulation of available money supply, along with adjustments generated through international channels, should help meet liquidity needs of the economy. This was partly the case in the early Islamic state. The Prophet SAWWS and his four Rightly-guided successors took no steps on the monetary steps. Money was injected into the system through foreign trade surpluses. An additional source of money was the interested people bearing the cost of having their gold and silver minted into dinars and dirhams, respectively, by those who had special dyes for this purpose.

6. CONCLUDING OBSERVATIONS

The existing Islamic economics literature on fiscal and monetary literature came up before development of the thinking on nature and role of state and government as well as contours of the Islamic financial system. This study builds upon the original argument in the light of developments on the said matters during the last two decades.

Main messages of this study are two. First, fresh thinking is called for at the systemic level. Many a beneficial changes are possible in respect of the way the economy works and goals assigned to the policies under reference. Second, there is room for reviewing active role by the government on economic and distributive planes. The government’s responsibilities
should be reduced to only governance. The economic goals of a country may be met through development on the monetary side in the light of the Shari’ah. Even on the monetary side, major role of the respective authority may be regulatory.

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