ISLAMIC DEVELOPMENT BANK GROUP
ISLAMIC RESEARCH & TRAINING INSTITUTE

FINANCING PUBLIC EXPENDITURE: AN ISLAMIC PERSPECTIVE

OCCASIONAL PAPER
NO.7

ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

FINANCING PUBLIC EXPENDITURE:
AN ISLAMIC PERSPECTIVE

Munawar Iqbal and Tariqullah Khan

OCCASIONAL PAPER
NO. 7

JEDDAH – SAUDI ARABIA
1425H (2004)

KING FAHD NATIONAL CATALOGING-IN-PUBLICATION DATA

Iqbal, Munawar
Financing Public Expenditure: An Islamic Perspective / Munawar Iqbal ;
Tariqullah Khan- Jeddah, 2004

114 p, 17 X 24 cm

ISBN: 9960-32-149-5

1- Finnce, Public (Islamic law)   2- Islamic economy
3- Islamic Finance   I- Tariqullah Khan (author)   II-Title

257.2 dc   1425/4124

L.D. No.1425/4124
ISBN: 9960-32-149-5

First Edition: 1425H (2004)

بسم الله الرحمن الرحيم

BISMILLAHIRRAHMANIRRAHIM

CONTENTS

List of Tables

List of Figures

GLOSSARY OF ARABIC TERMS

Ahadith	Plural of *hadith*. For meaning, see below.
Al-maks	A pre-Islamic practice whereby the tribesmen imposed levies on karvan trade passing through their areas.
Ameer	Ruler.
Amwal	Plural of *mal.* For meaning see below.
Awqaf (also waqfs)	Plural of *waqf.* For meaning, see below.
Bayt al-mal	Public treasury, Also used for a charitable institution meant to help the poor and needy.
Da[wah	Acts and deeds for propagation of religion.
Falah	Literally, it means to become happy, to have success. Technically, it means achieving success in the life Hereafter.
Fard	A obligatory duty.
Fard kifayah	An obligatory duty the fulfilment of which is a joint responsibility of all members of the community. If someone performs it, it is considered to have been fulfilled, otherwise all members of the community are considered defaulters.
Fay'	Properties/assets that come into the hands of Muslims without fighting. (Compare with *ghanimah*).
Fiqh	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, *fiqh* covers all aspects of life, religious, political, social, commercial or economic. The whole corpus of *fiqh* is based primarily on interpretations of the Qur'an and the Sunnah and secondarily on *ijma[* (consensus) and *ijtihad* (individual judgement). While the Qur'an and the Sunnah are immutable, *fiqhi* verdicts may change due to changing circumstances.
Fiqhi	Relating to *fiqh*.
Fuqaha'	Plural of *faqīh* meaning jurist, who gives rulings on various juristic issues in the light of the Qur'an and the Sunnah.
Ghanimah	Enemy Properties/assets that come into the hands of Muslims after fighting.
Hadith	Sayings, deeds and endorsements of the Prophet Muhammad (peace be upon him) narrated by his Companions.
Harbi	People belonging to countries with which the Muslim state is at war.

Hawalah	Literally, it means transfer. Technically, it refers to an arrangement whereby a debtor transfers the responsibility of payment of a debt to a third party who owes the former a debt. It is also used for cheque or draft.
Hawalah or hawalah al-dayn	Islamic rules governing transfer (sale) of debt.
Hisbah	Literally, it means reward, calculation. Technically, it refers to an institution that existed through most of Islamic history for implementing what is proper and preventing what is improper. The main role of *al-hisbah* was the regulation and supervision of markets to ensure proper market conduct by all concerned.
[Ibadah	Duties of man due to God.
Idtirar	Doctrine of necessity, i.e. condition of extreme necessity which may temporarily suspend some Shari[ah ruling.
Ijarah	Leasing. Sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership.
Ijtihad	In technical terms, it refers to the endeavour of a jurist to derive a rule or reach a judgement based on evidence found in the Islamic sources of law, predominantly, the Qur'an and the Sunnah.
Istisna[	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good (or premise) at a given price on a given date in the future. As against *salam*, in *istisna[* the price need not be paid in advance. It may be paid in instalments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.
Jizyah	A levy imposed on non-Muslims living an Islamic states in lieu of providing protection to them without obligatory military duty.
Kharaj	A land tax (either lump sump or share in produce) imposed on non-Muslim's lands.
Khums	Literally means one-fifth. Technically a rate of tax of 20% imposed on certain types of wealth/assets.
Ma[adin	Mines/natural resources such as coal, copper, gold, petroleum.
Mal	Anything in the possession of someone having value.
Maqasid al-Shari[ah	Basic objectives of the Shari[ah. These are protection of faith, life, progeny, property and reason.

Maslahah (plural masalih)	Literally, it means benefit. Technically, it refers to any action taken to protect any one of the five basic objectives of the Shari[ah i.e. Protection of faith, life, progeny, property and reason.
Mudarabah	A contract between two parties, capital owner(s) or financiers (called *rabb al-mal*) and an investment manager (called *mudarib*). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur's loss lies in not getting any reward for his services.
Mudarib	An investment manager in a *mudarabah* contract.
Muqaradah	Same as *mudarabah*.
Murabahah	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. *Murabahah* is also referred to as *bay[mu'ajjal.*
Musaqah	A contract in which the owner of a garden agrees to share its produce with someone in an agreed proportion in return for the latter's services in irrigating and looking after the garden.
Musharakah	Partnership. A *musharakah* contract is similar to a *mudarabah* contract, the difference being that in the former both the partners participate in the management and the provision of capital, and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital.
Muzara[ah	Crop-sharing contract. Two or more parties contribute land, seed, fertilizer, water, etc., and share the crop in agreed proportions.
Nisab	In reference to *zakah*, the limit of wealth that marks the beginning of the imposition of *zakah* liability. Wealth below this limit is exempt.
Nusus	Texts from Qur'an or Sunnah.
Qur'an	The Holy Book of Muslims, consisting of the revelations made by God to the Prophet Muhammad (peace be upon him). The Qur'an lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life.
Qur'anic	Reference from Qur'an.

Riba	Literally, it means increase or addition or growth. Technically it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by a predominant majority of *fuqaha'* to be equivalent to *riba*.
Sadaqah	An act of charity.
Salam	The short form of *bay[al salam*.
Sarf	Islamic rules governing currency exchange.
Shari[ah	Refers to the corpus of Islamic law based on Divine guidance as given by the Qur'an and the Sunnah and embodies all aspects of the Islamic faith, including beliefs and practices.
Shura	The Islamic principle of mutual consultation before arriving at decision.
Sukuk	Plural of '*sakk*' which refers to a financial paper showing entitlement of the holder to the amount of money shown on it. The English word 'cheque' has been derived from it. Technically, *sukuk* are financial instruments entitling their holders to some financial claims.
Sunnah	The Sunnah is the second most important source of the Islamic faith after the Qur'an and refers to the Prophet's (peace be upon him) example as indicated by his practice of the faith. The only way to know the Sunnah is through the collection of *ahadith*, which consist of reports about the sayings, deeds and endorsements of the Prophet (peace be upon him).
Surah	A chapter of Al-Qur'an.
Takaful	An alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone of the group, the loss is met from the collected funds.
[Ushr	Referring to the law of *zakah*, it means a rate of ten percent leviable on certain types of wealth/output/income.
[Ushur	Taxes imposed on foreign trade during the period of Caliph Omar.
Wakalah	Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
Wakil	Agent.

Waqf	Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the *waqf.*
Zakah	The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy.
Zakatul ard	*Zakah* imposed on the produce of land.
Zakatul mal	*Zakah* imposed on assets/properties.
Zulm	Unfair, unjust, unduly encroaching upon the rights of others.

FOREWORD

Financing public expenditure is one of the most important challenges faced by the policy makers of most countries. The problem is more serious in the developing world. In several member countries of the Islamic Development Bank (IDB), governments require huge amount of resources for financing basic programs such as poverty reduction, human development and maintenance of law and order. Therefore, large budget deficits have become a severe chronic problem in these countries. The challenge is complex. There are no simple solutions at hand nor such solutions can be expected from a single study. The present IRTI Occasional Paper on "Financing Public Expenditure: An Islamic Perspective" prepared by Munawar Iqbal and Tariqullah Khan makes an attempt to discuss and analyze some aspects of this difficult problem.

The paper puts the challenge in its historical context. It reviews the relevant literature regarding the size and purposes of public expenditure, provides an empirical background about the allocation of public expenditure in IDB member countries and presents an overview of the traditional and modern sources of financing public expenditure from an Islamic economic viewpoint. The potential of the Islamic financial instruments for public sector resources mobilization and the relevance of the build-operate-transfer (BOT) mechanism of project financing are discussed and analyzed.

At the end, the paper makes an effort to suggest some policy recommendations. IRTI will continue its efforts in discussing issues of current interest to member countries. It is hoped that the present paper can motivate further thinking, studies and analysis in this important area.

Bashir Ali Khallat
Acting Director, IRTI

EXECUTIVE SUMMARY

Governments require large amounts of resources for financing basic programs such as poverty reduction and maintenance of law and order. In most IDB member countries the required resources are not available. Therefore, in these countries large budget deficits have become a severe chronic problem. What may possibly be done that can contribute to alleviating the mismatch between government revenues and expenditures? This is a complex question. Obviously there are no simple answers available. The present IRTI Occasional Paper on "Financing Public Expenditure: An Islamic Perspective" makes an attempt to discuss and analyze some aspects of the difficult challenge.

The paper consists of five sections. Section one introduces the challenge and the objective of the paper. Section two reviews the position of Islamic scholars regarding the size and purpose of public expenditure, provides an empirical background about the allocation of public expenditure in IDB member countries and presents a historical overview of the traditional and modern sources of financing public expenditure in the Muslim societies. Section three discusses the potential of the emerging phenomenon of investment *sukuk* in this regard. Section four deals with the relevance of the build-operate-transfer (BOT) mechanism of project financing as an alternative source of financing public expenditure. In the final section of the paper, conclusions and policy implications are summarized.

The conclusions and policy proposals of the paper include the following:

i) All genuine expenditure of the government must be met through taxes and non-tax revenues. Deficit financing is not a good public policy for any government and under normal circumstances it should be avoided.

ii) There are a number of identifiable problems for the mismatch in government revenues and expenditures. The reasons include the large size of the public sector, the needs for large defense and security expenditures, narrow and rigid tax structure, tax evasion, availability of interest-based credit, and lack of transparency and good governance. These problems need to be properly addressed.

iii) It must be realized that the "classical" Islamic sources of financing public expenditure may not be enough in contemporary societies. There is an urgent need to find innovative ways for mobilizing resources to meet the requirements of the public sector. While doing this, the distinction between current expenditure and the development expenditure should be kept in view. The present practice of generating resources from all possible sources and then meeting current expenditure out of the available pool and transferring the residual to the development budget needs to be reviewed.

iv) The two kinds of expenditures need to be mobilized through distinctly separate approaches. For meeting the development needs, the possibilities of a more active participation by the private sector should be considered. Many public projects can be undertaken on the basis of techniques, such as BOT and investment *sukuk*, that do not involve interest. The efficiency of BOT and its variants depends on the health of the economy, especially of the financial institutions and markets. The arrangements function smoothly as long as the economy performs well. When there is an economic problem, particularly, during periods of financial crisis, due to rigid pricing and other contract structures, these arrangements do not remain viable and sustainable. In fact, under situations of financial crisis, the economic cost of the new forms of investment can be far greater for the economy concerned as compared to the cost of the traditional debt finance. However, if the economy is not prone to financial crisis, the new investment relations can be sustainable and more efficient. Since *sukuk* and Islamic financing in general are based on real assets, therefore, these arrangements are expected to enhance the stability of financial institutions and markets. Hence it can be suggested that the utilization of BOT and its variants along with the *sukuk* structures and Islamic financing principles in general can be a better alternative to the combination of BOT and traditional interest-based debt financing.

v) In general, tax revenues often fall short of government's resource needs. Therefore, a prudential combination of the BOT variants, Islamic financial instruments and taxation may be utilized by the governments. The important point which this research suggests is that such a policy towards financing government expenditure is expected to discipline public expenditure as availability of finance without an asset will be very limited. This is also expected to introduce prudence in the overall macroeconomic management as well as in the efficiency of microeconomic units operating in an economy.

vi) The role of *awqaf* and other non-governmental organizations in the provision of public goods such as education and health needs encouragement and promotion. These were the biggest sources of financing public utilities and services in the early Islamic history and there is no reason this cannot become sizable and dynamic if proper efforts for harnessing these are undertaken.

I. INTRODUCTION*

1.1 STATEMENT OF THE PROBLEM

Most developing countries are in need of large amount of financial resources to alleviate poverty, promote human development, and enhance the effectiveness of their governance systems. A large number of these countries are facing the challenge of chronic budget deficit, which causes inflation and further erodes the fragile standards of living. In many of these countries, the situation has reached alarming proportions. Simply stated, if the budget is not in balance, it is either because the public expenditure is too much or that the public revenue is too little. Most member countries of the Islamic Development Bank also share this common challenge.

Both inflation and the build-up of interest-based debts are repugnant to Islamic economic principles. Inflation distorts allocation of resources and renders the whole payments system inequitable. Public debt obtained on interest violates the clear and unequivocal prohibition of *riba* in Islam. Even on purely economic grounds, deficit financing is a dangerous policy except in a very limited way (to mobilize untapped resources by increasing aggregate demand through government expenditure). Similarly, public borrowing, even in a traditional framework, would be prudent only if the expected rate of social return from the project being financed through borrowing is higher than the social cost of obtaining the resources. However, this simple and rather obvious principle is often ignored in practice.

What is even more disturbing is the fact that in spite of huge public sector allocations financed through borrowing, most of these countries have not been able to build viable physical infrastructures. It is painful to note that a majority of population in these countries is living in slums or undeveloped rural areas without even safe drinking water, not to speak of

* The authors are grateful for the highly valuable comments received from the EP&SP Department and COD-3. These comments have been intensively utilized by the authors in revising the paper. However, the remaining weaknesses of the paper are the authors own and do not reflect the comments of the two departments.

electricity, sewerage or other civic facilities. The rates of literacy are low; health facilities are severely deficient; public transport facilities are extremely limited and infrastructure for sustainable development has not been put in place. Even after decades of high spending, most of these countries have not been able to develop good railroad facilities, good roads, good schools, adequate health care, sufficient energy for industrial and domestic requirements, adequate irrigation facilities and similar economic and social infrastructure.

Failure to build human and physical infrastructure compounded the problem because the supposed long-term benefits of over-spending in the form of generating higher public revenues as a result of higher growth rates did not materialize and the countries developed an inherent dependence on deficit financing and/or foreign borrowing. This led to a huge built-up of public debt and in many countries servicing of this debt became one of the largest heads of public expenditure. That has complicated the situation even further. The increasing burden of debt-servicing has siphoned off public resources from social and developmental sectors. Furthermore, as the debt increased, the countries were forced to borrow on more and more stringent conditions. Many of these countries are now caught up in the vicious circle of more borrowing, more debt-servicing, even higher debt-servicing and ever increasing debt. This situation resembles an inverse pyramid which is obviously bound to crumble sooner or later.

1.2 ARE THERE ANY SOLUTIONS?

The answer is that there are no easy solutions. Curtailing public expenditures and raising additional tax revenues are both difficult decisions to take. Instead of taking these difficult decisions, it has been found easier by policy makers to bridge the resource gap by printing more money or borrowing from domestic and international markets. Any reform proposal must start from “right-sizing” the public sector. The period starting from early 1940's and stretching well into 1970's was in general dominated by “big government” philosophy all over the world. In the light of the prevailing philosophy, the developing countries were advised to increase public investment to take over many economic activities, especially through the creation of public enterprises, thus providing capital and managerial skills assumed to be lacking in the private sector.

Most underdeveloped countries followed the advice. For a large number of IDB member countries this period was very crucial. They were becoming independent after long periods of colonial rule and were in the initial stages of public policy formulation. Dominant philosophy and the strong desire to develop as fast as possible pushed them into the direction of having large public sectors. In addition, the private sector was overburdened with a host of regulations. Such over-regulation and crowding-out almost stifled the private sector. They did not realize that the assumptions on which big government theories were based did not prevail in their economies. In developing economies, the infant industry argument carries a lot of weight. The private sector needs to be encouraged rather than subdued. Once a proper level of public sector has been determined, bold decisions need to be taken to mobilize resources for financing that expenditure. Borrowing should remain an exception that may be resorted to in rare and extreme situations.

1.3 OBJECTIVES

The main objective of the present paper is to discuss the contemporary challenges of financing public expenditure in the light of Islamic economic principles. To achieve this objective, the paper aims at:

- Deriving lessons from Islamic economic thought and history concerning the desirable economic role of the state, and the traditional Islamic sources of public revenue and heads of expenditure;
- Assessing the magnitude and the nature of the current problem faced by the IDB member countries and discussing the adequacy of the traditional Islamic sources of revenues in meeting the contemporary challenge;
- Studying the evolution and efficacy of the alternative methods of financing public projects and the recent emergence of *sukuk* as a form of sovereign borrowing, and;
- Putting forward more recommendations for consideration of policy makers.

1.4 SCOPE, METHODOLOGY AND OVERVIEW OF THE PAPER

The statement of the problem and the needs towards searching for the solutions given above define the scope of the paper. The approach of taking the government expenditure as more or less exogenously given has been at the root of the problem. Any reform proposal must therefore, start by "right-sizing" the public sector. In order to do that one needs to define the role of state in economic matters. Different economic philosophies ascribe different roles to the state. In this perspective, the paper will first attempt to define the role of state from an Islamic perspective. Different opinions of Islamic scholars on this issue have been presented and examined in section two.

The *raison-detre* of governments is the protection of public interests. Therefore, financing all public expenditure is the collective responsibility of the society. The problem does not normally assume serious proportions if a country has natural wealth as a major source of public revenue. For the rest of the countries, taxation has to be the major source of public revenue. Here lies the second problem. While these countries committed themselves to big government expenditure, they were not able to mobilize sufficient resources through taxation because: (i) The proportion of "cash economy" in these countries was very small which made it difficult to collect taxes; (ii) There were difficulties in defining and measuring the tax base and of assessing and collecting taxes due to low level of literacy; (iii) Administrative structures were not very well geared to fulfill these functions; and most importantly because (iv) Taxation is politically unpopular and governments, especially those which lack public support or stability, avoid this option. The lack of sufficient tax revenue forced these governments to resort to borrowing and deficit financing. These two in turn became the major causes of the fiscal crises in these countries.

Section two of the paper also presents empirical evidence on these issues in order to determine the right size of a government. This section also discusses different sources of financing public expenditure. In order to provide an Islamic perspective, a historical approach is adopted since the practices of the era of the Prophet (peace be upon him) and the rightly guided caliphs is regarded as acceptable precedence. Taxation being the most potent source of public revenue in modern times, the debate among

Islamic scholars on the right of the rulers to impose taxes have also been reviewed in that section.

Most of the relevant literature has been surveyed, but instead of providing a separate section on that, the methodology adopted in this paper is to survey the relevant literature in a thematic manner. Since on most of the issues discussed in this paper, more than one opinion exist among Islamic scholars, the methodology used is to present and analyze different opinions on a particular issue, put them into contemporary context, provide relevant empirical information wherever possible and then arrive at conclusions based on merits of the arguments and empirical evidence.

In section three Islamic financial instruments for public sector resource mobilization are discussed. The modes and instruments discussed there are not new in the sense that they are being proposed for the first time. Instead an attempt has been made to survey the theory and practices of these instruments particularly for financing public expenditure. In section four the role of build-operate-transfer (BOT) mechanism in financing infrastructure projects has been discussed.

As a result, a vast "menu" of available unconventional instruments for public sector resource mobilization has been provided. The fact that these new modes have been used and/or are being used in contemporary world, will hopefully help member countries to learn lessons from these experiences and follow best practices for their own resource needs after adapting them to local conditions.

The final section of the paper provides conclusions and some policy recommendations.

II. HEADS OF PUBLIC EXPENDITURES AND SOURCES OF REVENUES: A HISTORICAL PERSPECTIVE

The role of state in any society depends on the prevailing philosophy that it follows. The subject has been on of the most controversial issues in economics. Until 1930s, the dominant philosophy was *laissez faire*, whereby governments were advised not to intervene in the operation of market. It was believed that “rational” individuals pursuing there “self-interests” in “competitive markets” will achieve both private and public interest simultaneously. The “invisible hand” of market forces would ensure symmetry between public and private interests and the best allocation of resources. Hence there was no need for the government to assume any economic role accept to set the rules of the game according to the requirements of perfect competition. Government intervention could be accepted only to remove market distortions or to offset “market failures”.

In the aftermath of “Great Depression” this paradigm was challenged by Keynesian economists on the grounds that markets are generally characterized by imperfections and rigidities and hence may not always ensure full employment and the best allocation of resources. Moreover, the market forces left to themselves, may not produce the distribution of income desired by the society. Partly due to rising levels of unemployment and income inequalities and partly as a reaction to communist philosophy, governments started taking upon themselves the responsibility of supporting the unemployed, the disabled, the old and the very young. The period starting from early 1940's and stretching well into 1970's was in general dominated by big government philosophy all over the world.

A more serious challenge to the *laissez faire* paradigm came from Marxist economists who argued that the interaction of the institutions of market and the private property perpetuates injustice and exploitation leading to class conflicts. Hence markets were replaced with central planning and private property with public control of the means of production.

The collapse of socialism in the Soviet Union and Eastern Europe around 1990s shifted the balance once again in favor of economic liberalism. This however, proved to be short lived. The imperfections of the market, the unrest created by wide disparities in the distribution of income and wealth, the pressing concerns for social justice, unethical use of the enormous powers that the market bestows upon the transnational corporations, and non-sustainability of long run economic growth without active monetary and fiscal policies have once again focused the attention of economists and policy makers on the need for some critical role for the state in economic matters. There is now a near consensus in conventional economics that government policies have an important impact on economic variables and that governments can and should intervene in the markets to achieve economic goals of the society.

In Islamic economic literature also, the role of state has been a subject of debate. The importance of the institution of state has never been under-estimated. It is seen to be absolutely necessary to continue the mission of the prophet (peace be upon him), i.e., achievement of the *maqasid al-shari[ah*. The distinction from conventional economics is obvious. The state is seen to be an agent of God for the realization of *maqasid al-shari[ah*. For example, in an Islamic state any allocation of resources that hinders the realization of *maqasid* would be treated as inefficient. Similarly achievement of equity and justice become essential components of public policy.

The controversy among Islamic scholars arises when it comes to specifying the economic functions of the state. The institutions of *bayt al-mal* and *hisbah* have been the two indispensable components of the institutional set up of Islamic states in the economic sphere. *Bayt al-mal* looked after the welfare functions of the state while the institution of *hisbah* was to ensure that all economic agents fulfilled their obligations to one another on the one hand and worked within the rules prescribed by the shari[ah on the other hand. Beyond that there are two major schools of thought among Islamic scholars. Some writers have argued that in an Islamic economy a clear distinction must be made between the subsistence welfare and the desired welfare. Provision of the subsistence level is not only an objective of economic policy, but is also an obligation, whereas the provision of an adequate standard of living is only desired. Included in the first category are aids and services provided to people stricken by a natural calamity, war, famine, or lack of production to below subsistence level, etc. The second category includes social services aimed at improving the economic living of the poor. Some scholars believe that in fulfilling what is required, the state has to acquire the necessary resources while in providing what is desired, it is limited to the use of the available resources only (See Kahf, 1983). Many earlier writers were not in favor of a pro-active developmental role for the state. Similarly, these scholars were reluctant to allow the rulers to impose taxes other than the conventional ones. This view is based on the unequivocal guarantee of individual freedom and the sanctity of private property right in the Islamic system and contends that any compulsory government charge is a violation of private property rights. It is, maintained that the levying of taxes, in addition to *zakah*, is an exception and not a rule.[1]

Most modern scholars, however, see a more pro-active role for the state. The authority vested in the rulers has two aspects. First and foremost they are the "viceroy" of Allah and have to discharge the powers delegated to them by Him for to continue the function of Prophethood. It is agreed by all that the state has to strive for the fulfillment of the *maqasid*. Secondly, rulers are "agents" of the society for the achievement of objectives that the society sets for itself. Citizens may assign any duties to the state through the process of *shura*. Even under the first role, the achievement of the general welfare of citizens in contemporary context would require the state to take up some developmental functions. Therefore, modern writers in general envision a broader role for the state.[2]

---

1 See Kahf, 1983. We will discuss this debate in some detail later (section 4).

2 These writers include Shah Waliullah, Abu Yusuf, Baqir Sadr, Sayyid Mawdudi, Umer Chapra and Nejatullah Siddiqi. Siddiqi (1996) provides references to many writings on this point. Also see Ahmed, et al. (1983a), pp. 154-161.

ROLE OF STATE IN ISLAMIC PERSPECTIVE

The role of state in an Islamic framework has two tiers:
(i) Vicegerency and (ii) Agentship role.

In its first role, the state has to implement the provisions of Shari/ah. This involves two things. First to implement the Shari[ah laws in areas where these have been prescribed and second, to undertake fresh legislation to regulate and guide the society in affairs left unregulated by Shari[ah. In legislating in such matters the state will be guided by the spirit and objectives of Shari[ah. While the state cannot legalize what is explicitly illegal in Shari[ah or absolve individuals of duties Shari[ah has explicitly charged them with, it can always issue a fresh list of dos and don'ts to regulate the economy and guide it towards the cherished goals. In this regard it enjoys the widest powers, subject to the constraint that decisions are taken after due consultation. In terms of the economic functions of state, it would oblige the state to perform the functions assigned by Shari[ah on a permanent basis such as *da[wah*, defense, law and order, provision of justice etc[3]. It would also authorize the state to perform those economic functions which become necessary under present circumstances for the achievement of the objectives of Shari[ah. This latter category should emerge from proper process of *ijtehad*.

In its agentship role the state has to serve the broader interests of the society and to exercise the authority given to it by the collective will. The state is obliged to perform any function that the society assigns to it subject to the condition that it does not violate any principles of Shari[ah.

To conclude, the scope for state functions is very wide. Islamic state is a "welfare state" in the broadest sense, noting that when Qur'an speaks of "*falah*" (welfare), it always includes, rather emphasizes, the welfare in the Hereafter. However, except for very short-term, the size of the government must be limited by its ability to generate sufficient resources. Continued deficits for long periods, should not be tolerated.

[3] Some Islamic scholars have added other functions as being permanent heads of expenditure in an Islamic state. We will discuss that in a later section.

2.1 ECONOMIC FUNCTIONS OF STATE IN THE CONTEMPORARY WORLD

Moving from the general discussion on the role of state to the specific subject of our interest in this paper, i.e., scope of public expenditure in a modern Islamic state, the discussion must start from the heads of expenditure of *zakah* and *ghanimah* because these two have been laid down in the Qur'an itself. As the needs of the Islamic community increased, other functions became necessary to be performed. Other sources of public revenue also became available. Therefore, the role of Islamic state expanded gradually. The most important source of information on the economic functions of an Islamic state are the discussions in the classical literature of the institution of *Bayt al-mal.,* the exchequer. Writers have also discussed the sources of income and the heads of public expenditure under the title of *kharaj* or *amwal* and some times in the discussions of the heads of expenditure of *zakah* since collection and disbursement of *zakah* is an agreed public duty.

The eight heads on which of *zakah* revenue is to be spent, namely, (i) poor, (ii) needy, (iii) *zakah* collectors, (iv) those whose hearts are to be reconciled, (v) to free captives, (vi) debtors, (vii) in the cause of Allah and (viii) wayfarer are undisputedly the primary and permanent heads of expenditure of an Islamic state. Similarly, the heads on which the states' share of *ghanimah*[4] is to be spent comprise (i) the Prophet (after his death, this share is also allocated to the other four categories), (ii) Prophet's relatives (iii) orphans (iv) needy and (v) wayfarers.

From these two lists the heads of public expenditure that are established beyond doubt are (i) Provision of basic needs and relief, (ii) defense, and (iii) promotion and protection of faith. The share kept for collectors in case of *zakah* implies a fourth head i.e. civil administration.

Islamic jurists have also dealt with the functions of an Islamic state when they discussed the duties of the rulers. The list of duties of an Islamic ruler given by al-Mawardi cover defense, law and order, *da[wah*, enjoining right conduct, need fulfillment, administration and

[4] *Ghanimah* is that property which falls in the hands of Muslim fighters after a war. Four-fifths of this must be distributed among the fighters. The remaining one-fifth, called *khums,* is to be spent by the ruler as dictated by Qur'an.

development.[5] Abu Ya'la has a similar list.[6] Al-Ghazali has emphasized need fulfillment,[7] and al-Kasani includes roads and bridges, mosques, rest houses, canals and other public works among the heads of expenditure on which *kharaj* revenue may be spent.[8] Abu Yusuf includes public works of a development nature among the duties of the ruler, even though the modes of financing different works would differ depending upon whether the benefits flow to all or to people of a particular region.[9] Imam al-Haymayn al-Juwayni[10] emphasizes protection of religion, *da[wah*, defense and *jihad*, law and order, dispensation of justice, elimination of corruption and need fulfillment. Discussing the heads of expenditure of public revenue, Ibn Taymiyah includes defense, law and order, justice, civil administration, need fulfillment, grants to the newly converted or even to non-Muslims for promoting the cause of Islam, and salaries to public functionaries including those appointed to call for prayers or lead them. He includes public works like roads, bridges, canals, etc.[11] Shah Waliullah al-Dihlawi also includes need fulfillment, defense, law and order, *hisbah*, protection and promotion of religion and public works like canals and bridges among the heads of public expenditure.[12]

If we review the history of Muslim states in the first two centuries, evidence is found for the state spending on the following heads:

1. Beneficiaries of *zakah* and *khums* (these have been mentioned above).
2. Grants to Individuals. These included regular pensions, monthly rations of food (and some times clothing) and occasional bonuses. The purposes for which these grants were given included, (a) military service, either active or readiness to render on demand (b) civil service, (c) rewarding good

5 Al-Mawardi, (1979).
6 Abu Ya'la, (1974).
7 Al-Ghazali, Abu Hamid, (1967).
8 Al-Kasani, Abu Bakr bin Mas[ud, (1910).
9 Abu Yusuf, Kitab al Kharaj, (1397H).
10 Imam al Haramayn al Juwayni (1401H).
11 Ibn Taymiyah, (1967).
12 Al-Dihlawi, Shah Waliullah, (n.d).

behavior, (d) recognition and respect and (e) sharing public affluence to reduce income disparities.

3. Military Equipment and Installations
4. Civil Administration including market inspection (*hisbah*)
5. Payments to outsiders for seeking peace and protection or release of prisoners,
6. Public Facilities such as public hospitals, rest houses for travelers, postal arrangements
7. Public Works such as building of roads, canals, dams, land reclamation and habilitation, and
8. Welfare Activities.

Among the modern writers, Chapra (1979) and Siddiqi (1996) made the most important contributions to the subject. Chapra deals with the economic functions of the state in a general way while Siddiqi attempts to develop a theory of public expenditure from historical evidence on various heads of public expenditure. According to Chapra the economic functions of an Islamic state include:

1. To eradicate poverty and create conditions for full employment and a high rate of growth.
2. To promote stability in the real value of money.
3. To maintain law and order.
4. To ensure social and economic justice.
5. To arrange social security and foster equitable distribution of income and wealth.
6. To harmonize international relations and ensure national defence.

Siddiqi (1996) divides the heads of public expenditure in a contemporary Islamic state into three categories and provides a list of items under each category:

A. Permanent Heads of Expenditure

(i) Defense.
(ii) Law and order.
(iii) Justice.
(iv) Need fulfillment.[13]
(v) *Da'wah*, i.e. communicating the message of Allah to mankind.
(vi) Enjoining right conduct and forbidding wrong (*al-amr bi'l-ma'ruf wa'l-nahy 'an al-munkar*).
(vii) Civil administration.
(viii) Fulfillment of such social obligations (*fard kifayah*)[14] as the private sector fails to fulfill.

B. Expenditures Necessary in the Light of Shari[ah in Present Circumstances

(i) Protection of the environment.
(ii) Supply of necessary public goods other than those included in the first list.
(iii) Scientific research.
(iv) Capital formation and economic development.
(v) Subsidies for priority private activities.
(vi) Expenditure necessitated by stabilization policies.

C. Expenditure on Activities Assigned by the People

This is an open-ended category. Individuals are free to organize any activity individually or in groups, that they think would promote their individual, group or societal interests. But individuals are also free to assign any activity to the state. They may do so because the state is

---

[13] He considers provision of food, water, clothing, housing, education and transport as the minimum.

[14] As explained by Siddiqi, these are duties that must be performed irrespective of who performs them. In other words, their performance is not the duty of any particular individual. They devolve on the totality of all individual. If anyone performs them, the duty is discharged. If none performs, the whole society is guilty.

better equipped to serve a particular interest, because it will be more cost efficient or for any other reason. The decisive factor involved in the people's decision is *maslahah*, its protection and *mafsadah*, its prevention.

The list of heads of public expenditure given by Siddiqi is so wide that almost anything under the sun can be included in it. As far as "possibility" of inclusion of such expenditure in the public domain is concerned, there may not be much argument. Review of Islamic history summarized above shows that the scope of public expenditure is indeed very wide. However, the problem arises when it comes to finding appropriate resources for financing such expenditure. Siddiqi side-stepped that issue by saying, "that sufficient revenue has in fact been provided for making these expenditures, is not within the scope of this study". This seems to be counter-historical. New heads of expenditure paid out of *bayt al mal* were added only after revenues became abundant. In case of abundance, *bayt al mal* being the "property of Muslims", anyone could approach the government for *any* genuine need or the government could use it for *anything* benefiting the community at large. The tendency of the Prophet (may peace be upon him) and the rightly-guided caliphs was to "spend/distribute" all receipts into the *bayt al mal* and therefore, as the revenue increased so did the expenditure.

Another problem with his approach emanates from his view that "there are certain functions an Islamic state must perform and that the discharge of these functions <u>necessarily</u>[15] involves expenditure". Strictly speaking that is also not true.[16] Performing a function by the state may or may not necessarily involve public expenditure. For example provision of basic needs to the needy may be *organized* by the state without any or limited public expenditure.[17] Similarly, *provision* of social goods by the government does not necessarily mean *production* of these goods in the public sector. They may be *produced* in the private sector and then *provided* to the government in some cases for a price and in other cases free.

---

15 Underlining our's.

16 Later passages in the same article acknowledge that.

17 Zarqa (1986) mentions more than twenty redistributive schemes that can contribute towards the provision of basic needs. Very few of these require public expenditure.

2.2. RIGHT SIZING PUBLIC EXPENDITURE

In the light of above discussion, we believe that public expenditure cannot be fixed either in terms of the heads of expenditure or in terms of its quantity. As far as the scope of public expenditure is concerned, *anything* that contributes towards achieving the *maqasid al-shari[ah* is a genuine item of public expenditure. Any attempt beyond that to count or categorize the heads of public expenditure is bound to remain imperfect. The factors that determine the heads or size of public expenditure in a particular society include the specific circumstances facing it and the availability of resources at a given point in time. In some cases the size of expenditure on the most permanent of the permanent heads of expenditure may not be justifiable. Let us take the example of defense. There is evidence that the Prophet (may peace be upon him) resorted even to borrowing, something he normally very much disliked, in order to meet defense expenditure. However, compare this to the case of a modern state financing it through borrowing from not-so-friendly countries who may use the strangle of debt to dictate terms or create circumstances that would be counter to the achievement of other *maqasid al-shari[ah* or even the defense itself in the long run. In such circumstances, defense expenses may have to be curtailed unless ways are found to raise the required funds through other legitimate means. To give another example, there are emerging new heads of expenditure that may assume a higher priority in terms of *maqasid al-shari[ah*. For example, in a period when hostile propaganda is creating doubts about the very foundations of Islam, expenditure on media and public relationing should be one of the top priorities for public expenditure in Islamic countries.

2.3 EMPIRICAL EVIDENCE ON BUDGETARY POSITION FROM SELECTED IDB MEMBER COUNTRIES

Therefore, the right size of public expenditure has to be determined with respect to the ability of the government to mobilize sufficient resources. While the possibility of deficit financing cannot be ruled out in the short-term, it must be kept within manageable limits and in the long-term the government must try to balance the budget.[18] Table 1 presents historical data on the budgetary position of some Muslim countries.

[18] Later in the paper, we will also discuss the possibilities of some "off-budget" financing of public projects.

Table 1: Budgetary Position in Some IDB Member Countries

(Millions US $)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Algeria	NA	NA	NA	NA	-1695.0	-527.0	1390.9	1099.9	-1723.4	-168.0	5315.4
Azerbaijan	NA	NA	NA	NA	-133.2	-75.7	-93.6	-170.3	-237.0	-229.1	NA
Bahrain	-96.8	-87.8	-223.9	-130.1	-392.0	-183.2	90.2	34.8	-340.7	-122.1	767.6
Bangladesh	NA	NA	NA	NA	NA	NA	NA	NA	NA	-1573.8	NA
Burkina Faso	-111.4	-32.9	-106.4	-3.1	NA	NA	NA	NA	NA	NA	NA
Cameroon	-641.7	-666.9	-294.3	-199.8	-225.7	21.7	NA	NA	NA	NA	NA
Cote d'Ivoire	-270.5	NA	NA	NA	-574.7	-439.3	-299.7	-285.3	-285.8	-405.9	-160.3
Egypt	-2090.2	-808.3	-2777.6	-625.7	-234.8	659.6	-3303.9	-3295.3	NA	NA	NA
Guinea	-195.4	-216.4	-224.9	NA	NA	NA	NA	NA	-249.6	-324.1	NA
Indonesia	459.0	561.9	-766.3	639.6	3483.9	6087.2	5261.8	328.8	-1669.3	-3470.6	NA
Iran	-2205.3	NA	NA	-377.8	-220.5	951.6	851.3	-572.1	-5923.5	-887.6	-980.8
Jordan	-388.2	-434.0	40.8	-167.6	-216.6	-200.4	-427.2	-522.0	-642.3	-388.4	-515.1
Kazakhstan	NA	NA	NA	NA	NA	NA	NA	-1309.9	-1589.0	-1099.7	-549.9
Kuwait	635.4	-1830.8	-18060.7	-6986.7	-5336.7	-3696.4	-2919.1	1193.4	-1450.4	-2848.1	NA
Kyrgyz Republic	NA	NA	NA	-134.8	-118.3	-165.6	-137.1	-124.6	-73.7	-48.3	-52.5
Lebanon	NA	NA	NA	-697.2	-1867.8	-2041.0	-2671.7	-3881.0	-2596.1	-2680.5	NA
Malaysia	-1280.6	-225.1	-127.6	1133.6	3232.5	2120.7	2967.2	3394.7	NA	NA	NA
Maldives	-25.6	-43.6	-45.8	-50.5	-32.6	-43.5	-31.5	-24.2	-29.8	-37.1	-45.7
Morocco	-622.4	-592.3	-388.6	-932.2	-1198.4	-1705.6	NA	-787.1	-1191.2	-1025.3	NA
Oman	-70.7	-834.6	-1482.2	-1355.3	-1385.4	-1287.4	-750.1	22.1	-1054.6	-1228.4	-926.9
Pakistan	-1320.7	-2983.8	-3138.9	-3386.6	-2980.3	-3384.9	-4321.8	-4203.2	-3508.9	-3247.0	-3751.8
Senegal	NA	NA	NA	NA	NA	NA	-215.8	-97.0	-94.1	-146.4	-111.1
Sierra Leone	-17.9	-44.0	-43.3	-43.0	-63.5	-60.3	-63.5	-58.9	-44.7	-92.6	NA
Sudan	NA	NA	NA	NA	NA	NA	NA	NA	-44.8	-46.3	NA
Syria	7.2	-242.1	-0.7	-91.0	-402.5	-218.7	-67.2	-49.1	-107.0	112.3	NA
Tajikistan	NA	NA	NA	NA	NA	NA	NA	NA	-45.7	-24.2	-7.9
Tunisia	-479.1	-660.9	-405.9	-409.6	-144.6	-492.1	-580.4	-610.9	-466.7	-589.4	-673.9
Turkey	-5612.3	-10108.2	-7220.9	-12341.5	-5266.6	-7262.4	-15405.1	-15142.8	-16715.4	-23024.0	-22642.9
UAE	-3399.3	-3712.9	-3127.2	-3443.8	-3452.4	-3809.6	-3254.7	-3393.4	-3615.0	NA	NA
Yemen	-430.8	-212.7	-673.3	-596.2	-554.1	-179.6	-17.2	-1.2	-77.4	-209.5	NA

Source: Calculated from data given in Appendix Tables.

With thirty countries in the sample and 11 years' times series, altogether we have 330 observations. Out of these, in 94 cases, either public revenue or public expenditure figures are not available. This leaves us with 236 observations. Table 2 provides a summary position on budget for these observations. It may be seen that in 208 (88 percent) cases the governments ran deficit budgets while in only 28 cases (12 percent) surplus budgets were witnessed. With a few exceptions, most these cases were observed in countries where a large part of government revenue comes from oil wealth.

Table 2
Summary of Budgetary Position in Some IDB Member Countries (1990-2000)

	Budget Deficit Instances		Budget Surplus Instances		NA Cases
	Number	%	Number	%	Number
1990	18	85.7	3	14.3	9
1991	18	94.7	1	5.3	11
1992	18	94.7	1	5.3	11
1993	19	90.5	2	9.5	9
1994	21	91.3	2	8.7	7
1995	18	78.3	5	21.7	7
1996	17	77.3	5	22.7	8
1997	18	75.0	6	25.0	6
1998	25	100.0	0	0.0	5
1999	24	96.0	1	4.0	5
2000	12	85.7	2	14.3	16
Whole Period	208	88.1	28	11.9	94

Source: Based on Table 1.

That is not the end of the story. As may be seen from the data in presented in Table 3, public expenditure increased at a higher rate than the public revenue in 13 countries out of the 22 for which data are available for the growth rates for the both, which implies widening gap between public revenue and expenditure. As a group, public expenditures in IDB member countries grew at 6 percent per annum as compared to

3.4 percent per annum for the world and public revenues grew at an annual rate of 5.7 in IDB member countries as compared to 4.9 percent in the world.

Table 3
Growth of Public Revenue and Expenditure in Some IDB Member Countries (1990-2000)

	Public Revenue			**Public Expenditure**		
	Average 1990-95	**Average 1995-00**	**Ann. Growth Rate**	**Average 1990-95**	**Average 1995-00**	**Ann. Growth Rate**
Algeria	12495.5	15361.4	4.2	13106.8	14463.4	2.0
Azerbaijan	370.3	612.4	10.6	343.2	846.8	19.8
Bahrain	1307.0	1777.1	6.3	1492.6	1736.0	3.1
Bangladesh	NA	NA	NA	NA	NA	NA
Burkina Faso	NA	NA	NA	384.6	429.4	2.2
Cameroon	1518.2	NA	NA	1852.7	1319.3	-6.6
Cote d'Ivoire	2036.1	2175.1	1.3	2567.6	2487.8	-0.6
Egypt	15142.6	19802.6	5.5	16122.1	25323.3	9.5
Guinea	426.5	397.6	-1.4	703.9	780.4	2.1
Indonesia	27171.1	30888.1	2.6	25426.9	29978.3	3.3
Iran	18190.7	23153.8	4.9	18653.6	24247.3	5.4
Jordan	1495.9	1992.5	5.9	1723.6	2441.7	7.2
Kazakhstan	NA	NA	NA	NA	NA	NA
Kuwait	6636.2	11274.1	11.2	12515.6	13642.7	1.7
Kyrgyz Republic	255.2	245.3	-0.8	478.8	345.6	-6.3
Lebanon	1423.2	2544.1	12.3	2014.1	5393.6	21.8
Malaysia	16975.7	23172.6	6.4	16166.8	20229.4	4.6
Maldives	70.7	144.5	15.4	111.0	179.8	10.1
Morocco	8007.3	9735.3	4.0	8913.9	10930.9	4.2
Oman	3625.9	4138.9	2.7	4695.2	5009.8	1.3
Pakistan	8822.5	10165.0	2.9	11688.3	13901.2	3.5
Senegal	NA	NA	NA	NA	NA	NA
Sierra Leone	76.7	68.3	-2.3	122.0	132.5	1.7
Sudan	NA	NA	NA	NA	NA	NA
Syria	2770.7	3281.9	3.4	2928.7	3475.9	3.5
Tajikistan	NA	NA	NA	NA	NA	NA
Tunisia	4476.0	5676.4	4.9	4908.1	6245.3	4.9
Turkey	25839.1	42532.8	10.5	33807.7	59231.6	11.9
UAE	805.8	1385.0	11.4	4296.6	4903.1	2.7
Yemen	857.0	1721.3	15.0	1298.2	1818.3	7.0
IDB Members	**160796**	**212246**	**5.7**	**186322**	**249493.3**	**6.0**
World	**6122044**	**7784536**	**4.9**	**7014837**	**8303956**	**3.4**

Source: World Bank Live Database.

The evidence shows that contrary to the world trend, the overall deficit has increased in IDB member countries. Instead of taking the prudent economic decision either to cut government expenditure or to mobilize additional revenue for the public sector, they resorted to borrowing from domestic and international markets. This led to a huge built up of public debt mostly on the basis of interest. From an Islamic point of view this is most unfortunate. The countries which embarked upon an economy-wide Islamization program found this to be a major hurdle. Even on purely economic grounds, public borrowing can be justified only if the expected return from the projects being financed through borrowing is higher than the cost of obtaining the resources. In practice, this general economic principle has not always been kept in view. This has led to a number of problems. Table 6 presents data on external debt for some IDB member countries.

It may be noticed that in 19 out of 30 countries, the total external debt is more than half of their GNP and in 9 more than their GNP. In case of 11 countries, debt servicing eats up more than 20 percent of their earning from the export of goods and services. This of course is a very serious situation. But this is not the end of the malaise. In addition to the external debt, they have huge domestic debt as well. As a result they have to spend a huge chunk out of government expenditure on interest payments. On average, interest payments constitute 13.4 percent of total government expenditure in the IDB member countries. It is even more disturbing when one looks at individual country figures and finds that it is in many cases the largest or the second largest item in their public expenditure. A general, obvious and simple rule which is easily forgotten is that no public spending financed by borrowing should be carried out unless the expected social rate of return on it at least equals, and is preferably higher than, the costs (including the social costs) of obtaining the resources. This is one of the evils of interest-based borrowing. The costs of servicing the borrowed capital have been higher than the rate of return on investments carried out with those funds. And even that is on the generous assumption that these loans were used for investment. In fact, a good part of these loans was used to finance current government expenditure and personal expenses of government officials. It is also no secret that corruption is rampant in public expenditure. This again is due to the fact that under interest-based financing, the financier has little interest in the way the funds are utilized as long as the borrower does not default on his obligations. These inherent problems of interest-based borrowing are now widely recognized and a number of reform proposals are being discussed at international forums.

Table 4

Debt and Debt Servicing for Selected Muslim Countries

	Total Debt (Million US $)			Total Debt (% of GNP)			Debt Service (Million US $)			Debt Service (Percentage of Export of Goods & Services)			Debt Service (Percentage of GNP)		
	1990	1995	2000	1990	1995	2000	1990	1995	2000	1990	1995	2000	1990	1995	2000
Algeria	28149	33042	25273	47.0	83.5	49.9	8805	4251	4470	63.4	35.3	19.6	14.7	10.7	8.8
Azerbaijan	..	321	1274	..	13.4	25.9	..	10	181	..	1.3	8.1	..	0.4	3.7
Bahrain	0	0	0	..	..	..	..	..	..	..	..	..	..	..	..
Bangladesh	12439	15924	15679	41.5	42.0	33.4	749	780	796	27.4	14.2	9.2	2.5	2.1	1.7
Burkina Faso	834	1270	1406	30.2	58.4	61.0	34	49	47	6.8	11.2	14.5	1.2	2.2	2.0
Cameroon	6676	9385	9243	62.5	126.2	111.9	522	431	558	22.5	20.9	20.4	4.9	5.8	6.7
Cote d'Ivoire	17251	18899	12138	187.3	209.9	123.4	1262	1046	1020	35.4	23.1	22.6	13.7	11.6	10.4
Egypt	33017	33337	29027	78.6	55.3	28.9	3074	2377	1819	22.5	13.4	8.4	7.3	3.9	1.8
Guinea	2476	3242	3388	92.9	89.9	113.5	169	178	155	20.0	25.0	20.4	6.3	4.9	5.2
Indonesia	69872	124398	144057	64.0	63.4	102.0	9946	16416	16681	33.3	29.9	22.5	9.1	8.4	11.8
Iran	9021	21879	7982	7.5	25.2	7.9	655	5824	3225	3.2	29.3	11.1	0.5	6.7	3.2
Jordan	8333	7659	7366	219.0	117.2	87.4	628	600	741	20.4	12.4	12.6	16.5	9.2	8.8
Kazakhstan	..	3750	11805	..	19.0	69.0	..	235	3338	..	3.9	31.4	..	1.2	19.5
Kuwait	0	0	0	..	..	..	..	..	..	..	..	..	..	..	..
Kyrgyz Rep.	..	610	1827	..	41.8	142.1	..	60	173	..	13.2	27.4	..	4.1	13.5
Lebanon	1779	2966	9856	51.4	25.5	56.6	99	224	1469	3.3	10.7	..	2.9	1.9	8.4

	Total Debt (Million US $)			Total Debt (% of GNP)			Debt Service (Million US $)			Debt Service (Percentage of Export of Goods & Services)			Debt Service (Percentage of GNP)		
	1990	1995	2000	1990	1995	2000	1990	1995	2000	1990	1995	2000	1990	1995	2000
Malaysia	15328	34343	41797	36.4	40.6	52.7	4333	6041	6445	12.6	7.0	5.6	10.3	7.1	8.1
Maldives	78	155	206	40.2	43.7	36.3	9	11	20	4.8	3.4	4.2	4.5	3.0	3.5
Morocco	24458	22665	17945	98.5	71.6	55.3	1794	3764	2575	21.5	33.4	20.0	7.2	11.9	7.9
Oman	2736	5777	6564	29.0	48.3	37.2	739	953	864	12.3	14.8	7.2	7.8	8.0	4.9
Pakistan	20663	30229	32791	52.9	49.4	54.8	1902	3216	2855	23.0	27.5	26.7	4.9	5.3	4.8
Senegal	3736	3841	3372	67.9	88.9	78.5	325	281	217	20.0	16.7	13.7	5.9	6.5	5.1
Sierra Leone	1197	1250	1229	206.4	137.9	198.6	21	83	47	10.1	64.3	52.6	3.7	9.1	7.5
Sudan	14762	17603	15741	119.2	280.3	168.1	50	69	61	8.7	6.7	2.5	0.4	1.1	0.7
Syria	17259	21415	21657	144.4	184.8	126.8	1189	269	343	21.8	4.3	4.8	9.9	2.3	2.0
Tajikistan	..	634	1041	..	28.2	111.4	..	0	62	..	0.0	7.8	..	0.0	6.7
Tunisia	7690	10820	10610	64.7	63.2	57.1	1431	1480	1900	24.5	16.9	20.0	12.0	8.6	10.2
Turkey	49424	73781	118285	32.5	43.1	58.9	7422	11451	20736	29.4	27.7	35.4	4.9	6.7	10.3
UAE	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Yemen, Rep.	6352	6217	5615	132.6	170.2	64.2	169	102	268	5.6	3.1	4.5	3.5	2.8	3.2
IDB Member Countries	353527	505408	557175	82.9	82.3	78.2	45325	60199	71066	19.7	17.4	16.7	6.7	5.4	6.7

Source: World Bank Live Database

Muslim countries should pay serious attention to these proposals since they have a special interest due to prohibition of *riba* in Islam.

2.4 TRADITIONAL SOURCES FOR FINANCING PUBLIC EXPENDITURE

Islamic theory of public revenue, like any other Islamic economic theory, must start by looking at the *nusus*. From the Qur'an and sunnah, five sources for financing public expenditure can be derived. These are: *Zakah, Khums, Fay', Sadaqah,* and Borrowing. During the period of rightly guided caliphs, which is accepted as a source of Islamic law, *kharaj, jizyah* (a poll tax on non-Muslims), and *[ushur* (a trade tax) were added. Are these the only sources of revenue for a modern Islamic state? Are all of them still relevant? What is their potential in modern times? If current revenues are not sufficient, can an Islamic state borrow? If so, from whom and on what terms? In this section we take up a discussion of these and similar issues relevant to the financing of public expenditure. First, we examine the relevance and potential of the traditional sources in modern times.

Zakah

Zakah is a levy on all Muslims having a net worth higher than a minimum exemption limit called '*nisab*'. This is called *zakatul mal*. The rate of *zakah* is 2.5% of the total net worth. The agricultural produce is also subject to *zakah*, called *zakatul ard* or *[ushr*. The rate is 5% for irrigated land and 10% on rain-fed land. According to the consensus of *fuqaha'*, these rates are fixed and unchangeable. The beneficiaries of *zakah* are mentioned in a Qur'anic verse:

There is some room for interpretation of the eight categories mentioned in this verse but, by and large, these are also fixed. Hence, *zakah* is an earmarked levy. While it is an act of *[ibadah* having multiple purposes, its main thrust is on poverty alleviation. The fixity of the rates limits the use of *zakah* as a fiscal instrument but the fact that it is earmarked sets a guideline for fiscal policy in the sense that in case of priority areas earmarking of public revenue can be a useful technique. We will benefit from this lesson in the section on policy recommendations later.

With respect to the potential yield of *zakah* in modern times, very little empirical information is available. The empirical studies[19] done for Syria and Sudan respectively gave the potential yield as 3 and 3.6 percent of GDP. Estimation of *zakah* in Kuwait by Fuad al Omar (1995) produced an estimate of 2.1% of GDP. Kahf (1989) estimated *zakah* for eight Muslim countries and used three different definitions of zakatable items. First definition, Z_1 included agricultural output, livestock, and trade inventory and cash holdings. The second definition, Z_2 used the majority opinion after expanding it by including views of some contemporary *fuqaha'*. This methods included in the *zakah* base the return on fixed assets used in the industry, transportation and construction sectors as well as professional and other labor incomes with certain exemptions for the cost of living. The third definition, Z_3 included in the *zakah* base the capital value of fixed assets in all sectors at a *zakah* rate of 2.5%. His estimation produced a range between 1% - 2% of GDP for $Z_{1.}$ 3.1% - 4.9% for Z_2 and 3.2% - 6.2% for Z_3. It should be noted however that the amount of *zakah* estimated on cash holdings in all the eight countries ranges between 40% - 60% of the total *zakah* proceeds. It is not certain if the condition of holding the savings for one year before it becomes subject to *zakah* can be met for all of these amounts. Assuming that the average figure for the Muslim countries is 2-3 percent of GDP, this would imply that 8-10 percent of total government expenditure can be financed from this source. Since provision of basic needs should be a permanent head of government expenditure in Muslim countries, allocation of this amount to poverty alleviation programs can have a significant effect on poverty reduction. However, in view of a high incidence of poverty in many Muslim countries, in the short run it would be desirable to supplement *zakah* proceeds with other resources for poverty alleviation. This would be more so because not all of the *zakah* proceeds would be spent on poverty alleviation in view of claim of other categories of the recipient of *zakah*.

Khums and Fay':

Khums is that part of *ghanimah* which is assigned to state. *Ghanimah* is the wealth acquired from the enemy by force during a war. Its authority is derived from the Qur'anic verse:

---

19 Zarqa (1984), and Awad quoted in Zarqa (1984).

The same verse defines its utilization. Four fifths are to be distributed to the warriors and one fifth is apportioned to the state. That is why it is called *khums*. Fay' also refers to the wealth that Muslims acquire from the enemy. The difference is that *fay'* refers to that wealth which is acquired from the enemy *without* fighting. Fay' is also authorized by Qur'an.

ما أفاء ا على رسوله، من أهل القرى فلله وللرسول ولذي القربى واليتمى والمساكين وابن
السبيل كي لا يكون دولة بين الأغنياء منكم

"What Allah has bestowed on His Messenger (and taken away) from the people of the townships, belongs to Allah, to His Messenger and to kindred and orphans, the needy and the wayfarer; in order that it may not (merely) make a circuit between the wealthy among you." [59:7]

Its distribution is similarly defined by Qur'an. While there is some discussion in the *fiqh* with respect to the heads of expenditure mentioned in the above ayah, the stronger opinion among *fuqaha'* is that these heads are mentioned only as examples. All of *fay'* proceeds belong to society as a whole. The *ameer* as a custodian of society can spend it on anything that benefits the society. However, he should give preference to the heads mentioned in the ayah.

It should be noticed that both *ghanimah* and *fay'* are properties acquired from enemy. These were sanctioned because of the prevailing situation at that time and on reciprocal basis. Since non Muslims were taking the properties of Muslims in wars or war like situations, Muslims were also entitled to the enemies' properties. However, there were some important differences in approach. In case of non-Muslims, the practice was that the property gained from Muslims was taken by the leader of the tribe. It was up to him to share or not to share it with anyone, the later being the general rule. Islam gave four fifths of the *ghanimah* to the fighters and one fifth to the *ameer*. In case of *fay'*, whole of it was assigned to the society in general. Al-Qurtabi while commenting upon the *ayah* of *fay'* "in order that it may not make a circuit between the wealth among you", says that Allah has prescribed this way of distributing *fay'* lest it be divided by the leaders, wealthy and powerful among themselves to the exclusion of the poor and the weak.

Islam had to use an existing arrangement due to prevailing circumstances but reformed it for the benefit of the society. *We are of the view that in the present circumstances when the properties of warring parties are protected by international conventions to which all Muslim countries are signatories, ghanimah and fay' stand "suspended". We say "suspended" not "abrogated" because something authorized by Qur'an cannot be abrogated and who knows that in future the situation may change again and these may have to be revived on reciprocal basis.*

Jizyah

It is a poll tax leviable on all non-Muslim adults living in an Islamic state in lieu of exemption of non-Muslims from compulsory military service yet being entitled to the protection of the Islamic state. Once again, due to the way standing armies are organized today, this tax cannot be applied in the present circumstances, but again we cannot abrogate it for reasons mentioned above. It may be considered "suspended" for the time being.

Kharaj

Kharaj is a rental fee on the land that becomes the property of an Islamic state as a result of its liberation by Muslim troops. A consensus among the companions of the Prophet (may peace be upon him) emerged during the time of Umar (may Allah be pleased with him) to keep such lands as a property of the state and lease them to people for a fixed rental fee (or a crop-sharing arrangement).

It was one of the major, perhaps the biggest, sources of revenue for Muslim states in the past. While no new lands can be acquired for the reasons mentioned for the suspension of *ghanimah* and *fay'*, the lands already acquired by Muslim states have to be dealt with as a special case. According to one *fiqh* opinion, even if the lands have been sold by their original non-Muslim owners to Muslims, they are still subject to *kharaj*. The other opinion is that they would now be subject to *[ushr*. Whatever opinion one takes, it is evident that these lands are taxable. Since the more practicable opinion is to impose *[ushr* rather than *kharaj*, this source of public revenue as a distinct head has almost no scope in modern times, even though some other Islamic writers see it as one of the most potent sources of public revenue.[20]

[Ushur

In the pre-Islamic period, the tribes inhabiting the trade routes used to impose some levies on trade caravans in lieu of safe passage. This was called *al-maks* and sometimes *[ushur* because the usual rate was 10 percent. There are several *ahadith* which condemn this practice. For example:

1. It was narrated by Uqba Bin Aamer, that he heard Prophet Mohammed (peace be upon him) saying: The one who deals with *al-maks* will not enter paradise.[21]
2. It was narrated by Ahmed, that Abi Al Khier (may Allah be pleased of him) said: " that Musslemah Bin Mikhlid- who was in charge of Egypt- asked Rwifa Bin Thabet to take charge of Assuor, but he told him that he heard Prophet Mohammed (peace be upon him) saying: the one who deals in *al-maks* is in Hell.[22]
3. It was narrated by Imam Muslim from Abdullah Bin Baridah, from his father about the story of Maiz Bin Malik Al-Asslamy and the women how was pregnant from *zina*, and Prophet Mohammed (peace be upon him) ordered to be executed for death, that she had pleaded forgiveness from Allah in a way that if it was pleaded by a person who deals with *al-maks* then he would have entitled it.[23]

Some writers use these *ahadith* to argue against imposition of trade taxes, and sometimes all taxes.[24] However, there are several authentic reports that Caliph Umer imposed *[ushur* during his period after due consultation with the Companions. Hasanuzzaman (1981) reports:

---

[20] For example, see Salama (1983).

[21] Narrated by Abou Dawoud 3/132, Ibn Khozimah 4/51, and El- Hakim in his *Mustadrak* 1/562, all have narrated from Mohamed Ibn Ishaq.

[22] Ahmed as narrated by Ibn – Luhyaa 4/109 , El-Tabarany, *El-Mo[jam El-Kabir* 5/29.

[23] Imam Muslim 3/1323, Imam El-Nwawy, The explanation of Muslim Book (*Sahih Muslim*), 1/203, Abou Dawoud 4/152.

[24] Fahmy (unpublished).

(a). Abu Musa al-Ashari wrote to Umar that the Muslim traders were being taxed at a rate of one-tenth in *harbi* lands. Umar advised him to reciprocate and further suggested to him to charge 5 per cent from *dhimmis* and 2.5 per cent from the Muslims, provided the value of the goods exceeded two hundred dirhams.

(b). The traders of Manbij who were an enemy (*harbi*) nation across the waters wrote to Umer to allow them to enter his country for trade on payment of one-tenth of the value of goods. Umer consulted the Companions who voted for it. Thus it was the first national to pay *[ushur*.

Islamic scholars have reconciled the condemnation of the pre-Islamic practice of imposing taxes on trade by the Prophet (peace be upon him) on the one hand and imposition of such taxes by Caliph Umer. They have argued that the condemnation by the Prophet (peace be upon him) related to the pre-Islamic practice of "unauthorized" imposition of levies by tribes which was in the nature of vandalism whereas what was done by Caliph Umer was an action by the legally accepted Islamic state and the proceeds did not go to any individual or group but were deposited in the central treasury. Moreover, these taxes were imposed on reciprocal basis on the traders coming from those countries which had imposed similar taxes on Muslim traders.

***Sadaqah* (Voluntary Contributions)**

Islamic state has an important source of revenue by way of voluntary contributions that are made by individuals in response to appeals for financing specific projects and ventures. Until conquest improved finances of the *bayt al-mal*, this was the most important way of financing the needs of the society. Prophet (peace be upon him) used it for raising finances for many expeditions. The most famous among these is the expedition of Tabuk when Umar (may Allah be pleased with him) contributed half of his net worth and Abu Bakr (may Allah be pleased with him) brought all his wealth. The total funds collected were very huge. Several infrastructural projects, buying wells and donating to the community were also financed through voluntary contributions. But the most important application of this source was for meeting the needs of the poor. This was done both at a individual and state level. Unfortunately, modern governments are not making use of this important source. If properly managed, this has a lot of potential. The Islamic institution of *waqf* can also play an important role in this respect.

Borrowing

Most modern governments find it indispensable to borrow in order to meet public expenditure. This in turn has led many of them into serious economic as well as political problems. Therefore the issue requires a careful and dispassionate study. Can an Islamic state borrow? If so, for what purposes? From whom can it borrow and on what terms? These are very important question. Siddiqi (1995) explored whether early Islamic states ever borrowed. He did not find a single case of public borrowing during the period of rightly guided caliphs. This is not surprising because due to conquests *ghanimah, fay'* and *kharaj* had filled *bayt al-mal*. The period during which the Islamic state faced financial difficulties was the early Medina state. Therefore, he examined whether the Prophet as head of the state ever resorted to borrowing. He found six authentic instances of Prophet (peace be upon him) borrowing for public needs. On the basis of the *ahadith*, Siddiqi is able to establish permissibility of borrowing by an Islamic state. The Prophet (peace be upon him) borrowed in small amounts as well as large, and from Muslims as well as non-Muslims No coercion was involved in his borrowing. Nor was there any stipulation about repaying more than what was received as the loan. He borrowed in anticipation of future income from which repayment could be made, but he also borrowed when no definite future income was in sight. He also borrowed to roll-over existing debts.

However two issues need consideration. First, can an Islamic state borrow from non-Muslims? According to some reports, Prophet (peace be upon him) borrowed from non-Muslims. Can this be taken as a precedence and allow borrowing from non-Muslims in all circumstances? Anybody who is familiar with the *maqasid al-shari[ah* would not give a *carte blanche*. There is no doubt that in principle, it is allowed. However, if this compromises the achievement of the *maqasid al-shari[ah* in any way, this cannot be authorized. In instances quoted by Siddiqi, the lenders were residents of Medina, i.e. subjects of the Islamic state who could not damage the interests of the state because of it being their debtor. This is very important to realize. The situation drastically changes when we see modern Islamic states borrowing from foreign non-Muslim countries who use their position as lenders to impose conditions that clearly hinder the achievement of the *maqasid al- shari[ah*.

The second issue is whether borrowing on interest can be sanctioned. Siddiqi quotes some cases when Muslim ruler resorted to borrowing on interest. However, firstly, these relate to much later Islamic history, which cannot be considered as setting a permissible precedent. Secondly, it cannot be established by those reports whether it was a case of *idtirar* (dire need), or not, because in case of *idtirar* it is universally accepted to grant temporary permission for unlawful things.

To conclude, as a principle, it is permissible for an Islamic state to borrow. However, borrowing on interest can be resorted to only in case of *idtirar.* In borrowing from non-Muslim countries or foreign institutions extreme caution should exercised to ensure that such borrowing does not compromise the achievement of other objectives of public policy. Also by and large it is a short-term recourse. Any borrowing that continues over a long period of time is not advisable as it will almost certainly compromise the achievements of the *maqasid al-shari[ah.*

2.5 SOURCES OF FINANCING PUBLIC EXPENDITURE IN MODERN TIMES

Of course, all traditional sources of public revenue remain available to modern Muslim governments in principle. However, as mentioned above, due to historical developments, some of these stand "suspended" while the potential of some others is rather limited. Therefore, modern governments have to find new ways of financing its necessary expenditures. In the recent literature on Islamic economics, there has been some discussion on whether a modern government has the right to impose additional taxes i.e. taxes other than the traditional Islamic levies and if so under what conditions but in general the right of the government to impose taxes has broad support.[25]

An important source of public revenue in modern times has been the revenue from natural resources. Similarly, ever since the governments took over the minting of coins, seigniorage also became a source of public revenue. Therefore, the sources of public revenue in modern times include:

1. *Zakah*
2. Voluntary Contributions
3. Income from Minerals (*Ma[adin*)
4. Seigniorage
5. Taxes
6. User Charges and Fees

We have discussed the first two in the previous section. In this section, we discuss the others. In addition, there are other innovative non-interest methods that can be used to finance public expenditure. We will discuss those in the next section. If there is still need for additional resources for "essential" public expenses, borrowing can be resorted to as a last option.

Income from Minerals (Ma[adin)

The term *ma[adin* include all natural elements which are extracted from land except clay. There are various rules *fiqh* rules governing the ownership of minerals. Those are not our concern here. However, one of those is that according to number of *fuqaha'* all citizens have a share in minerals. Therefore, the state is entitled to organize them in such a way that a part of the income is spent on public goods. This source has great potential in view of the importance of mineral wealth such as petrol, coal, natural gas, phosphate, iron etc.

[25] See Iqbal and Khan (1981), pp.53-54. We will summarize that debate later when we discuss taxation.

Seigniorage

Since the time governments took over the minting of coins, this also became a source of public revenue. In the past the normal rate was one percent of the value of the coin.[26] After token money, especially paper money became the routine; this source of income has assumed great importance. Table 7 provides estimates of seigniorage in the selected IDB member countries. On average the amount of seigniorage works out to be 1.33 percent of GDP and 5.6 percent of total government spending, which is not a small amount.

---

[26] Hasanuzzaman (1981), p.275.

Table 5
Estimate of Seigniorage in IDB Member Countries

	Currency Issued	Seigniorage	Seigniorage	Seigniorage	Seigniorage
	in	National Currency	US $	As % of GDP	As % of Govt.
	2000	(Millions)	(Millions)		Expenditure
Algeria	44690	44467	591	1.11	3.77
Azerbaijan	213970	212900	48	0.90	6.51
Bahrain	7.7	8	20	0.26	0.99
Bangladesh	23007	22892	439	0.93	NA
Burkina Faso	-5900	-5871	-8	-0.36	-1.85
Cameroon	27560	27422	39	0.43	2.64
Cote d'Ivoire	5200	5174	7	0.07	0.38
Egypt	2592	2579	699	0.70	3.23
Guinea	75868	75489	43	1.41	4.86
Indonesia	14018000	13947910	1656	1.09	3.47
Iran	3368000	3351160	1899	1.87	8.53
Jordan	133.3	133	187	2.21	7.10
Kazakhstan	2942	2927	21	0.11	0.79
Kuwait	94.2	94	306	0.85	2.24
Kyrgyz Rep.	524	521	11	0.80	4.43
Lebanon	54100	53830	36	0.22	0.79
Malaysia	6595	6562	1727	1.92	6.85
Maldives	24.8	25	2	0.35	0.90
Morocco	1456	1449	136	0.41	1.13
Oman	3.3	3	9	0.04	0.15
Pakistan	69445	69098	1288	2.12	9.19
Senegal	40200	39999	56	1.28	6.22
Sierra Leone	6039	6009	3	0.45	1.45
Sudan	34000	33830	132	1.17	NA
Syria	21679	21571	1922	10.74	60.59
Tajikistan	NA	NA	NA	NA	NA
Tunisia	235	234	171	0.88	2.74
Turkey	1310000000	1303450000	2085	1.05	2.65
UAE	520	517	141	NA	NA
Yemen, Rep.	30199	30048	186	2.02	NA
IDB Member Countries			13849	1.33	5.59

Sources: Calculated by the authors.

Taxes

Taxes are the most important source of public revenue in modern times. However, in an Islamic framework some writers have argued that a taxation policy beyond *zakah* is un-Islamic. The argument relies on the sanctity of private property recognized by Islamic Shari[ah and contends that any compulsory government charge on it is unjust. It is, maintained for example, that the levying of taxes, in addition to *zakah*, is an exception and not a rule. It is argued that in an Islamic economy a clear distinction must be made between the subsistence welfare and the desired welfare of people. Provision of the subsistence level is not only an objective of economic policy, but is also an obligation, whereas the provision of an adequate standard of living is only desired. Included in the first category are aids and services provided to people stricken by a natural calamity, war, famine, or lack of production to below subsistence level, etc. The second category includes social services aimed at improving the economic living of the poor. Some of the writers believe that in fulfilling what is required, the state has to acquire the necessary resources while in providing what is desired, it is limited to the use of the available resources only.

Kahf (1983) quotes Imam Malik, Ibn Hazm and Abdel Haiy al Kattani on the conditions of imposing additional taxes. Imam Malik says that "if there were no funds in the treasury or the needs of the army increased above the capacity of the treasury, the state has the right to levy taxes on the rich up to the level that satisfies that need immediately and until the revenues of the treasury appear". According to Ibn Hazm "the poor people should be given the indispensable food and clothes for winter and summer and a shelter that protects them from rain, sun, and eyes of passers-by." Abdel Haiy al Kattani discusses the collective duties that strengthen the interests of Muslims both in religious affairs and in worldly affairs such as salaries of military personnel, students and researchers in Shari[ah studies, and teachers of young children and concludes that such payments should be provided by the treasury and in case of shortage of its revenues, Muslims are collectively responsible for raising funds."

Based on these quotations Kahf argues that additional taxes can be imposed only if (a) regular revenues are depleted, (b) defense expenses exceed current resources, (c) taxes are levied temporarily, (d) taxes are imposed to the extent not exceeding needs and (e) taxes are levied on the rich only. He further states that these scholars did not mention development, equilibrium and welfare as being a justification for levying taxes nor these goals of public policy find any mention, explicit or implicit in the texts of Qur'an or Sunnah.

There are several drawbacks in this line of reasoning. First of all, the first condition, i.e. regular revenues are depleted, does not limit the "regular" revenues to *zakah* (or even the traditional taxes) only. In the early Islamic history, whenever the rulers felt a need they imposed "new" taxes. Later on, *fuqaha*' became cautious in giving arbitrary powers of taxation to the state to play with the wealth of the people because of the non-representative nature of the rulers who were disposed to levying taxes for personal benefits rather than the needs of the society. One should not forget that taxes in modern societies which come through *shura* will be quite different from those arising out of *zulm*.

Secondly, those scholars who state that taxes in addition to *zakah* are an exception imply only taxes for meeting the basic needs of the people. But since there are other functions that an Islamic state has to perform, it can levy other taxes also. Even in case of basic needs, the *zakah* is not the only redistributive measure in the Islamic system. Zarqa (1988) lists more than twenty redistributive schemes that Islamic system has. Now the fact of the matter is that due to moral degradation in Muslim societies, most of those schemes have been inoperative for centuries. The result has been that the levels of poverty and income disparities have increased to levels that even those scholars who sanction additional taxes for poverty alleviation only as an exception would agree that the present situation is in fact exceptional. Furthermore, while the main thrust of *zakah* is for poverty alleviation, it is not its only objective. It has several categories of utilization other than the poor and the needy. Then again, *zakah* is an earmarked levy, with fixed rates as well as recipients. Therefore, no modern government can run an effective fiscal policy, if *zakah* was the only tool in its kitty.

The argument that development, equilibrium and welfare have not been mentioned in the Qur'an or Sunnah, either explicitly or implicitly, as goals of public policy is also weak. As far as welfare of people is concerned, it is the centre of the *maqasid al-shari[ah*, with welfare defined to include both worldly well being as well as success in the Hereafter. As far as development is concerned, as mentioned before there is an explicit injunction to the Ummah to muster as much strength as possible.

وأعدوا لهم ما استطعتم من قوة ومن رباط الخيل ترهبون به

"Muster against them all the military strength and cavalry that you can afford to strike fear in their (enemies') hearts" [8:60]

Some people may think that this instruction is limited only to defense capability. However, they must realize that economic strength is a pre-requisite for strong defense capability. Anybody, having any doubt in this respect should study the reasons for dethroning of the Soviet Union from the status of a world superpower and ultimate disintegration on the one hand and elevation of the United states to the status of only remaining superpower in the world today.

Furthermore, there is no difference of opinion among scholars that providing at least subsistence for the population is one of the responsibilities of the Muslim state. The question is that is this subsistence to be provided merely out of charity or are we also going to take into consideration the question of generating economic opportunities for the people to enable them to meet their needs by themselves? Islamic system does not want people to live on charities for ever. Therefore, generation of economic opportunities through creating productive jobs so that people can make an honorable living is a highly desirable goal of public policy. Similarly, poverty cannot be removed in the long run unless economic growth increases the size of the cake.

An Islamic state has to defend both its ideological and geographical frontiers. It should have enough resources to maintain strong defense capability. It has also to guard the faith of the people and promote it. It has to help the oppressed Muslims everywhere to be able to practice their faith. It has to ensure that basic economic needs of the entire population are adequately met. Like other states, an Islamic state has also the responsibility for maintain law and order for providing the necessary infrastructure to promote economic growth.

Most of the Muslim economists are, therefore, of the opinion that an Islamic state can impose additional taxes to fulfill its obligations towards God as well as towards its citizens. Nevertheless, the power of the state to impose taxes are not unlimited and it has to take into consideration the ability of people in various classes to pay taxes and at the same time try to reduce its expenditure to a minimum level compatible with its objectives. It is argued that there are certain constraints in the Islamic economy that prescribe the permissibility frontiers of taxation. Two unique built-in system constraints are mentioned (Faridi, 1983). Firstly, the Islamic taxation policy will be designed to compensate or supplement the 'resource gap' arising out of or incidental to *zakah* and *sadaqat*. Secondly, Islamic taxation system will be so structured as to fill in the 'objectives gap' indicated by or incidental to *zakah*. It will serve to promote primarily the same ends for which *zakah* has been levied. The first of these constraints is in principle the same as imposed by the other school with the important difference that the resource gap is defined in relation to a much longer list of objectives. The second constraint mentioned above has been subjected to criticism on the grounds that the very rationale for imposing additional taxes is that, since *zakah* is an earmarked levy, and since government may have other objectives to achieve for which *zakah* proceeds cannot be utilized, it will have to impose other taxes. Thus by definition other taxes will have objectives different, at least in part, from that of *zakah*.

Scope of Taxation in Modern Muslim States

In the light of the above discussion, we find widespread support for the right of Muslim governments to impose additional taxes. However, Islamic scholars are very careful with regard to seeking clear and proper justification for any additional taxes. They want to make sure that these are meant for the benefit of the people rather than filling the coffers of the rulers. This is due to a very high importance attached to the institution of private property in Islam. No one, not even the government, is allowed to take anyone's private wealth except for clear and strong justification for doing that in view of the overall *maqasid al-shari[ah*. But in view of the well- recognized Islamic principle that public interest takes precedence over private interest, once it has been established that people's interest can be served by a particular tax, taking private property becomes lawful.

In designing its taxation policy, the government has to follow certain criteria. In this regard if any of the Western criteria of imposition of taxes is in conformity with Islamic values, there is no harm in using it but there is nothing sacrosanct about those criteria. We may have, for example, a “social justice criterion” or a “piety criterion” etc. Even though the taxes may not have to be restricted to rich only, the ability to pay the taxes must be a fundamental consideration. Specifically, even though it is permissible to impose some taxes on the poor, e.g. tax on unnecessary consumption, they will be mostly corrective taxes and not basically revenue raising taxes. To ensure that taxes do not fall on the poor, it will be necessary to have a clear idea about the incidence of various taxes. It is in this sense that Islamic economies will generally favor direct taxes.

The structure of government revenue during 1995-2000 period in IDB member countries is given in Table 6. On average, taxes constitute 70.8% of total government revenue in IDB member countries which highlights the importance of this source. However, this average conceals the fact that in ten out of thirty countries taxes constitute more than 90% of public revenue. Within the various tax types, more than 50% taxes are indirect. As mentioned above, due to the fact that the incidence of indirect taxes is not easily known and usually falls on the poor, there is a need to increase the proportion of direct taxes.

Table 6

Structure of Government Revenue (1995-2000)
Taxes as Percentage of Total Revenue

	Taxes on Income &Profit	Social Security Taxes	Taxes on Goods& Services	Taxes on Int. Trade	Other Taxes	Total Taxes	Non-Tax Revenue	Total Govt. Revenue
Algeria	68.21	0.00	10.42	14.33	1.19	94.15	5.85	100.00
Azerbaijan	22.88	18.55	36.21	16.27	1.94	95.86	4.14	100.00
Bahrain	4.88	10.20	3.55	8.68	2.00	29.31	70.69	100.00
Bangladesh	10.90	NA	40.44	22.56	1.22	75.12	24.88	100.00
Burkina Faso	NA	NA	NA	NA	NA	0.00	NA	0.00
Cameroon	18.91	0.00	24.08	28.66	3.64	75.29	24.27	99.56
Cote d'Ivoire	20.00	6.27	17.24	50.10	3.30	96.91	3.08	100.00
Egypt	20.16	3.36	15.83	12.00	11.06	62.41	37.59	100.00
Guinea	9.95	0.65	5.44	76.90	3.33	96.27	3.73	100.00
Indonesia	54.95	3.20	28.67	3.37	0.70	90.89	9.11	100.00
Iran	15.37	7.65	8.99	15.94	1.14	49.09	50.91	100.00
Jordan	11.01	0.00	30.60	22.88	9.15	73.64	26.36	100.00
Kazakhstan	16.86	20.42	45.88	5.32	5.56	94.04	5.96	100.00
Kuwait	0.66	2.06	0.02	2.30	0.14	5.18	95.64	100.82
Kyrgyz Rep.	17.59	0.00	60.16	4.86	0.38	82.98	17.02	100.00
Lebanon	8.52	0.00	8.79	41.58	15.88	74.76	25.24	100.00
Malaysia	36.64	1.20	25.98	12.25	5.23	81.31	18.69	100.00
Maldives	1.87	0.00	15.74	32.42	0.61	50.65	49.35	100.00
Morocco	22.19	5.47	38.79	15.78	2.95	85.19	14.81	100.00
Oman	20.75	0.00	1.35	3.52	2.45	28.07	71.93	100.00
Pakistan	21.01	0.00	28.52	18.90	10.18	78.62	21.38	100.00
Senegal	22.09	0.00	29.94	39.33	3.51	94.87	5.13	100.00
Sierra Leone	18.39	0.00	29.43	48.50	0.14	96.46	3.54	100.00
Sudan	15.98	NA	37.91	28.18	1.06	83.14	16.86	100.00
Syria	29.53	0.00	24.50	11.49	6.81	72.33	27.67	100.00
Tajikistan	5.36	17.10	59.34	13.00	0.97	95.77	4.23	100.00
Tunisia	18.17	16.71	30.71	17.55	4.25	87.39	12.61	100.00
Turkey	34.41	0.00	40.74	2.15	5.22	82.51	17.49	100.00
UAE	0.00	1.71	51.75	0.00	0.00	53.46	46.54	100.00
Yemen, Rep.	17.24	0.00	8.03	12.14	2.07	39.49	60.51	100.00
IDB Member Countries	**19.46**	**4.24**	**26.17**	**20.03**	**3.66**	**70.84**	**26.73**	**97.57**
World	19.68	5.79	32.17	7.57	2.37	67.59	11.98	79.57

Source: Calculated from World Bank data.

III. ISLAMIC FINANCIAL INSTRUMENTS FOR PUBLIC SECTOR RESOURCE MOBILIZATION

In recent years some initiative have been taken to issue Shari[ah-compatible negotiable instruments for mobilizing resources for public sector. In this section, we discuss theoretical and practical developments in this respect.

3.1 ISLAMIC FINANCIAL INSTRUMENTS: AN OVERVIEW OF LITERATURE

During the last three decades researchers, policy makers and practitioners have paid substantial attention to developing Islamic financial instruments. Institutions including IRTI have organized a number Seminars dealing with financial instruments. Several research papers have been published by a number of scholars. In this paper, it is not possible to discuss all these valuable contributions. However, the proceedings of two seminars organized by IRTI, namely, Ariff and Mannan, (eds)(1990) and Ahmad and Khan (eds)(1998) specifically deal with Islamic financial instruments with special reference to public sector resource mobilization. Some of the papers published in these proceedings are reviewed here.

Homoud (1998; in Ahmad and Khan op. cit) provides a general framework for issuing Islamic financial instruments and argues that a system of financial intermediation between the owners and users of funds is well defined in the *fiqh*-literature and can further be refined to make it suitable for the issuance of negotiable Islamic financial instruments to meet various needs of different sectors of an Islamic economy. All such instruments are, however, expected to be genuinely negotiable provided the real assets underlying an issuing entity are larger than the debts and currencies as assets. This proposal of the author implies that an intermediary institution is expected to seek investment opportunities in, for example, roads, bridges, sea ports, air ports, industries and similar other areas and issue financial instruments to the public for the mobilization of resources to be invested in such projects.

Zarqa (1998; in Ahmad and Khan op. cit) suggests the Islamic instrument of *istisna[* to enable Islamic governments to finance social infrastructure. Projects which do not generate profits or revenues cannot be financed through profit or revenue sharing. Zarqa suggests that the best alternative in such cases is to resort to deferred sale. The deferred sale suitable for the construction of social infrastructure underlies the *istisna[* contract with the deferment of price. The deferred price can contain compensation for the delay in payments as well. Thus the total debts generated by the *istisna[* project can be owned by many investors by holding what he calls deferred price certificates (DPCs). The value of DPCs comprise of the principal plus profit margin. DPCs are however, illiquid assets as these can only be exchanged for cash on their face value. The liquidity problem of the DPCs would be overcome by making institutional arrangements to utilize the DPCs for purchasing goods and services. Zarqa expects that there may be many traders and producers who for the expansion of their sales will find this rational. DPCs can be of different maturity.

In another paper, "Rent Sharing Certificates: A Shari[ah Compatible Financial Instrument" Zarqa (1998; in Ahmad and Khan op. cit) offers yet another possibility, i.e., *ijarah*-based financial instruments. He proposes joint ownership of assets by certificate holders for sharing the rents of these assets in proportion to their ownership. As a rent-sharing certificate is a fixed income debt instrument, to protect the real value of the debts against inflation, he proposes some form of indexation of these instruments. The proposed mechanism is that the base of the instrument should either be a stable currency or a composite unit of account.

Kahf (1998; in Ahmad and Khan op. cit) also argues a case for issuing rent-earning financial instruments, i.e. asset *ijarah* bonds for bridging the budgetary gap. An *ijarah* (rent) bond can be designed either as a certificate of ownership of a durable asset or a certificate ownership of its usufructs. Rent bonds are different from common stocks *musharakah/mudarabah* certificates on at least three counts: these bonds earn fixed rent rather than profits, these represent ownership of only rent-able assets (not all assets) and that rent-bonds can represent usufructs which is not the case with common stocks.

Elgari (1998; in Ahmad and Khan op. cit) explores the prospects of improving the cash flow of governments. Availability of cash is vital for efficient operation of the government as it is for any other enterprise. Among Islamic modes of finance, *mudarabah* and *musharakah* provide cash but for specific investment and trading activities. Leasing and installment sale do not provide cash but, indirectly relieve the urgency for cash by providing finance. The author argues that the *salam* contract has the potential to enhance the cash flow of the government without restricting it to use the cash for specific purposes.

The proposed *salam* certificate is based on the Maliki concept of selling non-food commodities of *salam* without taking their possession. Using this principle, the government can assume the role of a *salam* supplier to the prospective buyers and issue a certificate in different denomination with the inscription that the owner of the certificate will be supplied on such and such future date with such and such amount of such and such asset. The cash as such mobilized will be used by the government freely, whereas, the buyer may keep the certificate or may sell it. The *salam* certificate is envisioned to be a short-term (3 months) instrument, calling for the government to actively involve in either direct trading or trade intermediation.

Furthermore, under conditions of risks, option features in contracts make the contracts more efficient. Khan (2000) and Ebrahim and Khan (2002) suggest Islamic financial instruments with embedded option features.

As discussed in this section, a number of Islamic financial instruments have actually been put into practice. Table-7 lists the menu of the potential and actual Islamic financial instruments. The menu shows that the Islamic financial instruments are flexible in nature and can meet various types of funding needs of the contemporary economies and the public sector.

In the remaining part of this section we discuss the requirements which need to be met in order to issue Islamic financial instruments, and present a survey of the actual utilization of some of the instruments for resource mobilization.

Table 7
Islamic Financial Instruments

	CERTIFICATE	BRIEF DESCRIPTION
1.	Term finance certificates (Declining participation)	The certificates are issued on the basis of a temporary *musharakah* and is redeemed by the issuer within a specified time. These certificates were initially designed by the International Finance Corporation for providing funds to the *mudarabah* companies in Pakistan. Due to their temporary nature these certificates are expected to be more popular for public sector resource mobilization.
2.	Islamic Deposit Certificates	Based on *mudarabah* principle, the proceeds of these certificates are meant for general purpose utilization by the issuing institution.
3.	(Islamic) Installment sale debt certificates	Installment sale debt certificate is proposed to finance big-ticket purchases by making a pool of smaller contributions. The certificate represents the principal amount invested plus the *murabahah* income. These are issued mostly in Malaysia as Islamic debt certificates. However, these are generally understood to be non-negotiable.
4.	Islamic Investment certificates	These are similar to Islamic deposit certificates; but their proceeds are meant to be utilized in specific projects.
5.	*Istisna[* debt certificates	Like the installment sale debt certificate, this certificate represents the investors' principal amount of investment in the *istisna[* project plus the *murabahah* income and is proposed for financing infrastructure projects.
6.	Leasing certificate • *Sukuk Al ijarah* Bahrain • Global *Sukuk Al ijarah*, Malaysia • *Sukuk Al ijarah*, Qatar	Leasing certificate represents ownership of usufructs leased out for a fixed rental income. Since usufructs are marketable, this certificate can be bought and sold. This has become the most popular format for issuing Shari[ah compatible substitute to sovereign and corporate bonds. These *sukuk* have already been issued by the governments of Bahrain, Malaysia, Qatar and Saxony-Anhalt, Germany, as discussed in some detail in this paper. Some other governments of the IDB member countries as well as non-member countries are reportedly planning to issue sovereign *ijarah sukuk*.

	CERTIFICATE	BRIEF DESCRIPTION
7.	*Sukuk Al Intifa[*	This is also called Time sharing bond (TSB) and represents ownership of specific time (usufructs) in a specific residential complex for a specified number of years. Utilizing TSB concept, Zam Zam Towers are being constructed in Makkah utilizing a 28 year BOT contract structure. The TSB will be negotiable.
8.	*Mudarabah* certificates	*Mudarabah* certificate represents ownership in the beneficiary company without a voting right issued so far by several institutions including 36 listed companies in Pakistan.
9.	*Muqaradah* certificates	*Muqaradah* certificate is a hybrid between *mudarabah* certificate and declining participation certificates to be issued by the government for the development of public utility projects. A *muqaradah* certificate law was enacted in Jordan during the early Eighties.
10.	*Musharakah* certificates • Central Bank *Musharakah* Certificates (CMCs), Sudan • Government *Musharakah* Certificates (GMCs), Sudan • *Musharakah* certificates Iran	*Musharakah* certificates are based on common stocks of companies doing Shari[ah compatible business. In Sudan, the government has issued GMCs based on the shares of the government enterprises. The central bank Sudan has also issued CMCs based on the common stock of the government owned banks (these are discussed in more detail in the paper). Also in Iran, for financing infrastructure projects, the government issues these certificates.
11.	National participation certificates	National participation certificates are proposed by the IMF staff as an instrument for mobilizing resources for the public sector. These proposed instruments are based on the concept of *musharakah* certificates are issued in Iran. The certificates are assumed to represent as an ownership title in public sector assets of a country. The *musharakah* certificates issued in Iran resemble this description.

	CERTIFICATE	BRIEF DESCRIPTION
12.	Trust Certificates, IDB	IDB Trust Certificates are *mudarabah* income notes with a secure stream of income from the ownership in a pool of properties securitized through a special purpose entity (discussed in more detail in the paper).
13.	Participation term certificates	Participation term certificates were issued by the Bankers' Equity Pakistan in the Eighties. These had some common characteristics of declining *musharakah* and *muqaradah* certificates.
14.	Rent sharing certificates	The holder of this certificate shares in the rental income of the asset against which the certificate has been issued. In fact all *sukuk al-ijarah* are based on rent sharing.
15.	Revenue sharing certificates	Revenue sharing certificates were issued in Turkey for re-financing the privatized infrastructure projects.
16.	*Salam* certificates	The holder of a *salam* certificate claims commodities, goods and services in a specified future date against payments the holder makes in advance. In Bahrain the Bahrain Monetary Agency issues *sukuk al-salam* as discussed in more detail in this paper.
17.	Hybrid certificates	Hybrid instruments allow the holder of any of the debt certificates to exchange the certificate for other assets of the issuing entity or in any other entity subject to the offer prescribed on the hybrid certificate. The government can issue these certificates to create market for infrastructure projects. Such certificates have however, not yet been issued in compliance with the Shari[ah.
18.	Mutual Funds	Mutual Funds are organized on the basis of *wakalah* contract in which the fund manger is paid a fixed fee or on the basis of *mudarabah*. This mode of resource utilization can be utilized by governments as done in Sudan by developing funds of good performing public enterprises and selling the units to investors on temporary basis.

Source: Updated from Khan and Ahmed (2001).

3.2 SHARI[AH CONSIDERATIONS

3.2.1 Guidelines for issuing financial instruments

Islamic scholars offer the following general guidelines for issuing of Islamic financial instruments.[27]

a) Instruments should represent share in equity, real assets, usufruct, money or debt or a combination of some or all of these:

   i) instruments representing real physical assets and usufructs are negotiable at market price;

   ii) instruments representing debts, in their negotiability are subject to the rules of *hawalah*;

   iii) instruments representing money are subject to the rules of *sarf* in their negotiability;

   iv) instruments representing a combination of different categories are subject to the rules relating to the dominant category;

   - if debts are relatively larger, the portfolio's negotiability will be subject to *hawalah al dayn*;
   - if currency component is larger to *sarf*; and
   - if real/physical assets and usufructs are overwhelming, to selling at market prices.

b) The issuance of Islamic financial instruments based on *mudarabah* or *musharakah* is subject to the following conditions:

   i) the principal and expected return on investment cannot be guaranteed;

   ii) if the financial instruments were issued for specific purposes or projects, the prospectus should include

[27] See, Ahmad, Ausaf and Tariqullah Khan (eds) (1998).

full disclosure of the nature of the activities, contractual relationships and obligations between the parties involved and the ratio of profit sharing; and

iii) the issuers of financial instruments should keep separate accounts for each project and must declare its profit and loss accounts at the date mentioned in the prospectus and balance sheets.

c) Holders of Islamic financial instruments are the owners of whatever rights these instruments represent and bearers of all related risks, and

d) An instrument the object of which is debt should not be allowed to earn any return and that its negotiability must be in accordance with the Shari[ah rules.

3.2.2 AAOIFI standards concerning investment *sukuk*

Sukuk may be differentiated from other Islamic financial instruments from the fact that these are the closest Shari[ah compatible substitutes to the fixed-income and asset-backed interest-based financial instruments. Since there has been a great interest in issuing Islamic financial instruments, the AAOIFI during Ramadan 1423H adopted an Exposure Draft of Shari[ah Standards concerning Investment *sukuk*. The salient features of these Standards are summarized in Tables 8.

Table 8

Salient Features of AAOIFI Exposure Draft of Shari[ah Standards Concerning Investment *Sukuk*

Sukuk	**Description of *Sukuk***	**Basis of trading in *Sukuk***
1. Certificates of ownership in leased assets	These are certificates that carry equal value and are issued either by the owner of a leased asset or an asset to be leased by promise, or by his financial agent, the aim of which is to sell the asset and recover its value from subscription, in which case the holders of the certificates become owners of the assets.	The issuer of these certificates is selling a leased asset or an asset be leased on promise. The subscribers are buyers of the asset. The mobilized funds from subscription are the purchase price of the asset, and the certificate holders become the owners of the assets jointly with its benefits and risks.
2. Certificates of ownership of usufructs	These certificates have various types, including the following:	
2.A. Certificates of ownership of usufructs of existing assets	These are documents of equal value that are issued either by the owner of usufruct of an existing asset or a financial intermediary acting on the owner's behalf, with the aim of leasing or subleasing this asset and receive rental from the revenue of subscription. In this case, the holders of the certificates become owners of the usufruct of the asset.	The issuer of these certificates is selling usufruct of an existing asset. The subscribers are buyers of the usufructs. The mobilized funds from subscription are the purchase price of the usufructs, and the certificate holders become the owners of the usufructs jointly with its benefits and risks.
2.B. Certificates of ownership of usufructs to be made available in the future as per description	These are documents of equal value issued for the sake of leasing assets that the lessor is liable to provide in the future whereby the rental is recovered from the subscription income, in which case the holders of the certificates become owners of the usufruct of these future assets.	The issuer of these certificates is selling usufruct of an asset to be made available in the future as per specification. The subscribers are buyers of the usufructs. The mobilized funds from subscription are the purchase price of the usufructs, and the certificate holders become the owners of the usufructs jointly with its benefits and risks.

3. Certificates of ownership of services of a specified supplier	These are documents of equal value issued for the sake of providing or selling services through a specified supplier (such as educational programs in a nominated university) and obtaining the value in the form of subscription income, in which case the holders of the certificates become owners of the services.	The issuer of these certificates is selling services. The subscribers are buyers of the services. The mobilized funds from subscription are the purchase price of the services. The certificate holders are entitled to sell all types of usufructs in addition to the funds of reselling such usufructs.
4. Certificates of ownership of services to be made available in the future as per description	These are documents of equal value issued for the sake of providing or selling services through non-existing supplier with the description of the subject matter (such as educational programs of a specific quality, schedule, duration, etc. without mentioning the educational institution) and obtaining the value in the form of subscription income, in which case the holders of the certificates become owners of the services.	
5. *Salam* certificates	These are documents of equal value issued for the sake of mobilizing *salam* capital and the items to be delivered on *salam* basis are owned by the certificate holders.	The issuer of the certificates is a seller of *salam* commodity. The subscribers are the buyers of that commodity. The funds realized from subscription are the purchase price of the commodity, which the *salam* capital. The holders of *salam* certificates are entitled to the *salam* commodity, the selling price or the price of selling the on parallel *salam* basis, if any.
6. *Istisna[* certificates	These are documents that carry equal value and are issued with the aim of mobilizing the funds required for producing a certain item and the items to be produced on *istisna[* basis are owned by the certificate holders.	The issuer of the certificates is the manufacturer (supplier). The subscribers are the buyers of the item to be produced, and the funds realized from subscription are the cost of the item. The certificate holders are entitled to the item or the selling price of the manufactured item.

7. *Murabahah* certificates	These are documents of equal value issued for the purpose of financing the *murabahah* commodity and the certificate holders become the owners of the *murabahah* commodity.	The issuer of the certificates is the seller of the *murabahah* commodity. The subscribers are the buyers of that commodity, and the realized funds are the purchasing cost of the commodity. The certificate holders owns the *murabahah* commodity or the price of selling it.
8. Participation certificates	These are documents of equal value issued with the aim of using the mobilized funds for establishing a new project or developing an existing one or financing a business activity on the basis of one of partnership contracts. The certificate holders become the owners of the project or the assets of the activity as per their respective shares. The participation certificates may be managed on the basis of *musharakah* or *mudarabah* or through an investment agent.	
8. A. Participation certificates managed on the basis of *musharakah* contract	Participation certificates managed on the basis of *musharakah* by appointing either one of the parties or any other party to manage the operation.	The issuer of the certificates is the inviter to a partnership in a specific project or activity. The subscribers are the partners in the *musharakah* contract. The realized funds are the share contribution of the subscribers in the *musharakah* capital. The certificate holders own the assets of partnership and are entitled to profit, if any.
8. B. Participation certificates managed on the basis of *Mudarabah* contract	These are documents that represent projects or activities that are managed on the basis of *mudarabah* by appointing *mudarib* for management.	The issuer of the certificates is the *mudarib*, the subscribers are the capital owners, and the realized funds are the *mudarabah* capital. The certificate holders own the assets of *mudarabah* operation and profit share as per agreement. The certificate holders, being the capital providers, bear the loss, if any.

8. C. Participation certificates managed on the basis of investment agency	These are documents that represent projects or activities that are managed on the basis of investment agency by appointing an agent to manage the operation on behalf of the certificate holders.	The issuer of the certificates is an investment agent. The subscribers are the principals and the realized funds are the subject matter of investment. The certificate holders own the assets represented by the certificates with its benefits and risks.
9. *Muzara[ah* (sharecropping) certificates	These are documents of equal value issued for the sake of using the mobilized funds in financing a *muzara[ah* con-tract. The certificate holders become entitled to a share in the crop as per agreement.	The issuer of the certificates is the landlord. The subscribers are farmers who invest on the basis of *muzara[ah* contract. The realized funds are the cultivation cost. The certificate holders are entitled to a share of the produce of the land as per agreement.
10. *Musaqah* (irrigation) certificates	These are documents of equal value issued on the basis of a *musaqah* contract for the sake of using the mobilized funds for irrigating trees that produce fruits and meeting other expenses relating to maintenance of the trees. The certificate holders become entitled to a share in the crop as per agreement.	The issuer of certificates is the owner of the land that consist of trees. The subscribers are those who assume the irrigation process on the basis of *musaqah* contract. The realized funds stand as the maintaining cost of the trees. The certificate holders are entitled to a share in the produce of the trees as per agreement.
11. *Muqarasah* (agricultural) certificates	These are documents of equal value issued on the basis of a *muqarasah* contract for the sake of using the mobilized funds for planting trees and meeting expenses of the work. The certificate holders become entitled to a share in the land and the plantation.	The issuer of the certificates is the owner of land that is suitable for planting trees. The subscribers are those who assume the agricultural or horticultural process on the basis of *muqarasah* contract. The realized funds stand as cost of maintaining the plantation. The certificates holders are entitled to a share in both the land and trees as per agreement.
12. Concession certificates	These are documents of equal value that are issued for the sake of using the mobilized funds to finance execution of a concession offer in which case the certificate holders become entitled to rights associated with the concession.	

The exposure on Shari[ah Standards of Investment *Sukuk* was adopted by Shari[ah Board in its meting No. (9) held on 11 – 16 Ramadan 1423H, corresponding to 16-21, November 2002.

Subject to the general guidelines presented above, Islamic financial instruments for public sector resource mobilization can be based on the Islamic financial contracts of *mudarabah, musharakah*, Declining *mudarbah* and *musharakah*, *istisna[*, *ijarah*, *salam, and murabahah* and pooled securitization of these subject to the above guidelines.

Debt certificates are not negotiable but are exchangeable for others assets at their face value. A special purpose vehicle (SPV) plays an important role in *sukuk* issuance. SPV is a *mudarib* that pools the revenues of assets and issues certificates to share the streams of incomes there from. It is essential that all assets pooled together must be of the same nature and quality generating the same income or revenues. If incomes of assets of various risk levels are pooled together in separate groups, instruments of as many risk classes can be engineered to suite the preferences of different investors. There are several possibilities of designing financial instruments by combining leasing, installment sale, *istisna*[and participatory principles of financing.

From the above discussion we can make a number of specific observations concerning the possibility of a diverse set of Islamic financial instruments.

- The issuance of Shari*[*ah compatible financial instruments shall preferably follow the guidelines and standards as summarized above. The most important among these is that if it is the case of pooled securitization, the receivables and cash equivalents must not exceed 49% of the pool;
- In case of *istisna[* and *ijarah*, the issuance can be implemented in the framework of a Master contract followed by smaller contracts;
- It is possible to embed a convertibility option with a debt contract; and
- It is also possible to combine contracts and make new hybrid instruments.

3.3 USE OF *SUKUK* FOR RESOURCE MOBILIZATION: COUNTRY CASE STUDIES

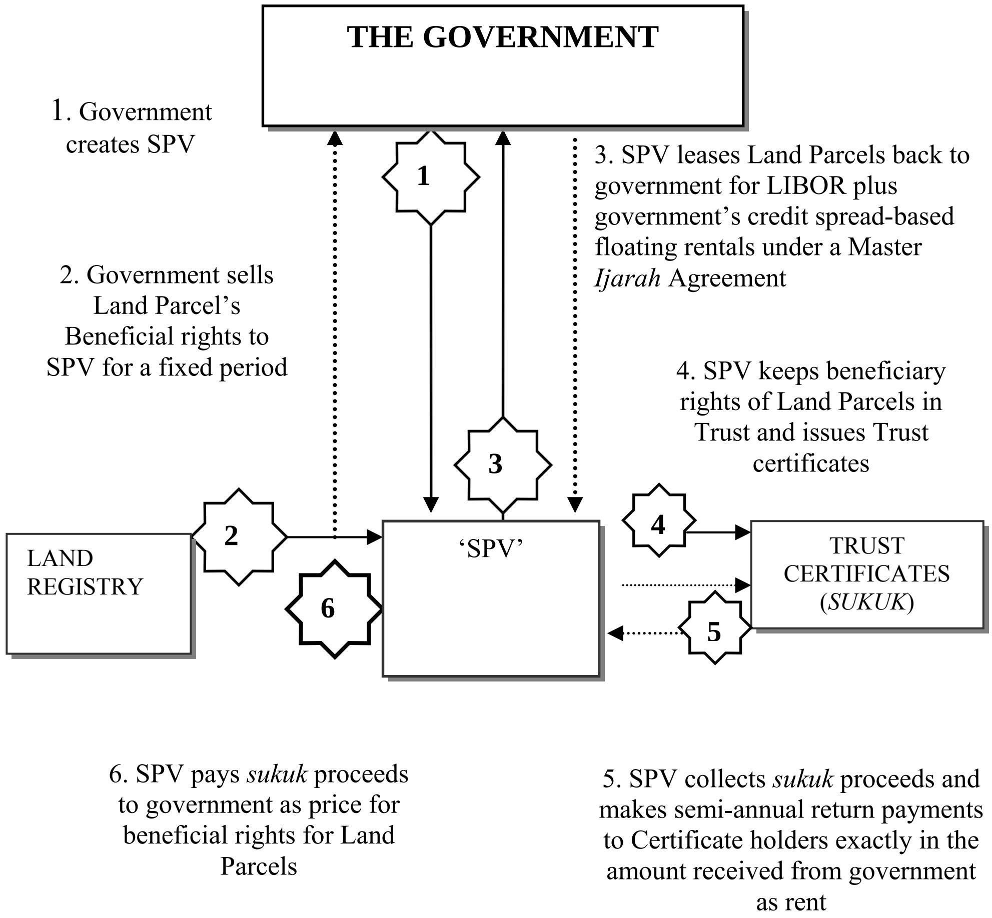
During the last three years substantial development has taken place in *sukuk* issuance both by governments as well as the corporate sector. These *sukuk* are based on *salam*, *ijarah*, *istisna*[, *istisna*[-cum-*ijarah* and on the basis of pooled portfolios. In this section, we discuss some practical cases of *sukuk*.

3.3.1 *Ijarah Sukuk*

Ijarah contract has been utilized for issuing *sukuk* for resource mobilization in Bahrain, Malaysia, Qatar, Saudi Arabia and most recently Saxony-Anhalt, Germany. In all these cases a similar structure has been utilized. The generic structure of *ijarah sukuk* is given in Fig 1. Six steps have been outlined. These steps all take place simultaneously where relevant.

Figure 1

A Generic *Ijarah Sukuk* Structure



Source: Abdul Majid (2003).

Bahrain

Since year 2001, the Bahrain Monetary Agency (BMA) issues *ijarah sukuk*. These *sukuk* are of medium-term maturity. The government uses the proceeds for financing government infrastructure projects. The government of Bahrain has so far issued *ijarah sukuk* worth US$ 730 million, 100 million in 2001, 200 million in 2002 and 430 million in 2003. Table 9 provides additional information on the *ijarah sukuk*. All except the 7th issue are based on fixed rates. The 7th issue is based on a floating rate of 6 month's LIBOR plus 60 bps. The last two issues are rated by the S&P as A-. All issues except the 7th one are issued by the BMA whereas the seventh one is issued by a special purpose company - LMC *Sukuk* Company BSC – a subsidiary of Liquidity Management Center. The lead managers of the seventh issue comprise of Kuwait Finance House, National Bank of Bahrain, IDB, Bank of Bahrain and Bahrain Islamic Bank.

Table 9
***Ijarah Sukuk* Issued by BMA**

Issue number	Maturity years	Size million US $	Rate of return	Issuer	Listing	Underlying leased assets
1	5		Fixed 5.255	BMA	BSE	Rifah Power Generation Plant
2	5		Fixed 4%	BMA	BSE	Ministry of Education Building
3	3		Fixed 4.25%	BMA	BSE	Government Central Stores
4	5		Fixed 3%	BMA	BSE	Um al Hasan water and electricity control center
5	3		Fixed 3%	BMA	BSE	Part of Port Salman
6	3		Fixed 3.75%	BMA	BSE	Part of Bahrain International Airport
7	5	250	Floating 6ms LIBOR plus 60bps	LMC *Sukuk* Co 1 BSC[28]	BSE	Salmaniyah Medical Complex

Source: Prepared from BMA Website.

[28] A subsidiary of Liquidity Management Center (LMC).
[30] The Certificates are listed in both Labuan, Luxembourg and Bahrain.

Malaysia

During July 2002, the government of Malaysia issued US$600 million Trust Certificates (TCs) due 2007[30] and utilized the proceeds for funding the general obligation public budget. The TCs are based on the concept of *ijarah*. Each certificate-holder holds ownership of *beneficiary right* of land parcels for the July 2002 – July 2007 period. These *beneficiary rights* of land parcels[31] have been sold by the government of Malaysia - Federal Land Commissioner (the FLC remains the registered proprietor of the Land Parcels) - to the special purpose vehicle (SPV) MALAYSIA GLOBAL *SUKUK* INC. (Incorporated in Labuan, Malaysia with limited liability) and then by the SPV sold to the investors for five years. The SPV kept the *beneficiary right* of the properties in trust and issued floating rate trust certificates (*sukuk*) to investors with pricing referenced against the government of Malaysia's sovereign-credit-curve rather than the value of the property assets. The receipts of the sale of trust certificates are paid to the government of Malaysia – FLC - as (rent) price for the *beneficiary right* of properties for five years.

The SPV in turn leased the properties to the government of Malaysia in accordance with the Master *Ijarah* Agreement. Under the framework of this agreement would be bi-annual leases are referenced to 6 months LIBOR. The basic objective of this structure is to avoid rate of return risk by linking it with 6 months LIBOR. The bi-annual, rental payments from the government to the SPV at LIBOR plus 0.95% exactly matches the payments payable on the trust certificates. The price of the

---

[31] The Land Parcels consist of the following four parcels of land located in and around Kuala Lumpur, Malaysia: 1. A parcel of land measuring approximately 15.8 hectares (identified as H.S. (D) 30670, Lot No. PT 35622) located in Mukim Batu, Gombak District, Selangor State, on which is situated Selayang Hospital, a Government-owned hospital operated by the Ministry of Health. 2. A parcel of land measuring approximately 63.0 hectares (identified as G 16202, Lot No. 9225) located in Mukim Klang, Klang District, Selangor State, on which is situated Tengku Ampuan Rahimah Hospital, a Government-owned hospital operated by the Ministry of Health. 3. A parcel of land measuring approximately 80.3 hectares (identified as H.S. (D) 68381, Lot No. PT 11099), located along Jalan Duta in Mukim Batu, Federal Territory of Kuala Lumpur, on which Government living quarters are being constructed. 4. A parcel of land measuring approximately 11.2 hectares (identified as G 13768 and G 13769, Lot Nos. 6176 and 6177), located along Jalan Duta in Mukim Bandar, Federal Territory of Kuala Lumpur, on which the Jalan Duta Government Office Complex (including Ministry of Finance, Ministry of International Trade and Industry and Inland Revenue Board offices) is located.

issuance at LIBOR plus 0.95 is very competitive. At the time of pricing, the sovereign's benchmark June 2009 bond was being quoted over a 10-year Treasury to yield 115bp over Treasuries or 106bp over LIBOR. Its other benchmark July 2011 issue was likewise being quoted over a 10-year and trading at 180bp over Treasuries or 133bp over LIBOR. At the expiry of the purchase agreement after five-years, the government will buy back the properties at the face value of the bond, so that any rise or fall in the valuation of the underlying assets will have no bearing on the bond issue.[32]

Since the rental return is guaranteed by the government of Malaysia, the certificates are thus equivalent to floating rate Malaysian sovereign debts traded internationally. At the time of issuance the Certificates were rated “Baa2” by Moody’s Investors Service Inc., and “BBB” by Standard & Poor’s Ratings Services. The rental is distributed periodically. The rental for each period is calculated on the outstanding principal amount of the certificates. The Clearance and Settlement Interests in the Global Certificates will be held in book-entry form through Euroclear or Clearstream, Luxembourg. Transfers within Clearstream, Luxembourg or Euroclear will be in accordance with the usual rules and operating procedures of the relevant clearance system. The Certificates are issued in minimum denominations of US$10,000 and integral multiples of US$1,000 in excess thereof. Each Certificate represents an undivided beneficial ownership in the Trust. Assets and will rank *pari passu*, without any preference, with the other Certificates. The Certificates are limited recourse obligations.[33]

---

[32] HSBC was the lead manager, alongside, there were three Asian co-managers numbering Bank Islam, Maybank and Standard Chartered, plus five Middle Eastern co-managers comprising ABC Islamic Bank, Abu Dhabi Islamic Bank, Dubai Islamic Bank and the Islamic Development Bank. In total, 51 investors were counted in the book, of which 27 were new to the Malaysian credit. In terms of volume, the new investors were said to account for about 65% of the overall deal, with three accounts (including one from the Middle East) placing orders for over $100 million. Unsurprisingly the floating rate structure appealed heavily to banks and by investor type, the book split 75% banks and 25% asset managers. By geography, the deal achieved an even split with about 50% of paper placed in the Middle East, followed by 30% to Asia of which about half was placed to Labuan-based institutions, 16% Europe and 4% the US. Middle Eastern investors were similarly said to be well spread following a four-city roadshow, with final participation from accounts in Abu Dhabi, Bahrain, Kuwait, Iran, Pakistan, Qatar and Saudi Arabia. See, http://www.financeasia.com/articles/3CC0F47D-84A8-11D6-81E00090277E174B.cfm

[33] Extracted from News reports and Malaysian Global Sukuk Issuance Document.

Qatar

During 2003 the government of Qatar needed to raise funds for the construction of Hamad Medical City (HMC), Doha Qatar. The government of Qatar, Qatar International Islamic Bank (QIIB) and the HSBC established a joint venture special purpose vehicle (SPV) – the Qatar Global *Sukuk* QSC, (incorporated in Qatar with limited liability).[34] The SPV acquired the ownership of Land Parcels which was registered in ownership for the HMC. The SPV kept this Land Parcel in trust and issued *ijarah*-based Trust Certificates (TCs) worth US$700 millions due by October 2010 at an annual floating rate of return of LIBOR plus 0.45%. The proceeds are used in acquiring the ownership title to Land Parcels. Under a Master *Ijarah* Agreement, the Land Parcel are leased to the government till October 2010 at a rent of LIBOR plus 0.45%. The rents are exactly the same amount as paid to the certificate holders and reflect the sovereign credit curve of Qatar with a credit rating of ‘‘A+’’ by the S&P.

The basic structure and features of Qatar Global *Sukuk* are almost similar to the Malaysian Global *Sukuk*. It is also based on a Master *Ijarah* Agreement and bi-annual leases on the basis of 6 months’ LIBOR so that through the floating rate the rate of return risk can be avoided for both parties.[35]

Saudi Arabia

A variant of the *ijarah sukuk* have been applied in financing the construction of Zam Zam Towers in Makkah. King Abdul Waqf Makkah Al Mukaramah decided to develop its property located in the vicinity of the Holy Haram as residential facilities. The project named as Zam Zam Towers (ZZT) was allotted to the Binladin Group of Companies (BGC) on the basis of a BOT concession contract for 28 years. The BGC in turn,

---

[34] *Joint Lead Managers,* HSBC and QIIB; *Co-Managers,* Abu Dhabi Islamic Bank CIMB, Gulf International Bank B.S.C. Islamic Development Bank, Kuwait Finance House K.S.C. Qatar Islamic Bank S.A.Q.

[35] Information is extracted from Qatar Global *Sukuk* Issuance Document,

http://lfxsys.lfx.com.my/others/qatar/Offering%20Circular%208%20Oct%202003.pdf.

leased the ZZT project to Manshaat Real Estates for the life time of the BOT contract.

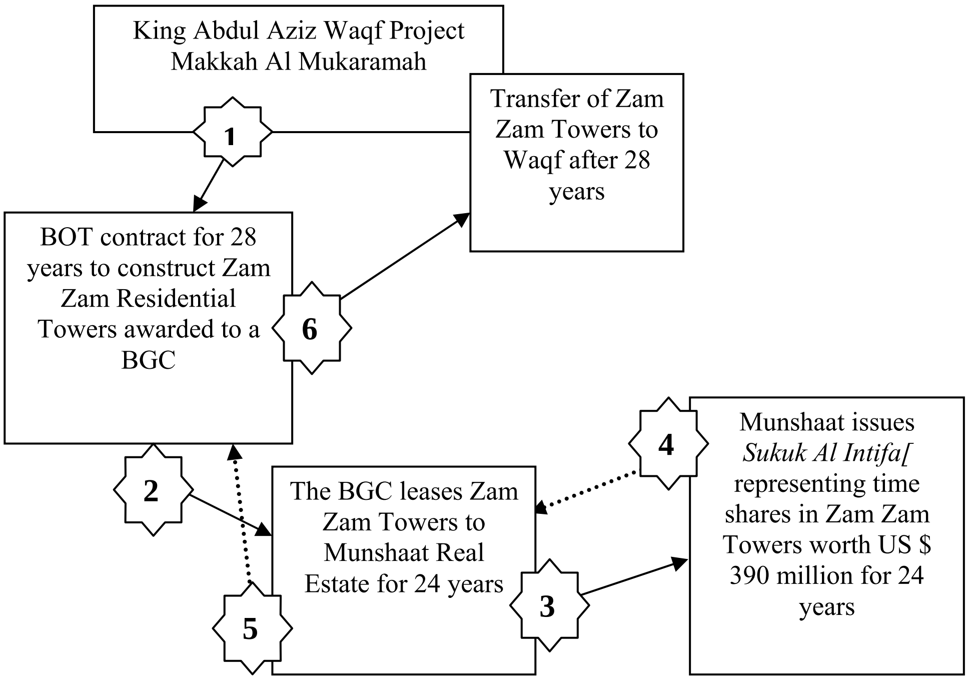
The Manshaat sold its usufructs rights for the 24 years by dividing them into weekly time shares to investors as *sukuk al intifa[* as negotiable instruments. The funds as such mobilized will be paid to BGC as rents for the 24 years. The Manshaat will cover its transaction cost and profit from the rent differentials between what it receives from *sukuk* holders and what it pays to BGC. After completion of the lease period and the BOT period, the BGC will transfer the ZZT to the King Abdul Aziz Waqf in accordance with the BOT agreement.[36]

It can be seen that this case is highly relevant for financing most types of BOT projects. It would particularly be ideal for such big ticket infrastructure projects which have good financial profile and which can be undertaken without much financial guarantees from governments. The structure of this case is summarized in Fig 2.

[36] Information extracted from news reports and http://www.zamzamtower.com.

Figure 2

Structure of Zam Zam Tower Financing



3.3.2 *Salam* and *Istisna[Sukuk*

The contracts of *salam* and *istisna[* can be used to procure/manufacture some public sector needs. These contracts have been successfully used by the governments of Bahrain and Saudi Arabia in recent years. These cases are briefly discussed below.

Bahrain

The government of Bahrain has been using *sukuk al-salam* for purchase of aluminum for public sector. The BMA makes the US dollars 25 million issues on behalf of the government of the Kingdom of Bahrain at regular intervals. The *sukuk al-salam* carry a maturity of 91 days and are always oversubscribed. The *salam sukuk* do not have secondary market. The Issue No 30 of *sukuk al-salam* was made on 5th November 2003 which matures on 4th February 2004, with a rate of return of

1.18%. The basic aim of these *sukuk* is to facilitate liquidity placement and management by the Islamic banks. So far the BMA has issued *sukuk al-salam* worth US dollars 700 millions, 175 million in 2001, 300 million in 2002 and 225 million in 2003.

Saudi Arabia

During 1993 the Ministry of Education, the Kingdom of Saudi Arabia needed to finance the construction of buildings for 400 public schools. For financing these schools the *istisna[* mode was utilized by the Al Rajhi Banking and Investment Corporation. The cost of the buildings construction was SR.3.2 billion and the *istisna[* total price was SR.5.54 billion. The Bank hired 50 engineers to supervise the projects and signed 56 sub-contracts.

The Master *Istisna[* Contract was signed between the Ministry of Education, Kingdom of Saudi Arabia and Al Rajhi Banking and Investment Corporation. The Ministry of Finance and National Economy, Government of the Kingdom of Saudi Arabia acted as a guarantor of the Ministry of Education. These responsibilities were undertaken under government rules governing the construction of educational facilities approved during Muharram, 1412H. The signing of the *istisna[*contract required that the piece of land on which the buildings were to be built existed physically with its size and geographical boundaries documented and the building's technical specifications and designs approved by the competent authorities.

Al Rajhi was responsible for construction of the buildings according to the technical and design specification. The Ministry of Education shall pay the due amount in forty installments of equal proportion payable quarterly starting from the initial delivery of the project or the end of the contract execution period whichever may be earlier.

Al Rajhi could subcontract the building to competent third parties by following existing rules for bidding transparently. The Ministry of Education could be invited as a supervisory partner in signing the sub-contracts and in inspecting the completed phases in line with the specifications. The two parties also agreed to increase the volume of work up to 10% or reduce it by 20% of the total contract value provided the value of the contract is adjusted accordingly with mutual understanding. The installment to be paid will also be adjusted accordingly.

The contract also specified penalties for willful breaching of the contract timely delivery, and meeting specifications. Further the contract also provided for responsibilities for maintenance of the buildings which is the responsibility of the Bank between the initial delivery and final delivery of buildings. The Bank will also be responsible for any damage to the buildings during 10 years of final delivery due to faulty construction. However, during this period, the Ministry of Education will be responsible for standard maintenance and careful utilization of the buildings. By end 2002, 399 schools had been finished and transferred to the Ministry of Education.

3.3.3 Pooled securitization

In this section we discuss three cases which we call pooled securitization. The first case is that of the Islamic Development Bank's Solidarity Trust Certificates which are based on the securitization of portfolio of assets - *ijarah*, *murabahah* and *istisna[* receivables. The second and third cases are of the Sudanese Government *Musharakah* Certificates and *Sukuk* based on portfolio of government shares in corporations and projects.

IDB Trust Certificates

Mobilization of additional resources from the market has remained one of the most important challenges faced by the IDB. During 2003 the IDB undertook a major initiative in this regard by securitizing worth US dollars 400 millions of its prime *ijarah*, *murabahah* and *istisna[* assets through Solidarity Trust Services Limited, a special purpose company established for the purpose, under Citibank's Lead Arranger's position.[37] Important feature of the arrangement is the fact that 51% of the pool of assets securitized must comprise of *ijarah* and the certificates issued are rated AAA by the S&P. The structure of the arrangement is given in the Fig 3.

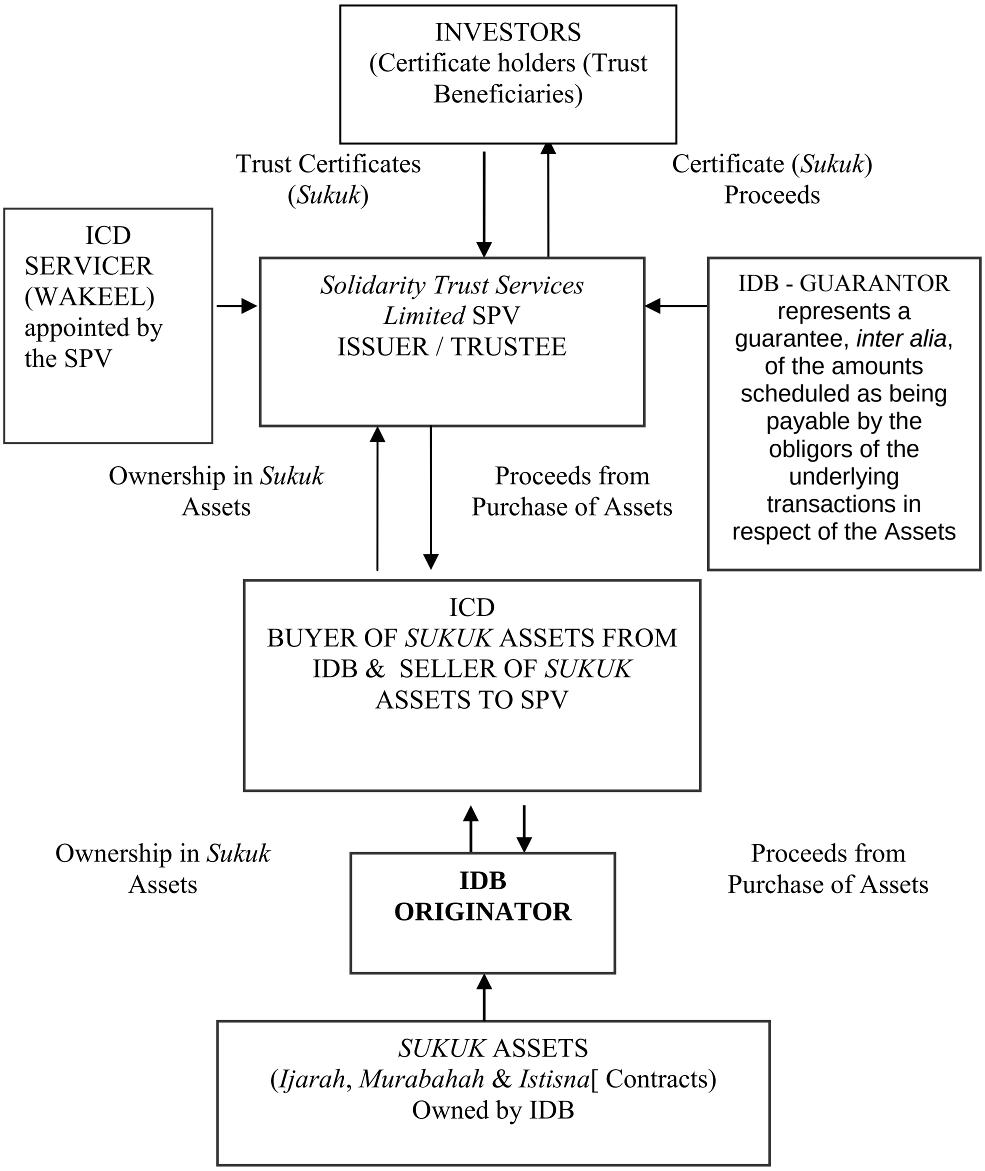
[37] Lead Manager, CITIGROUP, Co-Lead Managers, Abu Dhabi Islamic Bank and Kuwait Finance House and Co-Managers, HSBC and Nomura International.

The IDB *sukuk* are based on a number of key contracts. Some of the key contracts are the IDB/ICD[38] purchase agreement, which covers the sale-agreement of *sukuk-assets* by the IDB and the purchase-agreement of these assets and subsequently additional assets by the ICD. The contract also covers the responsibilities and obligations in detail. The second important contract is the ICD/Trustee purchase agreement is almost the same as the previous agreement except that now ICD is a seller and the Trustee is a purchaser. All obligations of ICD mirror the obligations of IDB. The third important contract is the *ICD wakalah agreement*. In this position, ICD will work as a *wakeel* of the Trustee to service the *sukuk-assets*. Finally, as a mirror of the *ICD wakalah agreement*, there would be a *IDB wakalah agreement*, through which the IDB assumes the obligations of ICD under the *ICD wakalah agreement.*

[38] Islamic Corporation for the Development of Private Sector, a member of the IDB Group.

Figure 3

IDB *Sukuk* Structure



Source: Abdul Majid (2003).

Sudan

The Sudanese government has experimented with the issuance of three types of financial instruments through pooled securitization, namely, Central (Bank) *Musharakah* Certificates (CMCs), Government *Musharakah* Certificates (GMCs) and Government Investment *Sukuk* (GIS). CMCs have been discontinued while the other two are continuing. Here we briefly discuss the other two instruments.

Government Musharakah Certificates

Since 1998 the Ministry of Finance (MoF) Sudan and the Central Bank Sudan have introduced Government *Musharakah* Certificates (GMCs) and Central Bank *Musharakah* Certificates (CMCs)[40] by temporary privatization of public sector shares in corporations. Both GMCs and CMCs are issued by the Government of Sudan and Bank of Sudan respectively by establishing a special purpose vehicle namely, the Sudan Financial Services Company (SFSC).[41] In the case of GMCs the SFSC acts as an agent of the Government and in the case of CMCs the SFSC acts as a *mudarib*. GMCs are issued to mobilize resources to finance the budget deficit whereas, CMCs are issued primarily as an instrument of monetary policy. Names of the corporations and their share in the pool are given in Table 10.

Table 10

Companies which Contribute to the Portfolios of GMCs

#	Name of Company	Shares Hold by Government	% in GMC	Business Line of Company
1.	Aryab Mining Co.	51%	44%	Mining
2.	Int'l Qasr Cooperation	40%	100%	Hotel
3.	Sudanese/Kuwaiti Hotels/Cos.	51%	51%	Hotel
4.	At Bara Cement Co.	99%	30%	Cement
5.	Sudan Free Zone Co.	25%	30%	Free Zones
6.	Nile Oil Co.	100%	100%	Petroleum
7.	Sudan Pipelines Co.	100%	100%	Petrol pipelines
8.	Port Sudan Refinery Co.	100%	100%	Petrol Refining
9.	Sudan Telecom	44%	15%	Communications

Source: GMC (Shahamah) Brochures – 2003.

[40] GMCs are also called Shahama and CMCs also called as Shamam.
[41] Owned 90% and 10% respectively by the BOS and MoF.

In principle, governments should facilitate the efficient working of the markets and shall not compete with the private sector for profit earning. However, in fact most governments do always own assets as a necessity. GMCs present a good case of periodic securitization of public properties for resource mobilization by the governments for meeting the general purpose budgetary obligations. In this perspective, the GMC experience has a significant relevance for other countries who like to utilize Islamic modes for resource mobilization for bridging budgetary gaps. However, as for securitization of the assets of financial institutions is concerned, there is an inherent difficulty because banks' predominantly hold debts which cannot be securitized as such as discussed the guidelines for issuing Islamic financial instruments.

Government Investment Sukuk[42]

The government of Sudan authorized the first issuance of its investment *sukuk* to the value of SD6 billion in April 2003. GIS is a fixed face value paper sold to individuals, companies and financial institutions with the objective of raising funds for the finance of government assets/projects through *ijarah*, *murabahah* or *istisna[* modes of Islamic finance. GISs are to be sold and bought in Khartoum Stock Exchange and the Sudan Financial Services (SFS) Company manages them, as a *mudarib* or fund manager, on behalf of Ministry of Finance. *Sukuk*s represent shares in specific government projects, and hence the value of GIS may vary depending on the performance of the projects financed.

There are three parties to *sukuk* activity: The investor or fund provider, the Ministry of Finance or fund demander, and the SFS Company as a *mudarib*. Shari[ah-compliant *mudarabah* contracts underpin the relationship between investors and the company, whereas the relationship between the latter and the Ministry of Finance (MOF) is based on specific contracts involving *ijarah*, *murabahah* or *istisna[*. The company invites investors to subscribe to an investment fund of a certain size and maturity. Investors receive *sukuk* according to the value of their contributions. The funds are to be used to finance government investment according to conditions set by a restricted *mudarabah* agreement. The company manages the fund and investors are not allowed to withdraw

[42] Authors are thankful to Dr. Adam for his help in extracting this information from the Arabic sources.

their contributions in part or in full before the maturity date. However, the *sukuk*s may be traded in the stock market or under any other legal arrangement. *Sukuk* proceeds are to be lodged in hybrid *ijarah*, *murabahah* and *istisna[* arrangements with the former being more preferred and given a dominant role. Profits from all operations will be distributed 95% to investors and 5% to the *mudarib*.

The government of Sudan/MOF is obliged to refund *sukuk* on maturity and this obligation is discharged by the Bank of Sudan and is not subject to negotiation or amendment. In the case of *ijarah*, the MOF is obliged to honor the agreement until maturity unless there is a legal reason for terminating the *ijarah*. The MOF undertakes to accept *ijarah*, *murabahah* and *istisna[* arrangement to the full amount of the fund or agreed proportions and up to maturity. The share of investors in the expected profit of about 15-20% per annum shall be paid each six months from the date of subscription and in terms of *tandid* of assets.

Subscription price equals 100% of the face value of *sukuk*, which is fixed at SD10,000 for the current issue of *sukuk*, with a 2-year maturity. Profits are to be distributed to investors 2 weeks after maturity. In the case of oversubscription, the company may, in consultation with the MOF, increase the value of *sukuk* or proportionately distribute existing *sukuk*. In the case of under subscription, the company has to cover the difference for the projects to be undertaken. *Sukuk* are to be refunded according their market value. *Sukuk* are to be traded in the stock market only when the project/assets' are in kind (i.e. the project takes off). Whereas *sukuk'*s ownership is transferable, their *zakah* is not the responsibility of the company. Subscription to GIS is open to all individuals, firms and financial institutions from within or outside Sudan. *Sukuk* activity is to be approved and monitored by the Shari[ah Board.

3.4 INVESTMENT *SUKUK*: KEY CONSIDERATIONS FOR SUCCESS

A number of key issues need resolution to strengthen the positive role which the framework of investment *sukuk* can play. Some of these are discussed below:

3.4.1 Building supportive legal and Shari[ah frameworks

Sukuk is a new phenomenon. All international *sukuk* are issued as trust certificates. Yet there are no trust laws in the member countries of the IDB. Appropriate legal framework and market micro-structure for the *sukuk* markets must be put in place. In addition, several unresolved *fiqhi* issues need to be resolved for proper mitigating of the legal risks underlying *sukuk*. Furthermore, for the competitive pricing of international *sukuk* issues, the *sukuk* structures must also be acceptable to other legal jurisdictions such as common law and civil law systems. These are serious challenges but are not insurmountable. They simply require concerted effort for dialogue on building the appropriate financial infrastructure for *sukuk*.

3.4.2 *Sukuk* framework and the size of the public sector

The application of the *sukuk* framework for public sector resource mobilization has the tendency to enlarge the active role of governments in economic activities. Islamic economic system encourages private ownership, initiatives and the efficient and transparent operation of the market mechanism. Moreover, there is an increasing policy shift in most countries towards privatization. Therefore, a conflict between the sovereign *sukuk* framework and privatization must not arise. To ensure this and to facilitate the efficient implementation of privatization strategies it is worthwhile to keep in perspective a number of considerations.

- Efficient privatization leads to improved performance of the entities and more tax revenues provided a sound taxation system is in place. In the same manner improved economic performance is vital for the success of the *sukuk* framework as these are based on real assets and services.
- The *ijarah sukuk* framework itself ensures the private holding of government projects in accordance with a systemic and properly designed maturity structure of the instrument.
- In many privatization programs governments like to maintain some minimum level of public ownership in the privatized entities. The management of the entities in private hands enhances efficiency and hence the value of the public sector's remaining

shares. These public shares can be pooled together for temporary privatization through the *sukuk* framework thus ensuring efficient private sector, improved tax revenues and robust *sukuk* markets. Hence, first, government tax revenues from the privatized part of the enterprises will increase. Second, government resource mobilization from its shares of the post-privatization and more efficient enterprise will increase through the *sukuk* framework.

3.4.3 Sovereign *sukuk* and collective action clauses (CACs)

Negotiations for rescheduling of problem sovereign debts face difficulties due to conflicts between investors in these debts and unequal investment stakes of various groups. Therefore, CACs have been introduced to facilitate smooth process of rescheduling of sovereign debts. The dispute settlement process is also an integral part of the *sukuk* structures, which are ensured by several contracts like dissolution clauses. Furthermore, a majority of *sukuk* so far have been based on the *ijarah* contract. In the framework, of a Master *ijarah* Contract, which is an integral part of all *sukuk* issues, *ijarah* allows for a floating rate subject to an agreed benchmark rate. Hence, the CACs are in fact in-built in the *sukuk* framework both for the dissolution of the contract as well as for renegotiating the rate of return according to the market benchmark.

IV. ROLE OF BUILD-OPERATE-TRANSFER MECHANISM IN FINANCING INFRA-STRUCTURE PROJECTS

Public expenditure has two components, current expenditure and development expenditure. Different strategies may be needed for financing the two types of expenditure. As far as current expenditures are concerned, recourse may be made to any one of the sources of public revenue listed in the previous section. For development expenditure, some additional instruments have emerged during the past few decades. In this section, a menu of such instruments as well as practical experiences is discussed with a view to learn lessons for financing public expenditure in IDB member countries.

A large part of public expenditure in the developing countries is allocated to the development of infrastructure projects. Governments of the developing countries have big responsibilities in the development of social-infrastructure - schools, hospitals, bridges, road-links etc., which may not be financed by the private sector because of the underlying externalities. Financing such projects is one of the main causes of budget deficit. Traditionally these are financed through interest-based borrowing. However, the build-operate-transfer (BOT) arrangements offer additional alternatives.

Since the 1980s, an increasing number of infrastructure projects in several countries are becoming *limited recourse* or *non-recourse* in nature with respect to the general obligation public budget. However, a significant number of new infrastructure projects are developed by the private sector and these are *non-recourse* in nature. Let us call them off-budget public projects. In these cases, individual projects are separated from the obligations of the public sector and shifted on to the private sector. The risks of individual projects are unbundled through various contracts. The cost of such projects is passed on to consumers in the form of competitive prices. The financial accruals go to the private sponsors but public authorities also share in these accruals through fees and tax collections. The financial viability of such projects is assumed to depend entirely on their own cash flows, and the nature of their assets and liabilities. Hence these projects must "stand-alone" as independent economic entities. In general, the cash flows from the assets of the projects and sovereign guarantees protect the interests of equity and debt providers. Governments also play critical role as facilitators.

4.1 CONTRACT STRUCTURES

Private infrastructure projects can take various forms of ownership, management, operational and maintenance structures. Some of these structures are summarized in Table 11. The list is neither complete nor universally uniform. Through financial engineering and legal analysis and evaluation, contracts are designed to meet the requirements of specific needs emerging from various circumstances. However, the BOT can be considered as the core concept behind these arrangements. Rest are its various variants.

It is important to note that these contracts are forms of project finance structures and these need financing facilities ranging from equity, quasi-equity to debts. As discussed above Islamic financial institutions can also offer complete set of BOT project financing facilities. In the next section we also discuss the possibility of financing the BOT project through the Islamic capital markets.

Table 11
Profile of Private Infrastructure Project Finance Structures and Relevant Contracts

	Structures	Description
1.	Build-Operate and Transfer (BOT)	It is a concession agreement between an entity representing the public authority and a private party whereby the private party constructs and operates an infrastructure facility for a fixed time period and after that time period the ownership of the project is transferred to the public authority without any or minimal financial obligations. The project specifications are made by the public authorities and the project development and operation is carried out by the private party with full responsibility for specifications. The private parties cover their capital cost and expected earnings from the project revenues during the period of the concession. The purchase of project output is guaranteed by the government at a specified fixed price. The public authorities provide limited or no financial accommodation but substantial market and other risk coverage and guaranties. The whole process involves several contracts for sharing the risks, liabilities, responsibilities and returns. The arrangement enables the governments to facilitate the development of infrastructure projects without a recourse to the government budget.
2.	Build, Operate & Renewal of Concession (BORC)	BORC is a more efficient variant of the BOT. It is a BOT, but with an option to re-negotiate the agreement of renewal of contract for operation at the end of a contract period. As a result of the negotiation the operation will either remain with the same project company or the ownership will be transferred to the public authority. This option makes the contract flexible and efficient provided the obligations and risk sharing processes are clearly defined, understood and implemented.
3.	Build, Own and Operate (BOO)	BOO is BOT variant as for as the specifications and obligations are concerned. However, generally BOOs are permanent franchises in which the private party keeps ownership until its performance on obligations is seen satisfactory by the public authority. In this sense it is a hybrid of BOT and BORC.
4.	Build, Transfer and Operate (BTO)	BTO is a short term BOT with a long term franchise for operation by the same private party. Hence the private party will design, finance, and develop the project on orders from public authorities and transfer the ownership of completed project to the public authorities on turnkey basis. Operation of the project will however, remain with the private party for a specified period for fees/revenue sharing etc. During the post transfer operational phase, the financial obligations of public authority will be limited.
5.	Build, Transfer and Lease Back (BTLB)	BLTB is a BTO but to be leased back to the private party for a specified time.

	Structures	Description
6.	Buy, Build, Operate (BBO)	In BBO an existing public project is bought by a private firm and rehabilitated, enhanced and operated by the private party. The specifications for rehabilitations and enhancements are made by the public authority. Like BOO, under BBO too, the unlimited duration of operation is linked to compliance with contracts.
7.	Lease, Develop, Operate (LDO)	LDO is a comprehensive lease of an existing facility plus its surroundings after which the private party develops the area subject to approval of the public authority and operates the facility. It can be considered a fixed term revenue sharing contract.
8.	Rehabilitate, Own and Operate (ROO)	Under an ROO an existing public project is given over to a private firm for rehabilitation according to specifications. The private firm will own the project until it meets the initial conditions.
9.	Rehabilitate, Operate and Transfer (ROT)	ROT is a fixed term concession like the BOT but the object is an existing public sector project and the objective is its rehabilitation and enhancement. Other than that, all conditions of the BOT may apply.
10.	Temporary Privatization	Existing public property is taken over by a private firm for a know period. The private firm undertakes renovation, expansion etc. The private firm fully and independently utilizes the project and bears all risks for a specified period.
11.	Transfer of Operational Rights (TOR)	Private company receives an existing facility against a transfer fee in favor of the government, manages, operates, maintains, invests and finances on the facility during the period and at the end of the TOR period returns the facility back without any cost or liability.
12.	Turnkey Contracts	Construction and transferring over to one party by another party a project for a specified price and subject quality and technology specifications.
13.	Construction Contract	Contract(s) for the construction of the project on turnkey or production-in-hand basis.
14.	Take – or – Pay Contract	The public authority as purchaser of the services generated by a BOT or its variant, agrees to pay specified amounts even if sometimes the public utility may not receive back from the users what it pays for to the BOT company. It is used as an incentive and risk coverage by public authority to private firm to develop projects with public specifications.
15.	Off-Take Contract	Agreement for the purchase of the output of a project for a specified price for a specified period – e.g., a power purchase agreement (PPA).
16.	Power Purchase Agreement (PPA)	In the public facilitated private power projects the public authority guarantees to purchase electricity at specified price for specified time. This covers the producer's market risk.
17.	Operation & Maintenance (O&M) Contract	Contractors or other parties take the responsibility of the operational efficiency and maintenance of a BOT project. In this way the risk of the private party with regard to operation and maintenance is covered.

Source: Updated from Khan (2002).

The experiences with the BOT and its variants have a number of salient features. These structures have been found relevant for almost all forms of projects, namely, defense projects, infrastructures projects, manufacturing, services and public utilities. The models are managed within the framework of several contractual agreements. Just as the models can be implemented for new investments, these can also be used for renewal of technologically obsolete facilities or for completion of investments which have not been completed. Even though the vast majority of the projects drawn up are presented in such a manner that they will be financed by the private sector, in practice few projects in which the contribution of the public sector is absent are actually implemented. Furthermore, sovereign guarantees imply that the governments are ultimately responsible for the obligations of the projects.

4.2 PROS AND CONS OF BOT PROJECTS

The BOT and its variants have several advantages and disadvantages for the economies that utilize these structures. These pros and cons are briefly discussed here.

i) The involvement of the public sector in economic activities is reduced to a supervisory role, economizing resources of the public sector which is crucial to curtail the public debt.

ii) Private interests are associated with public projects which were used to be the traditional concern of the public sector. This could ensure better operation of the enterprises.

iii) These schemes compromise between the considerations of host and foreign parties regarding the optimal control of ownership, and hence create an environment of understanding and favorable investment climate.

iv) The transfer of technology becomes more systematic and smooth and the projects contribute to net capital formation without resort to foreign aid and by the public sector.

v) Cash flows of the economy get improved, as substantial current funds can be relieved and future export earnings will be enhanced.

vi) These arrangements create debt, but the servicing of this debt is much easier as the projects are certain to generate income, and

vii) Certain aspects of risk-sharing between local and foreign parties is inherent in these arrangements.

viii) In developing countries in particular, entry of foreign capital is assisted and this enables projects to be implemented. With the BOT model foreign companies implement projects requiring advanced technology, thus ensuring the entry of these technologies into the country; employee productivity is enhanced by means of the vocational training/education programs provided.

ix) The private sector displays greater efficiency in choice of project, implementation and operation than the public sector. With the BOT model the state is able to make use of the dynamism of the private sector, which makes possible selection of the projects which will be most effective and rational for society. The BOT projects in the hands of the private sector are taken as benchmarks for evaluation of public projects, which introduces some discipline in the public sector. Moreover, BOT enables governments to decrease the funds allocated to infrastructure investments, which is a positive contribution to the budget balance.

x) In cases of implementation of a public service by the private sector, the BOT model does not mean privatization. Certain investments realized by the public sector are carried out by the private sector and then transferred to the state.

xi) With the BOT model half-completed projects can be finished and obsolete facilities renewed, thus preventing waste of resources.

On the other hand, the recipients of projects need to become careful about a number of problems related to these projects. Which often include:

i) In general, these arrangements are unique in the sense that during the design and construction phases of projects, local parties are not involved. When the project reaches the operational stage, the actual constructors leave the projects.

As a result, achieving proper operation of the projects and their maintenance becomes a real problem. To overcome this difficulty, a management contract is signed by the two parties, incurring additional costs but without solving the basic problems,

ii) Many countries have experienced that, in general, international contractors specify designs with specific import requirements particularly, in terms of capital and skill intensities. The general framework of the designs of the projects are kept the same irrespective of the climatic, geographical and economic realities of different countries and regions. Seldom the project designers take into account local realities. Consequently, the projects prove to be unsuitable in many cases,

iii) Other negative aspects are related to the regulation of the so-called priority sectors, and imperfections created as a result of incentives policies,

iv) The obligation of the foreign party often ends with an inconvenience for the respective projects in terms of operational and maintenance difficulties,

v) Many problems on the operational side of these arrangements are related to performance requirements, guarantees and bargaining strengths of the contracting parties. In general, foreign firms are reluctant to performance obligations. They do not provide guarantee of their performance. Guarantees usually range from 5 - 10 percent of the value of the contract which does not match any mishaps in the project. In some cases it may even mean complete project failure. Yet, in most negotiations the foreign firms always keep an upper hand.

vi) For the foreign contracting parties, the schemes have again several clear advantages. These advantages are related to the sale of technology, and entrepreneurial services as well as profits from the operation of the projects. The foreign firms which undertake to establish the production relationship enjoys the independence in decision making. The decision of purchasing the products and projects by the local authorities if and when taken with mutual understanding protects the foreign party against many apprehensions.

vii) However, the contractors could have many apprehensions too. Their fears could relate to transfer risks, pricing of the output of projects, contract frustration caused by sovereign position of governments and expropriation etc. From the contractor's point of view, the prevailing national, regional or international guarantee facilities do not give sufficient coverage to these important investment activities. So, in situations of calamities or any other wide ranging threat to the projects, responsibilities for risk are disproportionately borne by the contractor.

viii) The BOT model possesses a rather complex structure. The negotiations carried out by more than one party over documents lengthens the contract process and delays arrival at an agreement by the parties concerned

ix) One of the criticisms of this model is that the cost of a project realized by means of the BOT is higher than that of the one realized by means of public budget or sovereign loans. Guarantee of a certain profit and the fact that the cost plus profit system is taken as the basis for pricing increases the cost from the point of view of the state.

x) The large size of the investments to be made, the inevitable delay in obtaining financial returns and the fact that one of the parties to the contract is generally shown as a public body means that investors will attach great importance to political and economic stability. The fact that the BOT model is perceived as a new model in many countries and lack of examples of implementation mean that the parties will encounter various problems.

xi) The negative affects on the parties of the decisions made steadily increase and may constitute an obstacle to realization of the project. In order to avoid this situation it is necessary to ensure as far as possible that the parties concur with the decisions taken at every stage of the project.

xii) The long duration of BOT projects renders necessary taking of decisions based on long-term projections. This makes it more difficult for the parties to arrive at an agreement during negotiations. The fact that the investments to be realized within the framework of the model will be transferred to the state at the end of the operating period is the reason why new public economic enterprises emerge and this creates obstacles to privatization.

4.3 SOME APPLICATIONS OF BOT IN IDB MEMBER COUNTRIES

A number of countries have utilized the BOT and its various variants with different level of successes. In this section some practical cases of financing infrastructure projects through the BOT mechanism are briefly discussed.[43]

4.3.1 Suez Canal Egypt

Suez Canal[44] is in fact the world's most revolutionary infrastructure project and is widely considered as the first ever application of the BOT concept. In 1854 the concession contract for designing and building the maritime canal connecting the Red Sea and the Mediterranean was granted to a French BOT company (Compagnie Universelle du Canal Maritime de Suez, promoted by Mr. F. DeLesseps). The project was constructed during 1859-1869.

Some of the important conditions of this historical BOT concession contract were as follows:

- The concession period was 99 years starting from the opening date and after 99 years, ownership transferring to the government of Egypt.
- The project company was allowed to charge a fee of 10 francs per ton from cargos passing the canal.
- The contract also included construction of a fresh water canal from Nile River near Cairo to Suez.

---

43 This section has been adapted from Khan, Tariqullah (2002), pp. 1-36.

44 In 1956 the canal was nationalized by the Egyptian government. At that time its length was 175 km (now it is 195 km), breadth of the canal was 35 feet (now 62 feet), ship cargos 90 thousand tons per day (now million tons), daily revenue 90 thousand dollars (now 5 million dollars). See, http://www.sis.gov.eg/public/yearbook96/yearbook/ch10sc05.htm.

- The contract included the granting of appropriate amount of land to the project company to establish support infrastructure on the banks of the canal.
- Input (labor) was to be supplied by Egypt free of cost to the project company.
- Equity was to be provided by French investors and Egypt.
- Construction was to be carried out by Egyptian and British contractors.

In 1859, equity of 200 million francs of the project company's 400,000 shares was opened to subscriptions. As a result, 50% of the Compagnie Universelle du Canal Maritime de Suez was taken over by French investors, 27% by the government in Istanbul and the remaining by the government at Cairo. By 1965 the company had already used major part of its equity and had to raise debt. Towards completion of the project, the financial problems of the project company were so severe that at times, it faced bankruptcy threats. By the 1869 completion time of the project, 433 million francs were already spent on the project. The deficit was financed by various types of debt issues including deep discount debts with lottery attachments.

Like all other BOT projects, the Suez Canal project also faced several disputes related to the input supply agreement, toll rates, contract enforcement and sovereign *force majeure*. The first dispute arose in 1863 concerning supply of input (labor) in accordance with the initial agreements which were relatively unfavorable for workers. The dispute also led to renegotiating other parts of the concession agreement including the lands which were granted to the project company and specifications of the Nile river fresh water canal. The estimated costs of these disputes for the parties were 90 million francs which also led to the change in the ownership structure of the project company. However, renegotiation of the input supply contracts actually enabled the project company to replace labor with equipments and partitioning of the canal project into four portions and four separate construction contracts. These arrangements were found to be instrumental in ensuring the success of the project.

The second significant dispute arose in 1872 on the rates to be charged on cargos. According to the concession contract, this charge was

10 francs per ton passing the canal. In 1872, the project company imposed this rate on the gross capacity of ships instead of the actual tonnage, increasing the actual tonnage charges substantially over the 10 francs per ton. This triggered a dispute of the company with ship owners and an international arbitration conference had to be convened in 1873. The rates were renegotiated by the company and the ship owners to link these with traffic growth and the improvement of the canal's own facilities.

It is notice worthy that during initial years the cargo charges were barely sufficient to meet the running costs of the canal. Hence in addition to the 10 franc per ton charge, a 3 franc surcharge per ton was agreed with provisions for removing the surcharge overtime and reducing the net tonnage charge to 5 francs once the dividends to owners reached 25%. This target was achieved by the year 1881.

The most important lesson to be drawn from the success of the Sues Canal project at the project implementation stage as well as in the initial operational stage is the room, which was available for negotiation between the parties. Such understanding between parties is in fact a vital factor in determining the success of the most large and complex BOT projects.

4.3.2 The case of Turkey

The contemporary BOT method is widely considered as a Turkish innovation. During the early eighties, when privatization was embarked upon, the need was felt to harmonize the benefits of private capital inflow with long-term national interests in projects of vital national importance viz., electricity, atomic reactors, bridges, roads, airports, seaport, fertilizer etc. Under the BOT scheme, the State Planning Organization of Turkey and State Economic Enterprise encouraged foreign investors to form BOT concession companies. These companies then receive (concession) contracts from the public sector to build specific projects on the terms and conditions laid down in the contract. Two most important terms of the contract are: i) the Public sector's guarantee to purchase the product of the project, for electricity projects, e.g., through the power purchase agreement (PPA), and ii) Public sector also guarantees to purchase the project whenever so desired by the contractor companies. The general approach has however, been one of encouraging the contractors to operate the project for a longer period. On the other hand, if the government desires the contractors to sell their interest, it may have such options specified by the contract.

As of December 2000, there were 391 projects with a total cost of 28 billion dollars in the BOT project stock. There are 181 ongoing projects with a project cost of 21 billion dollars. The energy sector occupies first place in the project stock, with 337 projects worth 21 billion dollars. This is followed by the communications sector, with 27 projects to the value of 6.3 billion dollars. In the table below is a breakdown of BOT projects according to distribution and stage of development in accordance with data obtained from the State Planning Organization and the relevant organizations as of the end of December 2000. The main reason why energy sector investments occupy first place is that the State has given a guarantee to the companies concerned that the energy produced will be purchased.

These contracts impose large contingent liabilities on the economy. During financial and economic crisis, as it was the case in Turkey during 2000-2001, the burden of these liabilities become severe. During 2003, Turkey prepared detailed estimates of contingent liabilities arising from BOT and its variant contracts. Based on the findings of the report, the electricity BO, BOT, and TOOR contracts and natural gas take or pay contracts are being reviewed with the relevant parties to reduce the medium- and long-term financial impact of these contingent liabilities. The implication of this could be a complete restructuring of some of the BOT and other projects and their phased full privatization.

4.3.3 HUBCO power project Pakistan

BOT arrangements are often considered to be less risky, thus superior as compared to a permanent ownership such as provided under a Build-Own-Operate (BOO) facility. Yet, one of the largest (US dollars 1.5 billion about Rs. 80 billion in 1999 exchange rates) private power company in the developing world, namely, Hub Power Co., was initiated in Pakistan as a BOO project.

Despite meeting the major requirements of a solid security package, namely, multilateral financing, guarantees, host financing and host government guarantees etc., a dispute between the project's sponsors

(Saudi and British) and the Pakistani public utility (Water and Power Development Authority - WAPDA) continued for about two years. The main source of the contention was a single agreement namely, the PPA between WAPDA and the Project Company on the tariff rates. As a result of the dispute foreign investment climate in the country suffered until the dispute was resolved. The experience of Hub Power Co. provides some important lessons.

First, economic and statistical projections about the revenues of a specific project are not enough. Since such projects do not generate foreign exchange earnings, it is vital to carefully study the foreign exchange implications of capital repatriation resulting from the project. In case of Hub Power, this implication is tremendous for the economy as it is a BOO project.

Second, the BOO mechanism allows permanent ownership of projects. The sponsors might have expected that they would be able to sell a large part of the company in the stock markets. This could not happen due to the depressed stock markets as well as due to the dispute. A careful forecast about the performance of capital markets is thus also very important, particularly if a BOO scheme is to be adopted.[45]

Third, the PPA dispute shows that unrealistic tariff rates could destabilize even otherwise a sound security package.

Finally, it is obvious that such projects need a lot of debt. It is often recommended that since the risks are substantial, sponsors should mobilize large amounts of debt finance, particularly, through the multilateral financial institutions[46] having good bargaining strength.

4.3.4 North-South highway Malaysia

Among member countries, Malaysia has accumulated significant experience in implementing BOT projects in different sectors of the economy.[47] The North-South Highway (NSH)[48] project provides a good

---

[45] Keeping in view such considerations World Bank (1994) recommends BOT type for economies, which do not have developed capital markets.

[46] See, e.g., Wells (1995).

[47] The most important infrastructure projects with a significant role of the private sector in Malaysia is indeed the KLIA (Kuala Lumpur International Airport Sepang)

representative case of such experiences. This 900-km road links the country's north on Thai borders with the south on the Singaporean borders. Thus, it is one of the most important highways in Malaysia. We highlight three important features of this project, which is constructed as a BOT project.

First, in case of infrastructure projects, normally, it is the government, which initiates the idea of a project and motivates the private sector for its promotion. In the case of the NSH, the private sector played a crucial role in highlighting the usefulness of the NSH as a BOT project, and the government was convinced about it. The NSH was constructed in the early eighties in traditional ways as a public sector project, but the project was never fully completed in that form. In 1985 United Engineers Malaysian Bhd (UEM) submitted to the government a concept proposal on how the NSH can be improved tremendously as a BOT project. The 30 years BOT concession was awarded in 1988 the project was completed in 1995.

Second, the debt equity structure was 90:10 and the initial cost was calculated at RM 3.44 billion, which was subsequently, increased by RM 976 million. The debt comprised of Malaysian government support loan of RM 650 million, export-credits, commercial bank loans and revenue bonds.

Third, the financing arrangement for the project provides a good example in financial engineering with incentive compatible contracts. The Project Company had to assign the construction to the sub-contractors. Procurement through sub-contracting exposes the project to the risk of quality and contract enforceability. To overcome this dilemma, interests of the sub-contractor need to be aligned with the quality of assets to be constructed. The NSH was able to overcome this problem by designing incentive compatible compensation schemes for the sub-contractors. Accordingly, the Project Company and the sub-contractors contractually agreed that 87% of the contract value should be

---

opened for traffic in June 1998 at a cost of RM 10.5 billion. The project involved 26 design and 80 construction contracts. At least three major project consortiums were formed for the main terminal, satellite terminal, and transit system. This project is much more complicated for a proper description at this stage. Some more information can be downloaded from: http://www.jaring.my/airport/klia2/klia-details.html.

[48] This profile is based on information given in Walker & Smith (1995).

paid in cash and 13% in the form of stocks of the NSH Company after its completion.

The above cases are good examples of the development of infrastructure projects through the private sector. While concluding this section we need to make some observations.

First, these examples can be extended to all forms of infrastructures, which generate revenues. By extending the arrangements to such areas the governments introduce private sector efficiency in the projects. As such, the governments' own revenues can increase, which can be used for financing such projects, which cannot be taken up by the private sector.

Second, although these projects are taken up by the private sector, still due to the nature of infrastructures, the facilitating role of the government is necessary for the efficient implementation of the schemes.

Third, although the government is relieved from the immediate burden of financing these projects, the economy as a whole is not relieved, as the burden is simply transferred to the private sector. As the benefits of a successful project can be high for the economy, the cost of an unsuccessful project can also be very high too due to the cost of private capital.

Finally, debt plays a crucial role in financing BOT projects. This debt can be replaced by various Islamic modes of finance.[49]

4.4 SUCCESSFUL USE OF BOT: KEY CONSIDERATIONS

Utilization of the BOT and its variants as a proxy for public expenditures on infrastructure project finance is often called as "contract finance" because, there is a critical need for well defined contracts to arrange financing for projects. The security package[50] provides the crucial framework for raising finance for the specific projects. Some of

[49] See, Khan (1991, 1997, 2002).
[50] Package of obligations, pledge, mortgages, deposits, liens, guarantees etc., given by the project company and its sponsors, the government and other parties interested in the project.

the reasons, which make security package as the basis of raising finance, are given here.

i) BOT projects are standalone projects and are non-recourse to government budgets. In these public sector projects the governments risk nothing and the sponsors risk only their equities. However, the equity is often as low as 10 % of the project liabilities (see the example of the Malaysian NSH above).

ii) The Project Company owns only the revenues of the project, not the project itself. Therefore, the assets could not constitute the basis for raising finance except for the period of the concession.

iii) Investments are irreversible. The assets of the project are immovable and cannot be dismantled, separated and sold.

iv) The revenues of the project constitute the basis for its financing. But the revenue fixation, collection and administration involve several complicated contracts with several parties.

v) The enforceability of the contracts plays a crucial role. Therefore, the projects' revenue forecasts may actually be misleading. The finance providers get extremely concerned with the enforceability of these contracts and do not rely on only demand forecasts for financial flows.

vi) Thus the web of contracts worked out in the security package is factually the basis of the BOT project finance. Therefore, the importance of the security package makes BOT financing distinct as compared to e.g., financing manufacturing projects.

vii) The projects need short as well substantial long-term, debt, equity, and quasi-equity finance. Due to the predominance of *political force majeure,* most analysts suggest sponsors to minimize the use of their own equity and maximize that of debt, particularly, involving multilateral development financing institutions. Historically, the sources of funds for such projects have been sponsors as equity owners, export credit and guarantee agencies, equipment suppliers, commercial banks, multilateral development financing and guarantee agencies, and local governments. Bond issues are important sources of long-term funds in the developed market economies. Since capital markets in the developing countries are less developed, projects cannot raise funds through bond issues. Thus, institutional sources of funds such as banks have to play important role.

viii) The structure of BOT projects is complex. For this reason the legal infrastructure of host countries must be of a type which will respond to this complex structure. With the BOT model, due to the fact that a service provided by the public sector is to be realized by the private sector, there need to be clear and definite laws and regulations concerning the tax and operation régime to be applied in the construction and operation stages, choice of project, how bids will be evaluated, etc.

ix) The aim of BOT projects is to ensure entry of foreign capital into the country. The existence of a certain standard in the banking system, capital and labor markets in the country concerned will encourage foreign investors to look to that country and increase inflow of foreign capital. Together with this, there will also be a need for local companies which foreign investors can turn to for realization of their projects. In terms of seeing into the future, stability to be achieved in terms of inflation and foreign exchange rate prices will be an incentive for foreign companies and is also important due to the fact that the income derived will be based on the currency of the country concerned. Another important factor is that the country's credit rating must be of a standard which will satisfy foreign investors.

x) If the government of the host country ensures powerful political and bureaucratic support, solutions of any problems which may arise in the BOT model will be facilitated. It is for this reason that persons carrying out negotiations in the name of the public sector/the state about the model to be applied must be well-versed in the subject and fully authorized.

xi) Due to very rigid and complex contract structures as guarantees for input prices, output prices, and foreign exchange remittance guarantees, economic and financial stability is extremely important for the success of these arrangements. This is confirmed by almost all experiences. It is therefore, vitally important that the financial system shall not be exposed to systemic instabilities. This requires increase in equity oriented investments and finance to be based on real assets and services as the case is with Islamic finance.

V. CONCLUSIONS AND POLICY IMPLICATIONS

It is an unfortunate fact that most of the Muslim countries are facing fiscal problems. Every government needs resources for the fulfillment of its genuine needs. As a matter of principle, all genuine expenditure of the government must be met through taxes and non-tax revenue. Under normal circumstances borrowing and deficit financing should not be needed. Unfortunately, in most of the Muslim countries that is not the case. Governments have been living beyond their means for too long. This has resulted in huge deficits and build up of public debt of horrendous proportions in many Muslim countries. This is not a good public policy for any government. For Muslim countries, the situation has an added aspect which makes the situation even more serious. This relates to interest. The huge public debt means huge payment of interest, which is prohibited by Islam. Even in countries which have embarked upon an economy-wide Islamization, financing government expenditure through interest-free means have been the biggest hurdle in the Islamization effort.

5.1 REASONS FOR FISCAL PROBLEMS

While the reasons that led Muslim countries into fiscal problems may vary from one country to another, there are several factors which appear to be common to many countries. The arguments and data given in this paper lead us to conclude that some of the major reasons are the following:

5.1.1 Big government philosophy

Historically the problems started in early 1940s. Previously the only rationale for the involvement of public finance authorities in the production of goods and services had been the provision of public goods such as defense, law and order, justice, etc. These goods and services have certain technical characteristics (indivisibility, jointness of production, etc.) which make their provision by the private sector undesirable or unprofitable. Since the society needs these goods, they had to be produced by the public sector. In late 1930's John Maynard Keynes popularized the idea that the government can play a more active role in stabilization and growth through management of aggregate demand. Under the Keynesian influence these two functions i.e. stabilization and growth, also became necessary components of public sector objectives. Roughly, around the same period governments started realizing that the market forces left to themselves, may not produce the distribution of income desired by the society. Partly due to rising levels of unemployment and income inequalities and partly as a reaction to communist philosophy, governments started taking upon themselves the responsibility of supporting the unemployed, the disabled, the old and the very young.

In the light of the prevailing philosophy, the developing countries were advised to increase public investment to take over many economic activities, especially through the creation of public enterprises, thus providing capital and managerial skills assumed to be lacking in the private sector. Most underdeveloped countries, followed this advice. For a large number of Muslim countries this period was very crucial. They were becoming independent after long periods of colonial rule and were in the initial stages of public policy formulation. Dominant philosophy and the strong desire to develop as fast as possible pushed them into the direction of having large public sectors. In addition, the private sector was overburdened with a host of regulations. Such over-regulation almost stifled the private sector. They did not realize that the assumptions on which big government theories were based did not prevail in their economies. Many countries have now embarked upon privatization programs but the process has a long way to go.

5.1.2 Large defense outlays

The second major reason for fiscal deficit in many Muslim countries has been huge expenditure on defense. There are a number of Muslim countries where defense has taken 25 percent or more of total government expenditure. Since defense expenditure does not lead to a corresponding physical output, it creates a huge burden on government exchequer. Because of its crucial importance, however, it cannot be ignored by any government. Many countries find themselves in extremely sensitive circumstances which call for sizable defense outlays. Unfortunately, most governments have neither been able to execute the defense policies efficiently which could have saved considerable amount of money, nor have been able to motivate their populations to render necessary sacrifice that their situations demand. The result has been that this important function has become one of the most difficult items to finance.

5.1.3 Inelastic/narrow tax structure

While many countries committed themselves to big government expenditure, they were not able to mobilize sufficient resources through taxation because of several institutional factors including: (i) The proportion of "cash economy" in these countries was very small which made it difficult to collect taxes; (ii) There were difficulties in defining and measuring the tax base and of assessing and collecting taxes due to low level of literacy; (iii) Administrative structures were not very well geared to fulfill these functions; (iv) Tax laws and procedures were complicated and (iv) Taxation is politically unpopular and governments, especially those which lack public support or stability, avoid this option.

The lack of sufficient tax revenue forced these governments to resort to borrowing and deficit financing. These two in turn became the major causes of the fiscal crises in these countries.

5.1.4 Borrowing on interest

In order to fill the gap between total government expenditure and total government revenue, these countries borrowed heavily, both internally and externally. The result has been that public debt has accumulated to alarming proportions. The reason that public debt has led to fiscal problems is that almost all of this debt is on fixed interest basis. While borrowing this money, there has been little consideration of the rates of return on these funds. A general, obvious and simple rule which is easily forgotten is that no public spending financed by borrowing should be carried out unless the expected rate of return on it at least equals, and is preferably higher than, the cost of obtaining the resources. This is one of the evils of interest-based borrowing. The costs of servicing the borrowed capital have been higher than the rate of return on investments carried out with those funds. And even that is on the generous assumption that these loans were used for investment. In fact, many of these loans were used to finance current government expenditure. This is due to the fact that under interest based financing, the financier has little interest in the way the funds are utilized as long as the borrower does not default.

5.1.5 Tax evasion

The problem of tax evasion is well recognized. It is not easy to quantify, but its magnitude is generally believed to be substantial. In some cases, it has been estimated that the tax evaded is more than three times the amount of tax collected. The major reasons for tax evasion are multiplicity of exemptions on the one hand and high marginal tax rates on the other. Moreover, lack of clearly identifiable and easily assessable tax bases has made tax evasion quite easy.

5.1.6 Corruption

The problem of corruption is also part of common knowledge. It afflicts on both the revenue and the expenditure side. Due to poor fiscal governance, a good part of tax revenue goes into personal pockets rather than public exchequer. Similarly, cuts and kick-backs drain a significant portion of public expenditure into not so public uses.

5.2 POLICY RECOMMENDATIONS

There is an urgent need for a radically different approach towards public finance. We have to stop looking for easy solutions and ad hoc arrangements and face the problem squarely and boldly. There is need for structural changes on both the expenditure and the revenue sides of the government budget. The present approach of taking government expenditure to be more or less exogenously given and then posing the question as to how that amount can be mobilized through interest-free means is basically wrong. It is people who should decide what they need in terms of public services and how they are going to provide for them. The present practice of meeting a very substantial portion of government expenditure through borrowing must be seriously re-examined. Some humble suggestions for reforming the situation are given below.

5.2.1 Creating an optimal combination of market-based and traditional sources of financing

It must be realized that the "classical" sources of financing public expenditure may not be enough in contemporary societies. Many of those have become "irrelevant" and many others have limited potential if strictly interpreted. There is urgent need to find innovative ways for mobilizing resources to meet the requirements of the public sector. While doing this, the distinction between current expenditure and the development expenditure should be kept in view. The present practice of generating resources from all possible sources and then meeting current expenditure out of the available pool and transferring the residual to the development budget needs to be reviewed. In our view, the two kinds of expenditure need to be mobilized through distinctly separate approaches. For meeting the development needs, the possibilities of a more active participation by the private sector should be considered. Many public projects can be undertaken on the basis of techniques, such as BOT and investment *sukuk*, that do not involve interest. We have given several example of the use of Islamic modes in this area in recent years. The experiences are fairly new and need to be carefully monitored and studied with a view to learn lessons.

The efficiency of BOT and its variants strongly depends on the health of the economy, especially of the financial institutions and markets. The arrangements function smoothly as long as the economy performs well. When there is an economic problem, particularly, during periods of financial crisis, due to rigid pricing and other contract structures, the new arrangements do not remain viable and sustainable. In fact, under situations of financial crisis, the economic cost of the new forms of investment can be far greater for the economy concerned as compared to the cost of the traditional debt finance. However, if the economy is not prone to financial crisis due to the paradigm in use, the new investment relations can be sustainable and more efficient.

The question that how would the BOT variants will perform in combination with *sukuk* and Islamic finance in general is an important one. *Sukuk* and Islamic financing in general are based on real assets. Therefore, these arrangements are expected to enhance the stability of financial institutions and markets. Hence it can be suggested that the utilization of BOT and its variants along with the *sukuk* structures and Islamic financing principle in general can be a better alternative to the combination of BOT and traditional interest-based debt and financing.

However, *sukuk* are a new phenomenon. All international *sukuk* are issued as trust certificates. Yet there are no trust laws in the member countries of the IDB. Appropriate legal framework and market micro-structure for the *sukuk* markets must be put in place. In addition, several unresolved Fiqhi issues need to be resolved for proper mitigating of the legal risks underlying *sukuk*. Furthermore, for the competitive pricing of international *sukuk* issues, the *sukuk* structures must also be acceptable to other legal jurisdictions such as common law and civil law systems. These are serious challenges but are not insurmountable. They simply require concerted effort for dialogue on building the appropriate financial infrastructure for *sukuk*.

Although the Islamic modes of finance will not exacerbate an economic or financial crisis, the performance of all Islamic modes of finance are also based primarily on the performance of markets and soundness of economies. Furthermore, Islamic debt finance may also aggravate inter-generational equity, although much lesser compared to traditional debt finance. In addition, the utilization of the Islamic modes of finance for public sector resource utilization is an alternative to taxation. Therefore, comparing the cost of these arrangements with taxation as a competing alternative for financing public sector projects should always be conducted. This has to be done on case to case basis as the situation varies from one country to another.

In general, since taxation is politically unpopular, tax revenues often fall short of government's resource needs. Therefore, a prudential combination of the BOT variants, Islamic financial instruments and taxation may be utilized by the governments. The important point which this research suggests is that such a policy towards financing government expenditure is expected to discipline public expenditure as availability of finance without an asset will be very limited. This is also expected to introduce prudence in the overall macroeconomic management as well as in the efficiency of microeconomic units operating in an economy.

The role of *awqaf* in the provision of public goods such as education and health should be promoted. Voluntary contributions should also be encouraged. These were the biggest sources of financing public expenditure in the early Islamic history and there is no reason this cannot become a sizable source of revenue if proper efforts for harnessing these are undertaken. Contributions in terms of community services have great potential in Muslim countries.

5.2.2 Creating earmarked heads of public expenditure

Deriving the basic principles of public finance from the Qur'an, sunnah and the Islamic fiscal history, introduction of some ear-marked heads of expenditures will help to ensure fulfillment of those functions without ignoring some other important public needs. In our view, Defense and Poverty Elimination Programs are appropriate candidates for such ear-marking.

A modern government has to perform a number of functions. In order to perform these functions it needs to mobilize resources. The predominant practice at present is that all government revenue is kept in a general pool out of which expenditure to various heads is apportioned. This practice has in general resulted in the neglect of certain functions which from an Islamic point of view should get top-most priority. There are some other expenditures which are more or less unavoidable. Defense and debt servicing in current situation are examples of such expenditure. After meeting these expenditures from the general pool, sufficient amount is not left in the pool to perform other functions at the desired level. It is due to this fact that in spite of heavy government expenditures for decades, the general masses in a majority of Muslim countries live in miserable social and economic conditions.

In view of these realities and keeping the Islamic priorities in view, we suggest that a new scheme of apportionment of public expenditure may be adopted. This scheme is based on the principle of earmarking derived from the example of *zakah*. Under this scheme, certain heads of expenditure should be established for which separate resources should be mobilized. Under normal circumstances, money mobilized for these heads should not be transferred to other heads of expenditures. To start with, we suggest that public expenditure may be classified under four heads, namely:

i) Poverty Elimination Programs (PEP)
ii) Defense
iii) General Current Expenditure
iv) Development Expenditure

Poverty elimination programs

This head of expenditure would be reserved for programs and schemes for the benefit of poor only. These may include direct grants, loans for self-employment schemes, scholarships for acquiring education and skills, low-cost housing for the poor, food coupons, etc. *Zakah* would obviously be one of the major sources for this head. However, under present circumstances of incidence of poverty in Muslim countries that alone almost certainly would not be enough. Therefore, additional taxes may have to be imposed. These taxes should be such that their incidence falls on the rich only. Income tax or wealth tax or net-worth tax are some possibilities. The existing taxes in these categories should be reserved for PEP. As the level of poverty decreases, these taxes should also be reduced. In the long run, *zakah* proceeds and other built-in distributive schemes of an Islamic system are expected to be sufficient to fulfill the needs of PEP. Earmarking the proceeds of these taxes (or alternative taxes specially designed for this purpose) will help to fulfill one of the most important functions of an Islamic state i.e. guarantee of basic needs. When people will see these taxes being spent on the poor, the level of tax evasion is also expected to go down. This will be especially so in the long run as the rates of these taxes decrease with decreasing level of poverty.

Defence

Defense is a function that every government must perform. There is hardly any doubt that from Islamic point of view, the performance of this function should occupy a very high priority in the objective function of an Islamic state. However, it should be pointed out here that while ensuring proper defense for the country, the government should normally seek from the people whatever level of sacrifice their defense requires. Whatever expenditure seems necessary should be raised from the public through taxation and voluntary contributions. It is against this background that we are suggesting that a separate head of expenditure on defense should be created. Under the joint pool system, while the defense may get the necessary funds, other heads of expenditure usually suffer. It is one at the cost of the other. Ignoring other necessary functions, especially the needs of the people creates internal instability, social tensions and public antipathy. In such circumstances, the very objective of defense build-up, i.e. ensuring national and territorial integrity, is jeopardized by "excessive" defense spending (Chapra, 1988).

Having defense as a separate head of expenditure will make the people realize that this is sort of an insurance premium that they are paying for a specific service, i.e. security. The level of this premium that the nation has to pay, depends on the level of risk to which it is exposed. Naturally, that varies from country to country. In countries, exposed to more external threats, people must be convinced to offer a higher level of sacrifice.

General current expenditure

Expenditure on all other government activities will be met out of this pool. The amount of resources to be generated for this pool depends on the number of activities that the government has to perform. It is important to realize that even though expenditure for some inevitable activities of the Islamic state such as *da[wah,* law and order and general administration have to be met from this head, in terms of the level of expenditure, other activities of the government such as building of infrastructure, education, health, energy, etc. take a much bigger chunk of government expenditure. Nevertheless, a modern government has to offer many services and resources need to be generated. The major sources have to come from taxes, revenues from public properties, such as mineral wealth, and fees. The following general guidelines can help discipline government expenditure under this head.

i) The "benefit principle" whereby the beneficiaries should bear the cost is well established in Islamic jurisprudence. Therefore, wherever possible, this principle should be applied. In case of most of the public utilities such as telephone, gas, electricity, etc., this can easily be applied. Private sector can also participate in the provision of these goods on commercial basis. Many infrastructural projects, such as building of airports, railroads and highways can also be financed through user charges. As a general rule, public utilities should be priced so as to cover their costs. The policy of across the board subsidies must be reviewed. Subsidies can be given only for targeted groups. Creation of a special head for poverty elimination will further reduce the need for subsidies.

ii) The role of the private and voluntary sectors, especially the latter has to be strengthened. *Awqaf* have historically played a very important role in the provision of public goods in Islamic societies. This role has to be rejuvenated.

iii) A large portion of revenue from publicly owned resources should be transferred to this head.

iv) Since creation of money and the seigniorage arising from it is the right of the whole society, all banks may be required to transfer a percentage of their demand deposits to the public exchequer.

There will certainly be projects which may not be covered by the above mentioned arrangements. These are projects which have substantial positive externalities and "exclusion" is not possible. These have a genuine claim over the general pool of tax revenue. However, the application of above mentioned principles would reduce such claims by a very substantial amount. Resources for the remaining claims may be generated through taxation.

While we do not rule out any form of taxation that meets the principles of justice, equity and ability to pay, we would like to mention that it is not necessary that members of the community should contribute only in cash for the provision of public goods. If we define taxation broadly to mean transfer of resources from the private sector to the public sector, then one of the biggest potential sources for "taxation" in most of the underdeveloped countries hitherto untapped is labor. In other words, just as people are required to give money to the government, they may be required to give man-hours to public (community) projects. This would be one type of "community service" in Muslim countries and this can be a very good source for "financing" community projects. For countries with large populations and low incomes, this may be one of the largest sources for "taxation". Therefore, it seems desirable that these countries should have a separate ministry for community services to plan and execute community projects preferably through a decentralized institutional set-up and through creating circumstances and social incentives to motivate people to contribute work hours to community projects.

Development expenditure

Modern governments have to provide a number of public goods for the benefit of the society at large. The provision of these public goods by the government is justified on the grounds of their indivisibility and lumpiness. From an Islamic point of view, it has been argued that *maslaha* and the fulfillment of *fard kifayah* provide additional justifications for their provision by the government (Siddiqi, 1996).

While the provision of these goods by the government may be well justified, their provision through budget deficits and corresponding borrowing Needs careful reconsideration. Huge public debt that has been built in their name, itself goes against the long run public interest. It is not even the case that these public goods could not be provided through alternative arrangements. Many of these can be. A radically different approach for a number of items of expenditure under this head need to be adopted. Some suggestion for this category of expenditure are given below:

i) First and foremost, it is extremely important to set a *sustainable* rate of growth. In many cases, it has been observed that governments set artificially high rates as targets for their economic development goals. In doing so, usually the domestic rates of savings as well as domestic absorption capacities are not kept in view. The potential of external investments are also exaggerated. Development can be achieved only through a slow but steady process. There are no short cuts to it. One of the reasons for fiscal problems is the over-enthusiastic approach; trying to run towards developed countries status before learning how to walk.

ii) A large part of this expenditure, as mentioned above goes to infrastructure projects. We have argued above that in many infrastructural projects a combination of Islamic modes of financing, BOT mechanism and investment *sukuk* can be applied.

iii) Using development charges to undertake development projects in certain areas is also possible. Just as private companies develop residential areas and sell out residential plots with development charges, government or even private companies can develop industrial areas, provide all necessary infrastructure and recover the costs through selling industrial plots.

Limiting the role of public borrowing

As mentioned before, most of the Muslim countries have relied extensively on public borrowing to fill the gap in public budget. The resulting public debt has grown into a monster, literally. Beside other problems, interest payments are eating a sizable part of total government expenditure. In Muslim countries, this is most unfortunate. In addition to the economic problems that this public debt is creating for these countries, they are in violation of Islamic Shari[ah. As a matter of fact, a number of their economic problems are a result of ignoring the unequivocal prohibition of borrowing on interest.

As pointed out by Chapra (1988), the Islamic ban on interest-based borrowing is in fact a blessing. It introduces a strict discipline into public spending to ensure that the government lives within its means. The constraint it will impose on government spending in the short-run will be more than offset by the much smaller debt-servicing burden in future, the sustained and steadier economic growth supported by real resources, freedom from external pressures and a dignified position in the comity of nations.

We would like to re-emphasize that there are a number of ways for the government to fulfill national requirements and that for genuine needs government can levy additional taxes also. If the circumstances of a nation require additional sacrifice, people should be convinced of that and then asked to make that sacrifice. It must be remembered that borrowing does not eliminate the need for sacrifice. It only postpones it and increases its magnitude.

At the end, it may be emphasized again that *zakah* and *awqaf* have historically played an important role in socio-economic development of the societies. These institutions can also play a dynamic role in the contemporary types.[51]

[51] See, Ahmed (2004) for a detailed analysis concerning revitalizing these institutions.

REFERENCES

Abdul Majid, Abdul Rais (2003), "Development of Liquidity Management Instruments: Challenges and Opportunities", paper presented to the *International Conference on Islamic Banking: Risk Management, Regulation and Supervision*, held in Jakarta Indonesia September 30 – October 2, 2003, organized by IRTI, Bank Indonesia and Ministry of Finance, Indonesia.

Abu Ya'la (1974), *al-Ahkam al-Sultaniyah,* Beirut: Dar al-Fikr, pp. 27-8.

Abu Yusuf (1397 AH), *Kitab al Kharaj*, Cairo: al-Matba'ah al-Salafiyah.

Ahmad, Ausaf, and Tariqullah Khan (1998), *Islamic Financial Instruments for Public Sector Resource Mobilization,* Jeddah: Islamic Research and Training Institute.

Ahmed, Habib (2004), *Role of Zakah and Awqaf in Poverty Alleviation,* Occasional Paper No. 8, Jeddah: Islamic Research and Training Institute.

Ahmed, Ziauddin, Munawar Iqbal and M. Fahim Khan (1983a), *Fiscal Policy and Resource Allocation in Islam*, Islamabad: Institute of Policy Studies.

__________ (1983b), *Money and Banking in Islam,* Islamabad: Institute of Policy Studies.

Al-Dihlawi, Shah Waliullah (n.d), *Hujjatullah al-Balighah* (Vol. 2), Beirut: Dar al-Marifah.

Al-Ghazali, Abu Hamid (1967), *Al-Tibr al-Masbuk fi Nasihat al-Muluk,* Egypt: Maktabah al-Jundi.

Al-Jarhi, Mabid Ali (2002), "Financing for Development: Efficient and Equitable Options", paper presented to the UN Conference on Financing for Development, Monterrey, Mexico, March 18-20.

Al-Jarhi, Mabid Ali and Iqbal, Munawar (2001), *Islamic Banking: FAQs*, Occasional Paper # 4, Jeddah: Islamic Research and Training Institute.

Al-Kasani, Abu Bakr bin Mas'ud (1910.), *Bada'I' wa'l-al-Sana'I' fi Tartib al-Shara'I* (Vol.2), Egypt: Al-Matba'ah al-Salafiyah.

Al-Mawardi (1979), *Kitab Adab al-Dunya Wa'l-Din,* Beirut: Dar Ihya' al-Turath al-'Arabi, pp. 116-17.

Al-Omar, Fuad (1995), "Growth of Public Expenditure and Bureaucracy in Kuwait", *Islamic Economic Studies,* **2**(2), pp. 1-14.

Archer, Simon and Rifaat Ahmed Abdel Karim (2002), *Islamic Finance: Innovation and Growth*, London: Euromoney Books and AAOIFI.

Ariff, Mohammad and M.A. Mannan (1990), *Developing A System of Islamic Financial Instruments,* Jeddah: Islamic Research and Training Institute/ Islamic Development Bank.

Bendjilali, Boualem and Tariqullah Khan (1995), *Economics of Diminishing Musharakah*, Jeddah: Islamic Research and Training Institute/ Islamic Development Bank.

Caouette, John B., Edward I. Altman, and Paul Narayan (1998), *Managing Credit Risk: The Next Great Financial Challenge*, New York: John Wiley and Sons, Inc.

Chapra, M. Umer (1983), *Monetary Policy in an Islamic Economy,* in Ziauddin Ahmed, Munawar Iqbal and M. Fahim Khan (eds), *Money and Banking in Islam,* Islamabad: Institute of Policy Studies, 27-46.

_________ (1988), "Economic Development in Muslim Countries: A Strategy for Development in the Light of Islamic Teachings", paper presented to the seminar on Islamic Economics, Cairo, 6-7 September, 1988.

Chapra, M. Umer and Habib Ahmed (2002), *Corporate Governance in Islamic Financial Institutions*, Occasional Paper # 6, Jeddah: Islamic Research and Training Institute.

Council of Islamic Ideology, Pakistan (1981), *The Elimination of Interest from the Economy of Pakistan*. Islamabad: CIIP.

Dailami, Mansoor (1998), "Infrastructure Project Finance: An Overview", Lecture Delivered to the EDI Course.

Dailami, Mansoor, and Klein Michael (1998), *Government Support to Private Infrastructure Projects in Developing Countries*, Washington, DC: Economic Development Institute of the World Bank.

Ebrahim and Tariqullah Khan (2002), "Pricing of an Islamic convertible mortgage for infrastructure project financing", in *International Journal of Theoretical and Applied Finance*, **5**(7).

EDI Economic Development Institute of the World Bank (1998),, *Training Material on Building Knowledge and Expertise in Infrastructure Finance*, Washington, DC: June 15-26.

Elgari, M. Ali (1997), " Short term Financial Instruments based on *Salam* Contracts", in Ausaf Ahmad and Tariqullah Khan (eds), *Islamic Financial Instruments for Public Sector Resource Mobilization*, Jeddah: Islamic Research and Training Institute, pp.249-66.

EP&SP, Department, IDB (1998), "Private Financing of Infrastructure in IDB Member Countries", *Policy Background Paper,* Jeddah:. Islamic Development Bank.

Fahmy, Hussein Kamel (2003), "Limits of State Intervention in Economic Activity: The Case of Texas", unpublished mimeograph, Islamic Research and Training Institute, Jeddah.

Faridi, F. R. (1983), " A Theory of Fiscal Policy in an Islamic State" in Ziauddin Ahmed et al.(eds), *Fiscal Policy and Resource Allocation in Islam,* Islamabad: Institute of Policy Studies,pp.27-45.

Financial Times (1994), *International Infrastructure Finance: BOT*, London: Financial Times.

Finnerty, J D (1996), *Project Financing: Asset-based Financial Engineering*, New York: John Wiley

Gleason, James T. (2000), *Risk: The New Management Imperative in Finance*, Princeton, New Jersey: Bloomberg Press.

Haque, Nadeemul and Abbas Mirakhor(1999), "The Design of Instruments for Government Finance in an Islamic Economy", *Islamic Economic Studies,***6**(2), pp. 27-43.

Hasanuzzaman, S.M. (1981), *The Economic Functions of the Early Islamic State,* Karachi: International Islamic Publishers.

Homoud, Sami H. (1997), "Financial Instruments based on Intermediary Contracts in Islamic *Fiqh*", in Ausaf Ahmad and Tariqullah Khan (eds), *Islamic Financial Instruments for Public Sector Resource Mobilization,* Jeddah: Islamic Research and Training Institute, pp. 221-230

Hussain, Tan Sri Abdul Rashid (2000), "Resource Mobilization from Capital Markets for Financing Development in the IDB Member Countries", *Eleventh IDB Annual Symposium,* Jeddah.

Ibn Taymiyah (1967), *Al-Siyasah al-Shariyah*, Beirut: Dar al-Marifah.

Imam al Haramayn al Juwayni, Abd al-Malik bin Abd Allah (1401H), *Ghiyath at-Umam fi Iltiyath al-Zulam,* Cairo: Matbaah Nahdah .

Iqbal, Munawar (1988), *Distributive Justice and Need Fulfillment in an Islamic Economy* (Revised Edition)*,* UK: The Islamic Foundation.

__________ (1995), "Fiscal Reform in Muslim Countries with Special Reference to Pakistan", *Islamic Economic Studies,* **2**(2),15-36.

__________ (2000), "Islamic and Conventional Banking in the Nineties: A Comparative Study", paper presented at the Fourth International Conference on Islamic Economics and Banking, Loughborough University, UK., August 13-15.

Iqbal, Munawar and David T. Llewellyn (eds)(2002), *Islamic Banking and Finance: New Perspectives in Profit Sharing and Risk*, UK: Edward Elgar Publishers.

Iqbal, Munawar, and M. Fahim Khan (1981), *A Survey of Issues and A Programme for Research in Monetary and Fiscal Economics of Islam*, Islamabad: Institute of Policy Studies.

Iqbal, Munawar, Ausaf Ahmad and Tariqullah Khan (1998), *Challenges Facing Islamic Banking*, Occasional Paper # 2, Jeddah: Islamic Research and Training Institute/ Islamic Development Bank.

Iqbal, Zubair and Abbas Mirakhor*, "*Islamic Banking", *IMF Occasional Paper No. 49*, Washington: International Monetary Fund.

IRTI-OICFA (2000), *Resolutions and Recommendations of the Council of Fiqh Academy of the Organization of Islamic Conference*, Jeddah: Islamic Research and Training Institute and OIC *Fiqh* Academy.

Kahf, Monzer (1983), "Taxation Policy in an Islamic Economy" in Ahmed, Ziauddin, Munawar Iqbal and M. Fahim Khan (eds), *Fiscal Policy and Resource Allocation in Islam*, Islamabad: Institute of Policy Studies, pp.131-53.

__________ (1989), "Zakat Unresolved Issues in the Contemporary Fiqh", *Journal of Islamic Economics,* **2**(1), pp.1-22.

__________ (1997), "The Use of Assets *Ijarah* Bonds for Bridging the Budget Gap", in Ausaf Ahmad and Tariqullah Khan (eds), *Islamic Financial Instruments for Public Sector Resource Mobilization,* Jeddah: Islamic Research and Training Institute, pp. 265-316.

Khan, M. Fahim (1995), *Islamic Futures and their Markets with special reference to developing rural financial markets*, Jeddah: Islamic Research and Training Institute.

Khan, Mohsin S. (1986), "Islamic Interest-Free Banking", *IMF Staff Papers*, pp. 1-27.

Khan, Tariqullah (1991), *Contractual Forms of International Investments: Relevance for Islamic Economics,* Jeddah: Islamic Research and Training Institute.

__________ (1997), *Interest-free Alternatives for External Resource Mobilization*, Jeddah: Islamic Research and Training Institute.

__________ (2000), Islamic Quasi Debt (Equity) Instruments and the Challenges of Hedging - An Exploratory Analysis" *Islamic Economic Studies*, 7(1&2), pp.1-32.

__________ (2002), "Financing Build, Operate and Transfer Projects: The Case of Islamic Financial Instruments", *Islamic Economic Studies*, **10**(1), pp. 1-36 .

Khan, Tariqullah and Habib Ahmad (2001), *Risk Management: An Analysis of Issues in the Islamic Financial Industry*, Occasional Paper # 5, Jeddah: Islamic Research and Training Institute.

Mirakhor, Abbas and Mohsin S. Khan (eds)(1987), *Theoretical Studies In Islamic Banking And Finance,* Texas: The Institute for Research and Islamic Studies.

Osius, M. E. (1998), "Infrastructure Development Project Finance", in EDI.

Qurishi, Moeen (1999), "Preparing the Ummah for the 21st Century: Enhancing the Private Sector Participation in Physical Infrastructure", *The IDB Annual Symposium* .

Salama, Abidin Ahmed (1983), "Fiscal Policy of an Islamic State" in Ziauddin Ahmed et al. (eds), *Fiscal Policy and Resource Allocation in Islam*, Islamabad: Institute of Policy Studies, pp.99-118.

Siddiqi, M. Nejatullah (1995), "An Overview of Public Borrowing in Early Islamic History", *Islamic Economic Studies,* **2**(2), pp. 61-78.

__________ (1996), *Role of the State in the Economy: An Islamic Perspective,* Leicester, UK: Islamic Foundation.

Sundararajan, V. and Luca Errico (2002), “Islamic financial institutions and products in the global financial system: Key issues in risk management and challenges ahead”, *IMF Working Paper # WP/02/192,* Washington, DC: IMF.

Sundararajan, V., David Marston, and Ghiath Shabsigh (1998), “Monetary Operations and Government Debt Management under Islamic Banking”, *WP/98/144,* (September), Washington, DC: IMF.

UNIDO (1996), *BOT Guidelines*, Vienna: United Nations Industrial Development Organization.

Usmani, Muhammad Taqi (1998), *An Introduction to Islamic Finance,* Karachi; Idaratul Ma‘arif.

Vogel, Frank E. and Samuel L Hayes (1998), *Islamic Law and Finance: Religion, Risk and Return,* The Hague: Kluwer Law International.

Walker, C., and A. J. Smith (1995), *Private Infrastructure: The BOT Approach*, London: Redwood Books.

Wells, Louis T (1999), “Foreign Private Investment in Infrastructure: Managing Non-commercial Risks”, paper presented at a *Conference on Private Infrastructure for Development: Confronting Political and Regulatory Risks*, Rome: 8-10 September.

Wells, Louis T., and Eric S. Gleason (1995) "Is Foreign Infrastructure Finance Still Risky?", *Harvard Business Review* (October).

World Bank (1994), *World Development Report 1994: Infrastructure for Development*, New York: Oxford University.

Zarqa, M. Anas (1984), “Dawr al-zakat fi al-Iqtisad Al-Amm wa al-Siyasah al-Maliyyah”, paper presented at First International Conference on Zakat, Kuwait in April.

__________ (1986), “Islamic Distributive Schemes” in *Distributive Justice and Need Fulfillment in Islam* (ed.), Munawar Iqbal, Leicester, UK: Islamic Foundation, pp. 163-216.

__________ (1997), “*Istisna*[Financing of Infrastructure Projects”, in Ausaf Ahmad and Tariqullah Khan (eds), *Islamic Financial Instruments for Public Sector Resource Mobilization,* Jeddah: Islamic Research and Training Institute, pp.231-48.

Appendix Table 1
Total Government Expenditure ($Millions)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Algeria	15511.3	11428.9	12000.8	12486.6	14079.9	13133.1	13680.8	14958.2	14909.0	14445.3	15654.0
Azerbaijan	NA	NA	93.4	330.0	438.7	510.8	530.9	759.9	1032.1	1034.2	1212.7
Bahrain	1343.1	1337.2	1459.3	1578.2	1658.0	1580.1	1546.0	1648.9	1714.4	1859.9	2066.5
Bangladesh	NA	NA	NA	NA	NA	NA	NA	NA	NA	5837.5	NA
Burkina Faso	414.1	501.3	340.0	343.5	315.6	393.1	445.8	411.5	453.9	456.0	416.1
Cameroon	2360.6	2679.4	2063.1	1888.5	1111.5	1013.1	1366.3	1367.3	1291.5	1461.0	1416.7
Cote d'Ivoire	2643.1	2623.2	2788.3	2601.4	2100.1	2649.7	2707.9	2560.5	2639.7	2471.2	1897.8
Egypt	11995.5	11797.6	16444.0	16849.6	19389.7	20256.3	21933.9	23157.3	26266.8	28508.4	31816.8
Guinea	646.5	649.1	620.7	754.2	NA	849.2	889.5	870.0	640.8	728.0	704.6
Indonesia	21011.2	21185.8	25715.3	26344.2	28631.7	29673.2	33285.4	38803.1	17386.1	28754.8	31967.5
Iran	23947.6	NA	NA	13548.9	16134.2	20983.9	26643.4	25066.0	25024.9	25489.5	22276.4
Jordan	1439.2	1550.5	1590.4	1782.6	1878.9	2099.7	2351.1	2372.2	2647.1	2544.5	2635.5
Kazakhstan	NA	NA	NA	NA	NA	NA	NA	4407.6	4064.5	2544.8	2621.6
Kuwait	10184.0	2752.5	20054.6	14493.4	13905.7	13703.1	14057.7	12616.2	12803.9	12910.2	15765.4
Kyrgyz Rep.	597.2	571.2	520.0	416.6	353.6	414.3	408.2	395.8	362.7	246.3	246.5
Lebanon	709.6	1112.9	1386.5	1762.4	3201.6	3911.4	4920.5	6318.9	5530.8	5909.1	5770.9

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Malaysia	12883.3	13754.1	16854.5	16629.1	17352.5	19527.6	21785.8	19721.7	18043.8	19787.1	22510.3
Maldives	73.2	98.9	110.4	120.2	117.2	145.9	143.8	164.6	179.6	212.0	232.8
Morocco	7442.3	7741.3	8550.9	9122.7	9787.3	10838.8	NA	10210.5	11127.9	11473.2	11004.0
Oman	4163.9	4096.5	4942.3	4867.1	4974.5	5126.7	4887.9	4806.3	4733.7	4835.9	5668.4
Pakistan	8978.6	10612.3	11879.0	12763.4	12063.4	13833.4	15387.2	14081.5	13586.4	12510.4	14008.5
Senegal	NA	NA	NA	NA	NA	NA	986.6	837.5	878.3	970.6	903.1
Sierra Leone	54.1	104.6	114.1	138.7	178.4	142.1	139.2	145.9	94.0	140.2	133.6
Sudan	NA	NA	NA	NA	NA	NA	NA	NA	852.2	899.9	NA
Syria	2682.6	3199.0	3059.7	3156.8	2640.3	2833.5	3105.7	3535.5	3576.4	3688.0	4116.1
Tajikistan	NA	NA	NA	NA	NA	NA	NA	NA	168.1	134.9	112.1
Tunisia	4253.0	4447.8	4967.9	4832.7	5042.7	5904.2	6377.9	6038.0	6288.1	6630.3	6233.4
Turkey	26185.9	31666.7	32734.5	44368.9	30252.5	37637.9	48607.7	56527.0	64058.2	69970.2	78588.5
UAE	3934.1	4153.6	4241.6	4241.6	4351.1	4857.8	4617.8	4916.9	5219.9	NA	NA
Yemen	1343.2	1483.7	1643.6	1341.7	1063.5	913.2	1683.0	2219.5	2282.0	1993.8	NA
IDB Members	**164797**	**139548**	**174174**	**196763**	**191022**	**212932**	**232490**	**258918**	**247857**	**268447**	**279980**

Source: Compiled from World Bank Live Database.

Appendix Table 2

Total Government Revenue ($Millions)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Algeria	NA	NA	NA	NA	12384.8	12606.2	15071.6	16058.2	13185.7	14277.3	20969.5
Azerbaijan	NA	NA	NA	NA	305.5	435.1	437.3	589.7	795.0	805.1	NA
Bahrain	1246.3	1249.5	1235.4	1448.1	1266.0	1396.8	1636.2	1683.8	1373.7	1737.8	2834.1
Bangladesh	NA	NA	NA	NA	NA	NA	NA	NA	NA	4263.7	NA
Burkina Faso	302.7	468.4	233.6	340.4	NA	NA	NA	NA	NA	NA	NA
Cameroon	1718.9	2012.5	1768.8	1688.7	885.7	1034.8	NA	NA	NA	NA	NA
Cote d'Ivoire	2372.6	NA	NA	NA	1525.4	2210.4	2408.2	2275.2	2353.9	2065.3	1737.5
Egypt	9905.3	10989.4	13666.4	16223.9	19154.8	20915.9	18630.0	19862.0	NA	NA	NA
Guinea	451.2	432.7	395.8	NA	NA	NA	NA	NA	391.2	403.9	NA
Indonesia	21470.2	21747.7	24949.1	26983.8	32115.6	35760.4	38547.2	39131.9	15716.7	25284.2	NA
Iran	21742.3	NA	NA	13171.2	15913.6	21935.5	27494.7	24494.0	19101.4	24601.9	21295.6
Jordan	1051.0	1116.5	1631.2	1615.1	1662.3	1899.4	1923.9	1850.2	2004.9	2156.1	2120.4
Kazakhstan	NA	NA	NA	NA	NA	NA	NA	3097.6	2475.5	1445.1	2071.7
Kuwait	10819.5	921.7	1993.9	7506.6	8569.0	10006.7	11138.6	13809.6	11353.6	10062.1	NA
Kyrgyz Rep.	NA	NA	NA	281.8	235.2	248.7	271.2	271.2	289.0	198.0	194.0

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Lebanon	NA	NA	NA	1065.3	1333.8	1870.4	2248.7	2437.9	2934.7	3228.6	NA
Malaysia	11602.7	13529.0	16726.9	17762.7	20584.9	21648.3	24753.0	23116.4	NA	NA	NA
Maldives	47.6	55.4	64.6	69.7	84.6	102.4	112.3	140.4	149.8	174.9	187.1
Morocco	6819.9	7149.0	8162.3	8190.5	8588.8	9133.2	NA	9423.4	9936.7	10447.9	NA
Oman	4093.1	3261.9	3460.1	3511.8	3589.1	3839.3	4137.9	4828.4	3679.1	3607.5	4741.5
Pakistan	7657.9	7628.4	8740.1	9376.8	9083.1	10448.5	11065.5	9878.2	10077.5	9263.4	10256.7
Senegal	NA	NA	NA	NA	NA	NA	770.8	740.5	784.2	824.2	792.0
Sierra Leone	36.2	60.6	70.8	95.7	114.9	81.8	75.7	87.1	49.4	47.6	NA
Sudan	NA	NA	NA	NA	NA	NA	NA	NA	807.5	853.5	NA
Syria	2689.9	2956.9	3059.0	3065.8	2237.8	2614.8	3038.5	3486.3	3469.4	3800.3	NA
Tajikistan	NA	NA	NA	NA	NA	NA	NA	NA	122.4	110.7	104.1
Tunisia	3773.9	3787.0	4562.0	4423.1	4898.1	5412.1	5797.5	5427.1	5821.4	6040.8	5559.5
Turkey	20573.6	21558.5	25513.6	32027.4	24986.0	30375.5	33202.6	41384.2	47342.8	46946.2	55945.6
UAE	534.7	440.8	1114.4	797.9	898.7	1048.2	1363.1	1523.6	1604.9	NA	NA
Yemen	912.4	1271.0	970.4	745.5	509.3	733.6	1665.8	2218.3	2204.5	1784.3	NA
IDB Members	129821.8	100636.6	118318.2	150391.9	170927.2	195757.9	205790.2	227815.1	158024.8	174430.2	128809.5

Source: Compiled from World Bank Live Database.

ABOUT THE AUTHORS

MUNAWAR IQBAL

born in Pakistan (1950). He holds M.A. (Economics) degree from McMaster University and a Ph.D. from Simon Fraser University, Canada. He has worked as Senior Research Economist, Pakistan Institute of Development Economics, Islamabad; Dean, Faculty of Social Sciences, International Islamic University, Islamabad; Director, International Institute of Islamic Economics, Islamabad; and Economic Adviser, Al-Rajhi Banking and Investment Corporation, Saudi Arabia, before joining IRTI. Currently he is holding the position of Chief of Research, Islamic Banking and Finance Division, IRTI. He is also Editor of *Islamic Economic Studies,* the professional journal of IRTI. He has published more than thirty research papers and books on Islamic economics and banking. Some of his recent publications include: *Islamic Banking and Finance: New Perspectives on Profit Sharing and Risk* (2002) (co-ed.); *Islamic Banking and Finance: Current Developments in Theory and Practice* (2001); *Islamic Banking: Answers to Some Frequently Asked Questions* (2001) (co-ed.), Occasional Paper # 4, IRTI.
E-mail: munawariqbal@isdb.org

TARIQULLAH KHAN

born in Chitral, Pakistan (1954) is currently Senior Economist at IRTI. Before joining IRTI in 1983, he held faculty positions in Universities in Pakistan since 1976. He holds M.A. (Economics) degree from the University of Karachi, Pakistan, and a Ph.D. degree from the Loughborough University, United Kingdom. His current areas of interest are Islamic financial products and markets, risk management, regulation and supervision. He has several publications and has presented conference papers and presentations in these areas. Some of his recent publications include: *Risk Management: An Analysis of Issues in the Islamic Financial Industry*, Occasional Paper # 5, Jeddah: IRTI (2001) with Habib Ahmed; “Financing Build, Operate and Transfer Projects: The Case of Islamic Financial Instruments”, *Islamic Economic Studies*, (2002); "Pricing of an Islamic convertible mortgage for infrastructure project financing" *International Journal of Theoretical and Applied Finance*, Vol 5 No 7 (2002) with Shahid Ebrahim, and "Modeling an exit strategy for Islamic venture capital finance" in *International Journal of Islamic Financial Services*, Vol 3 No 2 (2002) with Boualem Bendjilali.
E:mail: tariqullah.khan@isdb.org

ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE
Postal Address: P.O. Box 9201, Jeddah 21413
Kingdom of Saudi Arabia
Cable Address: BANKISLAMI-Jeddah Telephone: 6361400
Telex: 601137/601945 Facsimile: 6378927 / 6366871
E. Mail: ibfd@isdb.org. Home Page: http://www.irti.org/

Legal Deposit no.1425/4124
ISBN: 9960-32-149-5

Legal Deposit no.1425/4124
ISBN: 9960-32-149-5

Legal Deposit no.1425/4127
ISBN: 9960-32-150-9

Legal Deposit no.1425/4127
ISBN: 9960-32-150-9

ISLAMIC RESEARCH AND TRAINING INSTITUTE (IRTI)

Purpose

The purpose of the Institute is to undertake research for enabling the economic, financial and banking activities in Muslim countries to conform to Shari[ah, and to extend training facilities to personnel engaged in economic development activities in the Bank's member countries.

Functions

The functions of the Institute are:

1. to organize and coordinate basic and applied research with a view to developing models and methods for the application of Shari[ah in the fields of economics, finance and banking;
2. to provide for the training and development of professional personnel in Islamic Economics to meet the needs of research and shari[ah-observing agencies;
3. to train personnel engaged in development activities in the Bank's member countries.
4. to establish an information center to collect, systematize and disseminate information in fields related to its activities; and
5. to undertake any other activities which may advance its purpose.

Location

The Institute is located in Jeddah, Saudi Arabia

Address

ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE
P.O. Box 9201, Jeddah 21413
Kingdom of Saudi Arabia
Cable Address: BANKISLAMI-JEDDAH
Telephone: 966-2-6361400, Fax: 966-2-6378927, 6366871
Telex: 601407, 601137 ISDB SJ
e-mail: archives@isdb.org
e-mail: ibfd@isdb.org
Web Site: http://www.isdb.org
http://www.irti.org