Seminar Proceedings Series
No. 30

FINANCING DEVELOPMENT IN ISLAM

ISLAMIC RESEARCH AND TRAINING INSTITUTE
ISLAMIC DEVELOPMENT BANK
JEDDAH, SAUDI ARABIA

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Papers presented at the Third International Conference on Islamic Economics which was held in Kuala Lumpur, Malaysia, on 23-25 Rajab 1412H (January 28-30, 1992) under the joint sponsorship of the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB), Jeddah, International Islamic University, Malaysia, and the International Association for Islamic Economists. The Conference's theme was Financing Development in Islam.

Edited by

M. A. MANNAN

Seminar Proceedings Series No.30

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ISLAMIC RESEARCH AND TRAINING INSTITUTE
ISLAMIC DEVELOPMENT BANK

First Edition
1416H (19%)

Published by:

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ISLAMIC DEVELOPMENT BANK
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CONTENTS

Page

FOREWORD

As the area of development financing constitutes a vital concern of contemporary economic theory and policy in general and for development planning in the developing countries in particular, it is only natural that it gains much consideration from IRTI. This consideration has been manifested in the keenness of IRTI to incorporate this subject in its in-house research programs and organize seminars, workshops and conferences on it so as to facilitate wide dissemination of knowledge and exchange of views. IRTI's particular interest in this field is-to investigate the contours of development financing in Islamic framework, to highlight issues and suggest alternatives to contemporary Muslim economies seeking to apply *Shari'ah* in their economic and financial affairs.

The Third International Conference on Islamic Economics is one of the activities sponsored by IRTI in cooperation with the International Islamic University, Malaysia and the International Association for Islamic Economics, UK in order to explore a multitude of ideas and deliberate on several issues pertaining to the subject.

This volume is compilation of all the papers presented in this conference. The topics and quality of the papers presented in the conference included in this volume make it a valuable contribution to the existing literature on Islamic economics. Islamic Research and Training Institute has published the proceedings of earlier conferences and seminars which have proved to be good reference and teaching material for researchers, teachers and students of Islamic economics. It is hoped that this volume too will add to the available teaching and research material in this discipline. It is also hoped that the discussion on various issues relating to development financing will induce further fruitful thinking on the subject and motivate further research in this important area.

Dr. Mohammad Fahim Khan

M F Khan

Officer-in-Charge, IRTI

INTRODUCTION

M. A. MANNAN*

The Third International Conference on Islamic Economics was held in Kuala Lumpur, Malaysia on 23-25 Rajab 1412H (January 28-30 1992) under the joint sponsorship of the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB), Jeddah, International Islamic University, Malaysia and the International Association for Islamic Economists. The Conference's theme was "Financing Development from an Islamic Perspective". The main objective of this Conference was to determine Islamic strategies for financing development, and to find out the ways and means to float Islamic instruments for effective mobilization of resources.

The papers presented at this Conference are grouped in four sections : the first section deals with Islamic Strategies for Financing Development consisting of three papers: *a) Shari'ah* Compatible Shares: A Suggested Formula and Rationale, b) Financing Economic Development From Islamic Perspective, c) Role of Equity Participation in Financing Economic Development. The second section dealing with Domestic Financing of Development also consists of three papers namely, a) A Simple Model of Income Determination, Growth and Economic Development on the Perspective of An Interest-Free Economy, b) Causes of Fiscal Problems in Muslim Countries and Some Suggestions for Reform and c) Is Equity Financed Budget Deficit Stable In An Interest-Free Economy? The third section deals with Financing Development in Selected Muslim societies. This section includes the following six papers: a) The Basic Needs Fulfillment Guarantee in Islam and A Measure of Its Financial Dimension in Selected Muslim Countries, b) Long Term Finance in Islamic Countries: A Case Study of Pakistan, c) Financing Economic Development in Islamic Economics: Attitudes

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Towards Islamic Finance in Small Manufacturing Business in Saudi Arabia, d) Some Considerations on the Size of the Public Sector in The Islamic Republic of Iran, e) Efficiency of the Islamic Approach to External Debt-Management in North Africa and Middle-East, 6) The Survival and Development Strategies of the Minority of Nairobian Muslims in Nairobi. The last section dealing with Financing Development from Historical Perspectives consists of following four papers : a) The Role of Finance in Development: The Ottoman Experience, b) Public Borrowing in Early Islamic History: A Review of the Records, c) Provision of Public Goods: Role of Voluntary Sector *(Waqf)* in Islamic History and d) Relevance of the Ottoman Cash *Waqfs* (Awqaf Al-Nuqud) For the Modern Islamic Economics.

These sixteen papers which are presented at the Conference both individually, and collectively provide wide range of options for financing development in an Islamic economy.

In his paper entitled, *Shari'ah* Compatible Preference Share: A Suggested Formula and Rationale, Muhammad Zarqa made a case for a modified form of Islamic preference share which can serve specific economic functions in conformity with the *Shari'ah.* Recognizing that preference share as found in the western secular market is contrary to the principles of *Shari'ah,* he examined the Islamic loss sharing rule as well as accumulative Islamic preference share scheme. He suggested that in case of Islamic preference share, share holders can contract preference share by offering more favorable profit sharing ratio. In case of losses, no preferential treatment can, of course, be given. His proposal for preference share scheme deserves a serious consideration. It introduces an element of flexibility in raising capital of the company.

In his paper Financing Economic Development from Islamic Perspective, Hatem El-Karanshawy tried to present a framework for mechanism that may enable the mobilization of the surplus fund available in some Islamic countries for the utilization of capital deficit countries on the basis of *Shari'ah* based principles. While discussing this framework, the paper attempted to determine the finance gap between the surplus and deficit countries. In this context, the paper discussed the role of the Islamic states and other relevant issues relating to mobilization of domestic as well as external resources.

In his paper, Role of Equity Participation in Financing Economic Development Rodney Wilson made a strong case for equity financing as a source of long term investment. It is argued that such finance being participatory in nature is also more equitable as risks are shared rather than being the entire burden on the enterprises being financed. It is however pointed out that main difficulty so far as most developing countries are concerned is the under development of equity market. When markets are limited and small, prices of the share tend to be volatile. His paper clearly indicates need for developing the secondary security market so that Islamic financial instrument can be floated.

Fahim Khan's paper entitled "A Simple Model of Income Determination, Growth and Economic Development on the Perspective of An Interest-Free Economy" tried to develop a macro-model to demonstrate that Islamic financial system can generate a macro-framework of an economy leading to full employment, growth and development. Utilizing conventional framework the proposed model highlighted the investment and demand function and tried to relate them to the process of economic development in an Islamic economy. The main conclusion of the paper is that Islamic economy can potentially have a macro-model where growth and development variables can be manipulated through supply side.

In his paper "Causes of Fiscal Problems in Muslim Countries and Some Suggestions for Reform" Munawar Iqbal argued for a structural change in both expenditure and revenue of the Government budget. It is argued that given government expenditure approach then for mobilizing the necessary fund is not the right one. The paper also advocated that the clear distinction should be made between current expenditure and development expenditure while mobilizing resources. The author argued in favor of greater participation of private sector for meeting the development expenditure. The paper stressed the need for activating the rural *Waqf* and community services for financing education, health etc.

In their paper," Is Equity Financed Budget Deficit Stable In An Interest-Free Economy" Hasan and Siddiqi constructed a fixed price closed economy macro-economy model with budget constraints in order to investigate whether or not equity financed deficit is stable for an Islamic economy ? Contrary to the popular views, the paper argued that equity financed deficit is not necessarily instable and appropriate fiscal policy measures are expected to have positive effect on the growth of the economy.

In their paper, "The Basic Need Fulfillment Guarantee in Islam and A Measure of its Financial Dimension in Selected Muslim Countries", Hasan and Ariff tried to highlight the problems of adopting internationally standardized basic need in the context of a poor Muslim country. The authors argued that every country's poverty is to be evaluated in its own context and the cure is to be prescribed within its own resource capacity.

In his paper, "Long Term Finance in Islamic Countries: A Case Study of Pakistan" Akram Khan tried to review the progress made by Pakistan in Islamizing its financial system and tried to draw its lessons of experience. It is argued that as long as avenue for interest bearing investment is opened, the possibility of successful transition of Islamic system of finance would be very difficult. While advocating for a structural change in the financial system in Pakistan, the paper argued that the *Shari'ah* principles of no-risk-no-return in all financial transaction should be strongly enforced. While the importance of his suggestion can hardly be over estimated the problem of transition can not be ignored. Necessary institutional framework should, however, be developed for eventual structural change from interest bearing system to the pure Islamic financial system.

Bandar Al-Hajjar and John Presley in their paper "Financing Economic Development in Islamic Economics: Attitudes Towards Islamic Finance in Small Manufacturing Business in Saudi Arabia" tried to explore the role *of Musharaka* (participatory) finance and *Mudaraba* finance. They tried to demonstrate that these two modes *of* finance may not be fully adequate to finance small manufacturing business in Saudi Arabia. While advocating for exploring other modes *of* finance it is argued that these two modes *of* Islamic financing can make significant contribution to small business finance. There is a need to create an awareness among the existing investment agencies.

Iraj Toutounchian's paper "Some Consideration on the Size *of* the Public Sector in The Islamic Republic *of* Iran" tried to evaluate the size of the public sector in Iran in the light of new constitutional' obligations coupled with old assumed responsibilities. Having in mind Islamic states assume greater responsibilities than a capitalistic state, the paper tried to find a measure for optimal size of the government of Islamic Republic of Iran although the conclusion appears to be tentative.

In his paper entitled "Efficiency of the Islamic Approach to External Debt-Management in North Africa and Middle-East", I. 0. Taiwo tried to highlight the problem of debt crisis confronting North Africa and Middle East. He stressed the need for a program for comprehensive development based on indigenous technology and greater co-operation among the Muslim countries and also tried to demonstrate how Muslims minority in Nairobi, Kenya have resorted to informal finance for income transfers from the deficit to the surplus households for sustaining the economic well being of the community. In order to get a clearer understanding of the determinants of transfers, a multifarious regression model has been estimated from data collected from 267 households. The results shows that in order to strengthen the role of transfers in the improvement of the economic well being of this community, there is need to strengthen their commitment to the religion of Islam, improve their education, and improve their access to the formal labor and capital markets.

In his paper, "The Role of Finance in Development: The Ottoman Experience" Ahmet Tabakoglu tried to outline 800 year experience of Anatolian Muslim rule from 11th to 19th centuries in economic terms and made an attempt to derive its contemporary implications for financing development. It is argued that Ottoman economy discouraged credit and encouraged participatory financing and financing social security services through patronage of private foundations. It is argued that Ottoman administration followed essentially export oriented policy.

In his paper, "Public Borrowing in Early Islamic History: A Review of the Records" N. Siddiqi. tried to report the cases of borrowing by the ruler for public services covering the periods of the holy. Prophet (Pbuh), four pious Caliphs, Ummayids and Abbasides during the 333H (944 AD). The study demonstrated that borrowing was a legitimate activity even from non-Muslims in case of a need. Fulfilling basic need was one genuine reason justifying borrowing. No evidence was found from the record of early history of borrowing for financing economic development. The paper concluded that the social authority should make public borrowing purpose specific and identify purposes most likely to motivate the potential lenders for providing interest-free participatory financing.

In his paper, "Provision of Public Goods: Role of Voluntary Sector *(Waqf)* in Islamic History" Abdul Azim Islahi tried to state the nature and extent of public goods provided by the voluntary institutions of *Waqf* in Islamic history. The paper also established that voluntary sector in general and *Waqf* in particular played a great role in providing public goods to Muslim community. The paper stressed the need for internationalizing the institution of *Waqf* by setting up a World Muslim Foundation to combat illiteracy and diseases and ignorance.

Murat Cizakca's paper on "Relevance of the Ottoman Cash *Waqfs* (Awqaf Al-Nuqud) For the Modern Islamic Economics" argued that cash *waqf* constituted a special category of Islamic endowment and played a very significant role in the Ottoman economy and financial history. It was pointed out that while the cash *waqf* constituted about 16% of the *waqf* establishments during the reign of Mohamet, the conqueror in 1505, the ratio increase to 50% by 1560. It became the dominant mode of endowment. The paper argued that cash *waqf* was instrumental in transferring the savings of the well-to-do to those who needed cash for financing various socio-economic activities. The author argued that by combining the cash *waqf* with long term capital finance, the problem of cash-waqf's perpetuity can be solved. It can also promote participatory finance, free of interest.

These sixteen papers covered a wide range of topics dealing with various Islamic strategies for financing development and mobilization of resources both from home and abroad. While the emphasis was given for mobilization of resources through Islamic profit-sharing and equity finance, this does not however preclude the possibility of raising funds through other Islamic modes of financing such as leasing, instalment sale, hire-purchase, *bay salam,* etc. While efforts should be made to introduce and float various Islamic financial instruments, it is indispensable that attempt should be made to develop private sector and secondary securities market where these instruments can be bought and sold. In the absence of this secondary market, scope for raising funds through Islamic financial instruments will remain limited. Various models and options for financing development in selected Muslim countries are discussed and have rightly emphasized the need for curtailing the wasteful expenditure and altering priorities of allocation of resources in favor of fulfilling the basic needs of the people and supporting developmental activities which will ensure equitable distribution of income among masses of the people. In this context, the role of informal finance deserves serious consideration.

An analytical review of the records in early Islamic history as well as Ottoman experience showed that this sector can play a powerful role in mobilizing domestic resources for financing development of modern Muslim societies. Besides *waqf,* there is an urgent need to activate other voluntary sector institutions such as Hajj, *zakah, sadaqah,* Mosque, etc.

In conclusion, it can be said that while effort should be. made to institutionalize Islamic socio-economic values, Governments of Muslim states should encourage the development of private sector. It is also imperative to meet the government deficit out of conventional tax and non-tax revenues. In the process of creating secondary securities markets for Islamic financial instruments, the central banks of the Muslim countries can play a significant role. It is gratifying to note that there is a growing recognition of Islamic modes of participatory financing both in Muslim and Western countries. The historic decline of rate of interest in almost all western countries such as USA, UK for stimulating investment and growth (i.e., where bank interest rates, in 1993 is within the range of 3.5% to 4.5% in USA and UK, the lowest in the last 20 years) provides further justifications for Islamic participatory and custom-tailored financing program for alleviation of poverty in the informal sector and economic progress in the Muslim countries. In this context, the importance for reactivating the voluntary sector can hardly be over-estimated.

Section I

ISLAMIC STRATEGIES FOR FINANCING DEVELOPMENT

1

SHARI'AH COMPATIBLE SHARES : A SUGGESTED FORMULA AND RATIONALE

MOHAMMAD ANAS ZARQA*

1. CONVENTIONAL PREFERRED SHARES AND THEIR FUNCTIONS

1.1 Preference Shares

Preference shares are best understood when compared to ordinary shares which denote part-ownership of a company. The holders of ordinary shares are residual claimants on the profits and assets of a company. Ordinary shares normally carry voting power and generate variable returns depending on the profits of the company while in contrast, the main characteristics of preference shares are as follows:

a) Preference shares have a stated rate of dividend usually stipulated as a percentage of par value. Thus, a $100 5 per cent preference share can be expected to give $5 per annum. But unlike interest on a bond, that 5 per cent promised dividend rate does not constitute a fixed obligation on the issuing company. If the company makes no profits, or sustains losses in a given year, preference shareholders get nothing.

b) Preference shares are preferred over ordinary shares as to dividends. All profits go first to preference shareholders until they obtain their specified dividend rate. Remaining profits, if any, go to ordinary shareholders only.'

c) Preference shares are also given priority over ordinary shares as to claims on company assets on winding-up. Thus, in case of

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liquidation, debtors such as bondholders are paid first, followed by preference shareholders who are paid the nominal value of their shares. Ordinary shareholders receive what remains.

d) Cumulative Preference Shares

1. If dividends on *cumulative* preference shares are not earned in a particular year, they are not lost but must be paid up in a later year if earnings permit.

2. Non-cumulative preference shares are entitled to their stipulated dividends which are completely lost to the preferred shareholders for any particular year - Which year? - This is not clear.

e) Preference shareholders may or may not be given voting rights, whereas ordinary shareholders are almost always given such rights. This matter will not concern in this paper.

1.2 Economic Functions of Preferred Shares

"Preferred stock is a curious hybrid between debt and equity. Although it is technically a form of equity investment, it has many of the characteristics of debt ..."

"In terms of risk, the preferred stockholder is in a less risky position than the common stockholder but in a more risky position than the corporate bondholder. Preferred stockholders generally receive a greater of return on their investment than bondholders in compensation for the slightly greater risk they assume. However, they generally receive a lesser rate of return than the common stockholder because they assume less risk". (Francis, pp. 19, 22).

Preference shares thus appeal to investors who would like a risk-return mix between that of a bond and an ordinary stock.

From the issuing company's point of view the advantage of financing itself by preference shares is that they are a hybrid between bonds and ordinary stocks.

When compared to bonds, preference shares represent less of a financial risk to a company. This is so because interest payments on bonds are fixed financial obligations that must be met in good and bad times. In contrast, stipulated dividends on preference shares, as we have mentioned earlier, need not be paid unless the company makes profits.

"As compared to financing by issuing new ordinary shares, conventional preference shares do not dilute[2] ordinary shareholders rights", (Coopers and Lybrand, p.47). This stands to reason, because preference shares have a limited claim on company's earnings and have often no voting rights.

2. WHY PREFERENCE SHARES ARE ISLAMICALLY OBJECTIONABLE[3]

The main Islamic *fiqh* objection to preference shares are two:

Firstly, Muslim jurists are agreed that a partnership contract should not contain provisions that may occasionally lead to the suspension of profit-sharing among partners. It is clear from para 1.1(b) above that preference shareholders may end up taking all the earnings of the issuing company if such earnings do not exceed the stipulated dividends on these shares.

Secondly, on liquidation of the company, preference shareholders may receive the full par value of their shares, in precedence over ordinary shareholders. Thus they virtually stand as lenders (who can reclaim their principal) rather than as partners. From *fiqh* point of view, if they are to be considered lenders they may not receive dividends in the first place; they can only get back their principal. If they are partners, they may not have preference over other partners, i.e. over ordinary shareholders.

3. ISLAMIC PREFERENCE SHARES: A PROPOSED FORMULA

I would like to propose a modified form of preference shares which would serve specific economic functions, while_ maintaining full conformity with *fiqh*.

To meet the first *fiqh* objection, I propose that preferred shareholders get a higher share of profits as long as their stipulated rate of dividend has not been exceeded. By higher share, I mean a share higher than the ordinary, i.e. higher than that corresponding to their share in the company's total capital. For example, suppose a company has the following capital structure:

Ordinary shares (units of $1 each)	$ 500	(or 50 per cent)
6 per cent preference shares (units of $1 each)	$ 500	(or 50 per cent)
	$ 1000	

Under conventional preference shares rules, the first $30 (= 6 per cent of $500) of earnings would go to preference shareholders only. Earnings beyond $30, if any, would go to ordinary shareholders.

Under ordinary Islamic rules of partnership, any profits earned would be simply divided (50/50) among the ordinary and the preferred shareholders.

Under my proposed formula of Islamic preference shares, ordinary shareholders would attract preference shareholders by offering them a more favorable profit-sharing ratio as long as the 6 per cent stipulated dividend is not exceeded. In our example, preference shareholders may be offered, say, 80 per cent of any profits below the level that would bring them their stipulated 6 percent dividend. This works out to be $37.5 (=30/.8). Beyond $37.5 of profits, the profit-sharing ratio would swing in favor of ordinary shareholders to, say, 70 per cent, with the remaining 30 per cent going to preference shares.

In case of losses, Muslim jurists are unanimous that they must be shared "normally", i.e., in strict proportion to each partner's capital. There can be no preferential treatment in this case.

4. *FIQH* BASES OF THE PROPOSED FORMULA

Several *fiqh* rulings are crucial to establish the *shari'ah* acceptability of our proposed formula for Islamic preference shares.

The first is that it is permissible *('inan)* partnership to agree on a profit-sharing ratio which is different from the ratio of capital participation of the partners. This rule, in strict interpretation, applies to partnerships where each partner provides some capital and some labor. For reasons to long to spell out here, I feel there is good justification for extending the same principle to cover common stock companies.

The second ruling is the permissibility of making the profit-sharing ratio in a partnership variable, depending on the level of realized profits. That second ruling was approved by the *shari'ah* Board of Faisal Islamic Bank of Sudan (see Appendix).

The shareholders, ordinary and preferred, are free to agree on any variation in the profit-sharing ratios from their ordinary levels (i.e. levels that correspond to the capital shares of ordinary vs. preferred shareholders). The only limitation is that partnership in profits be truly maintained among all groups of shareholders. In other words, what must be avoided is a situation where almost all profits go to one group of shareholders. As a rule of thumb, it should not be objectional for a group of shareholders to give up to two-thirds, of their ordinary profit-share to another preferred group. But to give up say 90 per cent of their ordinary share is either it is or it is not unacceptable from *a fiqh* point of view.

5. A NUMERICAL EXAMPLE

5.1 The Assumptions

Assume a company has the following capital structure:

Ordinary stock (units of $1.00 each)	$ 50.00
7 per cent Islamic preference shares (units of $1.00 each)	$ 50.00
	$ 100.00

The preference shareholders were offered 70 per cent of any profits earned by the company as long as the return on their preference shares does not exceed the stipulated 7 per cent. This, practically, means .that when total profits are no more than $5.0, preferred shareholders get 70 per cent of the profits,' while ordinary shareholders get 30 per cent. For profits above $5, preferred shareholders get only 30 per cent of the extra profits and ordinary shareholders get 70 per cent.' Losses are to be shared equally (see section 3 above).

To illustrate, if profits in a given year were only $3.0 i.e., less than the critical $5.0; then:

- Preferred shareholders would get 70 per cent or $2.1.
- and ordinary shareholders would get 30 per cent or $0.9.

If profits had been say $20:

- Preferred shareholders would have got $8.0 (= 3.5+4.5 = 70 per cent of 5 + 30 per cent of the remaining 15).

- and ordinary shareholders would have got $12.0 (= 1.5+10.5 = 30 per cent of 5 + 70 per cent of 15).

The following table illustrates the implications of our assumed example:

TABLE

TOTAL EARNINGS, PREFERRED AND ORDINARY DIVIDENDS FOR AN ASSUMED COMPANY

YEAR	Total Company Earnings ($)	DIVIDENDS TO	
		Islamic Preference Shares ($)	Ordinary Shares ($)
1	17	7.1	9.9
2	8	**5.9**	2.1
3	(-5)	(-2.5)	(-2.5)
4	9	6.2	2.8
5	22	10.1	11.9
6	21	9.8	11.2
7	(-10)	(-5)	(-5)
8	(-2)	(-1)	(-1)
9	18	8.9	9.1
10	14	7.7	6.3
11	10	6.5	3.5
12	(-4)	(-2)	(-2)
Arithmetic Mean (m)	8.17	4.3	3.86
Standard Deviation (s)	10.5	5.13	5.55
Coefficient of Variation (s/m)	1.29	1.19	1.44

In the table, column (1) gives the earnings of the company for a 12 year period. I assume that when earnings are positive, they are fully distributed as dividends to all shareholders according to the ratios mentioned earlier. Column (2) and (3) must add up to column (1) (total profits), of course.

It is important to notice in column (2) and (3) that losses, in conformity to *fiqh,* are shared strictly in proportion to the capital contributed by each group. Thus, the losses sustained in years 3, 7 etc., have been assigned equally to ordinary and preferred shareholders, as both groups contributed equally to capital.

5.2 Risk and Return in the Assumed Example

Let us compare the risk and return of total earnings for the full 12-year period in column 1 of the table to the dividend streams of preferred and ordinary shareholders in columns 2 and 3. Annual earnings of the company averaged $8.17, out of which $4.3 or about 53 per cent were distributed as preferred dividends, and $3.86 or 47 per cent as ordinary dividends.

Relative risk[6] as measured by the coefficient of variation was 1.29 for annual company earnings. For preferred shareholders relative risk decreased to 1.19 while for ordinary shareholders it increased to 1.44.

This numerical example demonstrates that our suggested formula has the potential to achieve its desired objective of generating from the same stream of earnings two sub-streams, one with lower risk and the other with higher.

There is an apparent anomaly however: ordinary shareholders received a lower return with a higher relative risk. Normally, they would expect a higher return for their higher risk. Presumably our scheme would lead to this outcome when the company's profits became higher as higher profits improve the relative position of ordinary shareholders.

One cannot of course generalize from numerical examples. Analytical treatment is needed to explore the general conditions under which our suggested formula can achieve its objectives.

6. THE ECONOMIC FUNCTIONS OF ISLAMIC PREFERENCE SHARES

By way of introduction, it may help us appreciate the potential role of Islamic preference shares in an interest-free economy if we answer first the following question:

Why are preference shares much less popular than stocks or bonds in Western countries? This can be explained by one fundamental reason. It is that preference shares are a mix (hybrid) between stocks and bonds; hence their main characteristic can be matched by a suitable portfolio containing both stocks and bonds. The existence of preference shares probably owes more to institutional or tax system peculiarities than to basic functions not achievable without preference shares. This leads me to believe that preference shares can play a useful role in an Islamic interest-free economy where interest bearing bonds are prohibited. In such a setting, Islamic preference shares can provide, for any particular company, a financial instrument which is less risky than its ordinary shares. It may thus appeal to those investors who would like to sacrifice some return to achieve lower risk.

6.1 Attracting Investors with Diverse Risk Preference

A particular company has an expected earnings stream with an associated expected return and risk. The expectation may be based on its past record, if it has one, or on those of similar companies within its "risk class". One may appeal here to the capital asset pricing model or some alternative theoretical structure to characterize the given company's expected return and risk. Investors preferences as regards risk and return may mean only a sub group among them would consider that particular company as a suitable investment. Other potential investors would shy away if they considered its risk/return combination too high(or too low) for their particular needs.

The proposed formula of Islamic preference shares would permit a company to partially change its risk/return profile for a sub-group of potential investors by offering them suitably designed Islamic preference shares. It would add flexibility and desirable diversity to other *shari'ah* approved modes of financing.

6.2 Conserving the Rights of Ordinary Shareholders

Imagine an on-going company that has only ordinary shareholders but needs additional financing for some new very missing investment. Issuing new ordinary shares would lead to dilution of profits for the majority of existing shareholders. The proposed formula has the potential of providing a partial solution by limiting the extent of dilution. This is because preferred shareholders would get lower profit-share when earnings (are very high) exceed a certain return.

Similarly, the assumed company may find Islamic preference shares an attractive financing instrument if present earnings are meager but are expected to increase significantly in the future.

6.3 Overcoming Information Asymmetry Among Investors

The two previous functions discussed in 6.1 and 6.2 are those usually ascribed to conventional preference shares. Restating them is meant to underscore the fact that proposed Islamic preference shares can maintain these functions to a degree that is compatible with *shari'ah.*

The author has been unable to find any reference in relevant literature to the function now described.

Assume two groups of investors B and C who have identical risk/return preference maps (functions), but different assessment of the risks and potential returns of a given venture. Group B may be a new oil-exploration group, or a new innovative company, that has no track record to convince group C of its high potential earnings. One way to still attract investments from C is to offer them Islamic preference shares on suitable terms.

7. CONTROLLING RISK IN. ISLAMIC PREFERENCE SHARES

7.1 Introduction

Company earnings fluctuate over the years. A given stream of such earnings has a corresponding mean (m) and a measure of relative risk devoted by its coefficient to a fixed share(p) of the earnings, the group's sub-stream of dividends would have a mean equal to (pm) but its relative risk would be identical to that of the original stream (=s/m). Thus any fixed profit-share cannot generate a change in the risk character of the resulting dividends stream.

This suggested formula for Islamic preference shares changes the risk measure of preference shareholders because it involves a <u>variable</u> profit-sharing ratio.

7.2 Implications of Islamic Loss-Sharing Rule

As mentioned earlier, Islamic *fiqh* require losses to be shared in strict proportion to capital contributed. Thus, no preference rules can apply in those years when earnings are negative. Rather, given fixed proportions apply then, transmitting to preference shareholders' stream the full consequence fluctuations in company earnings. The more years with losses, land the larger those losses, the less effective would be Islamic preference shares in insulating preference shareholders from fluctuations in company earnings.

Thus, fluctuations in <u>positive</u> earnings may be controlled for preference shares by changing the terms and proportions that apply to preference shareholders. For fluctuations in <u>negative</u> earnings, however, one must seek a different method of control.

7.3 Cumulative Islamic Preference Shares

In conventional "cumulative" preference shares, preferred dividends that are "missed" in a given year are carried forward in arrears, to be paid in later years. This is objectionable from Islamic *fiqh* point of view, as it treats "missed" dividends much like a debt on ordinary shareholders.

The advantage of cumulation, if it were permissible, is that it helps reduce or sometimes (iron eliminate out) completely the losses that we need to be controlled.

After some reflection, a simple accounting rule that is well accepted in *fiqh* can be quite helpful here.

It requires setting the accounting period among partners to be longer than a year. Suppose it is made three years. This means that all earnings, whether positive or negative would be, cumulated and assigned to a "profit stabilization fund". The same preference sharing rules would apply to the balance in this fund every three years. This would go a long way to achieving the goal of cumulation within the *fiqh* guidelines.

If a three-year profit fund is applied to our earlier example, the relative risk measure for preference dividends would be further reduced significantly.

Appendix

FATWA OF THE *SHARI'AH* SUPERVISORY BOARD OF FAISAL ISLAMIC BANK, SUDAN

Answer to Question 11

It is essential for validity of a contract of partnership in profits that the division of the profits takes place in such a way that each has a given common share of them, e.g. 50 per cent each, if there are only two partners. The partnership will be considered invalid if the share of either party is determined as a given sum of money, e.g. LS.1000, or 10 per cent of the share capital, since the profit realized may not exceed the fixed share of profits, and so the party given such a share will retain all the profits. The profits may well be less than the fixed rate of profits and the fortunate party may take part of the share capital. A third situation is where the profits may exceed the fixed rate and the partner with the fixed rate will feel aggrieved. Ibn El Munthir said: "All the learned men whom we know are in consensus in invalidating *a mudharabah* contract if one of both parties have fixed a given sum of money for their share in the profits."

This is the case where the term fixing a given sum of money is expected to result in one of the parties being deprived of sharing the profits; but if fixing the sum is not expected to result in such deprivation, fixing the profits may be permissible. For example, if one of the parties agrees to give the other LS.1000 over and above his share in the profits, if the profits realized amount to LS.5,000, then the remaining portion is to be divided equally between the two partners. This is the rule as stated in the book called "El Bahr El Zakkar" as follows: "If one of the parties asks for ten (pounds) if the profits exceed that, then the stipulation is correct and binding and there is no reason to consider it as voidable.."

Accordingly the agreement referred to in the question posed by the bank is permissible, since the profit is shared in common between the two parties; and the stipulation according to which a fixed sum of the profits is to be given to the bank's partner if the profits exceed a given sum will not result in negating the fact that both parties will have a common share in the profits. This is so because the partner will not deserve the fixed sum except after sharing fifty-fifty with the bank out of the fixed profits agreed.

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ENDNOTES

1. One variety of preference shares, called "participating preference shares" get a share in these extra profits.

2. By dilution we mean the reduction in the actual or potential earning per share caused by issuing more shares.

3. For more *fiqh* details see: Al-Khayyat, Vol. 2, pp. 222-24, and Al Marzooqi, pp. 358-61.

4. To reach the stipulated 7 per cent of $50 preference shares, profits assigned to preferred shareholders must reach $3.5. This amount is 70 per cent of $5.0 of total profits.

5. The profit-sharing ratios beyond $5 level of profits need not be (from *shari'ah* point of view) the reverse of those below $5.0 m.

6. Risk is often measured by the standard deviation (s) of an income stream, and as such would be in the same units as the stream. *Relative risk is* often measured by the coefficient of variation (s/m) or the Standard Deviation divided by the arithmetic mean (m). This measure of relative risk is adopted here because it is a pure number that is directly comparable for different streams regardless of units or time span.

2

FINANCING ECONOMIC DEVELOPMENT FROM AN ISLAMIC PERSPECTIVE

HATEM EL-KARANSHAWY*

1. INTRODUCTION

The question of development finance has occupied the minds of economic thinkers, economic policy makers and executors for more than half a century. As a result of a number of factors, probably the most important of which is the adoption of imported development models, underdeveloped countries have suffered what was known as a resource or "finance gap" which was faced by external *flows* in its various forms i.e. loans, grant and direct foreign investment. These flows did not lead, as was expected, to the structural changes that were required but rather in many cases lead to the deterioration of the relative economic position of recipient countries. The capacity of these countries to meet their debt service obligation has been reduced gradually. Islamic countries in general, apart from those producing oil, are among those indebted countries. The external debt ratio to gross national income in some of them has reached 213 per cent as in case of Mauritania. Debt service burdens have, in some cases, reached 69 per cent of the total export of goods and services revenue as in Algeria and about 33 per cent in Somalia, Niger, Indonesia, Morocco and Turkey. Not only this, but several recent studies on grants, as well as the so called "easy loans" which are tied most of the time has indicated that the effective cost of each such loan may not be cheaper than the commercial cost of borrowing and could even be note. What is more important is the fact that Islamic countries have been trapped in the prohibitive *riba?* dealings and once they are trapped in this vicious circle escaping from it becomes extremely difficult even if those countries want to do that.

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In this working paper, we shall try to present a framework for a mechanism that may enable the mobilization of the surplus available in some Islamic countries which is currently utilized in international capital markets in order to deal with some of the needs of deficit countries on *shari'ah* based principles. Such a mechanism should ensure the efficiency of utilization in these countries. Before going into the basic principals of this mechanism, it is important, from our view point to discuss three points which represent the framework through which one can determine the finance gap and as such we can work out ways and means to face how such a gap can be worked out. The very concept of development itself represents the first point in such a frame while the second point is the role of the state and its responsibilities in Islamic jurisdiction. The third point discusses the relation between the proper concepts and institutional framework in Islam and the mobilization of domestic as well as external resources.

2. THE CONCEPT OF DEVELOPMENT

Needless to say, any attempt to review the literature on development from an Islamic perspective goes beyond the scope of this paper. However, it is important to choose one of the many definitions given for development in these writings in order to reach a criteria that will help in the measurement of the finance gap in deficit countries. The development concept which will be adopted in this paper starts from the fact that all resources in heaven and earth are created with the objective to serve human beings. As such, humans are committed in the light of this dedication of resources, to exert their utmost effort in order to free the Islamic society as individuals and as a society from the pressure of need and to ensure that the individual in that society, irrespective of his beliefs or ideology, is guaranteed such satisfaction through his work or through the institutions in the society even if his output and income is not enough to satisfy his needs. The concept of needs satisfaction in Islam goes well beyond the traditional economic concept of basic needs. The quantity, type and level of goods and services provided is based on sufficiency and continuously moves with the general average standard of living in Islamic society. This commitment extends to ensuring the power of the state in providing domestic as well as external security in a general way i.e. economically, politically, militarily and socially. Development in this way has a dynamic content which means that it has to continue all the way through so mankind will achieve increasing degrees of control over available resources. Rationalization of resources utilization, as well as the fair distribution of output, are the other commitments necessary to achieve ever increasing levels of income and economic possibilities which keep Islamic society in its proper place domestically and internationally as a model and leading society. Needless to say, the achievement of the development of such frames will require a set of mechanisms and methods, some of which are linked directly to the question of financing development. Others deal with the issues of production and distribution. With respect to the question of finance, we would like to point out the following:

2.1 Consumption patterns and consumption behavior in an Islamic society is directly controlled through a number of directives that have an effect on the type, size, the growth rate and direction of such demand in various stages in society's development. In this way, the volume of needed resources and their allocation to produce a type of mix that would satisfy the needs of the society within the frame of these directives would also be affected. In other words, the predominance of inappropriate imported consumption patterns in Islamic society will be reversely correlated with the degree of commitment of that society to Islamic values and directives.

2.2 The basic concept in the relation between man and the process of full utilization of resources is the responsibility of both individual and the state, whether these resources be capital, natural resource or even the labor power of man himself as a factor of production. As a result of this commitment, the gap between the available and utilized;the attainable and actual, in all areas, including financial is substantially reduced.

3. THE ROLE OF THE STATE AND ITS RESPONSIBILITIES IN ISLAM

The government, in Islam, plays an essential role in economic life represented basically in its commitment to ensure the minimum standard of living for members of the society. Despite the general consensus about this commitment, the question remains: Does this commitment fall primarily on the state if the initial distribution of income does not make such an objective possible. If we say that it is primarily the responsibility of the government or state, this would require a high level of intervention for the economic decision makers in order to ensure the availability of resources to carry out policies. But if we say that the role of the state starts from the point where the efforts of the members of the society end, it means that the basic burden in the area of satisfying the needs of members of the society will fall upon the shoulders of the Islamic market mechanism at which point the government steps if there is a departure from Islamic limitations or standards or in extraordinary circumstances such as war or natural disasters. This does not mean, in any way, that the government in Islam should play the role of the guardian state in its role of monitoring the application of Islamic guidelines to relations. Its responsibility is in ensuring the necessary prerequisites exist for proper economic activity and social life, either through giving enough incentives for individuals to undertake development investments, or through the allocation of public funds to carry out these activities. Such a role excludes completely the concept of the guardian state and replaces by the effective state and interventionist state when necessary. In other words, it could be said that the responsibility of the state in normal conditions is to prepare and ensure the productive and efficient utilization of resources and to take the necessary steps for individuals to undertake required infrastructure facilities or use public resources to create such an infrastructure. These measures could extend to allow the imposition of utilization fees from those who can pay for these services given that the state is going to provide such services free of charge for those who cannot afford the fee i.e. the legitimate need, not the ability to pay, would be the basis for the decision.

In the meantime, the government has to secure the proper environment for the producer, investor and the consumer. Such an environment would require prohibition of all types of illegitimate activities, such as production of illegitimate goods and services, prohibited monopolies, *riba* in all forms, quality control of all goods and services, adherence to announced specifications. Pricing in such cases might be needed and accepted by the jurists. This will also extend to the commitment of the government to undertake direct investment in areas where individuals is not able or willing to step in or to run what is agreed upon to be part of the public domain. With these concepts for the role of the state, the market plays an essential function in the mobilization of resources, its allocation and distribution of the production on the various factors of production according to each factor and contribution in the production process. The word market, in this case, covers factor markets, goods and services markets as well as capital markets which are all controlled by the same principals. The government, through its various organs, would accept the responsibility of monitoring and control. Price and quality control would be borne by Al Mohtasib; the monetary policy by the central bank etc. These organs would step in when necessary to harmonize action within these markets and between them.

One of the more important empirical results from the utilization of Islamic financial instruments in the market would be the elimination of one of the most severe problems in investment finance in developing countries which is the malfinancing structures as a result of high debt to equity ratios. In such a case, the relation between the lender and borrower vanishes completely. The nature of all funds going into the project will be unified. Financiers will make sure that studies are precise, follow implementation and monitor the management activities. They will provide bridging finance in cases of temporary technical insolvency and in the same spirit and readiness will be available to finance expansions or increases in production in later more profitable stages. One of the basic requirements for the success of the Islamic financial system, if it is partially implemented together with the *riba* based interest system, is the necessity of modifying taxation laws they are based on the luminance of interest finance on all transactions. As such, it gives implicit agreement to borrowing with interest, since interest payment is treated as a cost element. As such the effective cost of borrowing is reduced with as a result of tax relief while the. return on profit sharing or risk sharing is treated as part of profit. As such, it is taxed which increases its effective cost on the institution at the business level. At the same time this reduces the return to the financier. Needless to say, it is the principal of Islamic countries to encourage Islamic financial concepts that result from Islamic financial formats. The *zakat* system represents what might be called the perfect tie balance for the economic transaction cycle in Islam, not only because of its redistribution effects, but also because of the effect on the production process and its effect on the increase of supply of capital and its effects on the cost of finance used as a base in investment decision making. All this directly affects both the availability of finance and type of investment.

4. ESTIMATION OF FINANCIAL GAP

The estimation of financial needs for development depends - generally speaking on a number of factors:

- ❑ Development objective and its time dimension
- ❑ Development model adopted in the society
- ❑ The stage of development of the society.

The distribution or "the mix" between internal and external sources depends basically on the development model, the technological pattern to be followed and the mobilization possibilities of local resources, including capital resources. The development model adopted by most Islamic countries actually emanates from the school of thinking that puts capital in the top position in the development process. The two sides of this school of capitalism, and what used to be known as Socialism or Marxism, are similar in that respect. As a result of such concepts, industrialization was linked to modern technology which is capital intensive was considered a basic path to achieve development. This was linked directly with a wasteful and repeated misuse of local resources and an increasing gap between the so called developmental imports and exports of these developing countries. In our view, the adoption of Islamic development concepts, the utilization of Islamic forms and tools and the adherence to Islamic Market principles are going to lead not only to reduction of the absolute size of the finance gap but also to the structural uprooting of the discrepancies between the estimation of the absorptive capacity and the misuse of available finance domestically and external finance. Funds are more often than not allocated to projects that do not produce direct or indirect returns sufficient to carry the burden or cost of that finance.

Technological choice, on the other hand, will be controlled by the demand mix and by society's ability to absorb the new technology, given that demand is subject to a lot of mechanisms and directives including *zakat* which made demand for essential goods a basic ingredient in total demand in the society. It follows that technological choice will be biased to whatever area of production of these essential goods is selected. The chances of a wider choice of production techniques in this area substantial.

Commitment to Islamic principles in this area of society should increase its local contribution to the process of technological development in a way that leads to technological independence. Imported technology is not a neutral factor or a catalyst in the development process, rather it brings with it products, production techniques, behavioral patterns and values of the originating society which may or may not contradict with those prevailing in the importing society. In terms of financial needs, inappropriate imported technology certainly places demands on foreign exchange as well as on total funds required for investment and operation.

In the field of finance technology, the utilization of Islamic based tools and techniques instead of interest based techniques in undertaking public utility projects, for example, would lead to the following direct and indirect effects:

a) Rational use of available finance as it would be tied to certain projects that would have clear costs and returns and an accounting system as to guarantee investors capital and returns in the project itself rather than the government or the Central Bank commitment to pay back the loan with' the due interest.

b) Implementation schedules are likely to be adhered to - thanks to the follow up by investors - which is not the case particularly with the so-called developmental easy soft loans where the long grace and repayment periods leads to a sort of relaxation and lack of seriousness.

c) Once the Islamic Financial System is used, repayment of capital as well as returns profits would be made out of the actual revenue from the project i.e. users fees and government allocated funds for subsidized users - instead of payment of debt service out of the general budget. This would mean the real burden borne by non-direct beneficiaries of the projects would be eliminated. It would also mean that the unfair allocation of debt service on future generations who might not benefit directly or even indirectly from the project would stop.

In short, it could be said that the size of the finance gap, ways to face it deal with and the efficiency of utilization and the distribution of the burden of such finance would differ substantially if Islamic countries were to adopt development models and financing techniques directly linked to proper Islamic concepts rather than the present utilization of imported development models, methods and tools of finance.

5. PROPOSED MECHANISM FOR THE MOBILIZATION OF EXTERNAL FINANCE

The success of any finance mechanism requires the availability of a group of financial tools that are diversified and attractive. It also requires handling and dealing institutions and a market where dealing can be carried out as well as an increasing size or volume of transactions that would ensure the self-sustained growth of the finance system as a whole. As for the external finance for development and activities, the condition of diversification and attractivity would be satisfied if these tools carried the following characteristics:,

a) Full adherence to Islamic legitimacy away from anything that may have an indication or attachment of illegitimate transaction or any *riba* dealings.

b) It should vary in its nominal or face value and its maturity date as such it would be capable of addressing various types of investors.

c) It should have sufficient insurance against non-commercial risks as well as risks of inconvertibility to freely convertible currencies at maturity date.

d) It should be easy to circulate.

1. The assurance of the seriousness and viability of the investments to be financed.
2. To follow up the implementation and circulation.
3. Indicate the market value of various indirect tools.
4. Provide the necessary insurance on *shari'ah* accepted basis against non-commercial risk and against the risk of losing all or part of the principle.

As for the market, there is no choice in the absence of capital and stock markets that follow or adhere to Islamic principles that such markets have to be simulated through Islamic financial institutions working at present and making full use of recent developments in communications and circulation mechanisms. The following sections will point out the possibilities of interaction between flows:

- ❑ Direct foreign investment
- ❑ Indirect foreign investment
- ❑ Development grants.

5.1 Direct Foreign Investment

Direct foreign investment is the one type of international flow that largely adheres to basic principles of economic transactions in Islam, unless of course it is directed to prohibitive goods and services. As a result of many factors which include limitations on repetition, restrictions on the movement and transferability in the ousting countries, lack of information about investment opportunities, a high degree of non-financial risks in the host countries and insufficiency of bilateral or international assurances or agreements that ensures against such risks. The relative weight of this type of flow has deteriorated sharply since the mid-70s leaving its place for commercial loans and development grants or development finance. With the recent international debt crises, writings and discussions have began again to point out and emphasize the vital importance of linking finance to specific projects and presenting various formats for debt/equity swaps. Requests have been made for international banking systems to review their financing strategies so as to reduce the risk of failure kin meeting debt service. All of these would lead to the expectation of a higher percentage for direct foreign investment in international flows particularly with the signing of a growing number of agreements both bilateral and multilateral for the protection of direct investment from non-commercial risks. The introduction of new forms of direct foreign investment that goes beyond the traditional form of owning physical assets in foreign country to cover so many forms of agreements and transactions which extend to financial leasing, licensing, marketing, know-how, trade marks and so on would enhance such a trend. Islamic countries with a financial surplus might be interested at the present time, where the importance of diversification of foreign placements and foreign utilization of its funds is mounting, to study the possibility of transferring some of these placements. Needless to say, direct foreign investments alone, even with the assumption of facilitating and developing the necessary environment in both the recipient and exporting countries, would not be sufficient to cover the needs for the host countries. Some of the activities would not by virtue of its nature be suitable for direct foreign investment. In infrastructure activities for example, it would not be feasible to imagine that in short or medium run, the private foreign investor would be permitted to offer it for sale or close it down if its return is not coping with the opportunity cost of the investment and so on. Such infrastructure projects as well as other activities are badly needed in the host countries and as a matter of fact considered as a pre-condition for enhancing investment opportunities to attract local as well as foreign investment. On the other hand, there are a number of advanced and developing countries which enforce some limits on direct foreign investments and control ownership or property rights in some activities. This is linked to economic or political calculations and balances that are difficult to change. All of the above recommendations indicate the need for other forms of external flows together with direct foreign investment. The following are some recommendations that would, in our view, facilitate the flow of direct foreign investment to the host countries. These recommendations could be divided between measures to be taken at the level of host countries and others to be taken on the multilateral or international level.

5.1.1 Measures to be taken at Host Countries Level

a) Develop a clear precise investment environment which means spelling out clearly where direct foreign investment could step in, investment opportunities are enough information about various activities and legal as well as procedure aspects.

b) Full respect for local as well as international agreements and the announced readiness of the host country to protect the parties in these agreements on an equal basis without discrimination for or against the foreign party.

c) Providing assurance against non-commercial risks. The could be arranged through host country participation in investment guarantee agreements (either bilateral or multilateral) that provides schemes against such risks.

d) Legal restructuring of present laws - if needed - so as to recognize the various formats of contracts that is proposed according to *shari'ah* and determination of the legal position for parties to these contracts.

5.1.2 Measures to be taken on Multilateral Level

a) There is a need for either an independent body or a body attached to an international Islamic organization such as the Islamic Development Bank to carry the responsibility of the collection, verification and analysis of information concerning investment opportunities in Islamic countries, as well as legal and procedural forms in these countries. This information would be available to investors from member countries for a certain fee. It would enhance the performance of this body or institution to have sufficient financial resources to enable it to participate in the equity of some of the projects that would analyze a limited basis and circulate them at a later stage in the secondary market to act as a promoter or catalyst for these projects. Some lessons could be drawn here from the experience of other international finance corporations. One major task for this institution would be to study the legitimacy of various formats used in the direct foreign investment and propose new formats that adhere to *shari'ah* principles if needed.

b) The coverage of insurance companies that carry the non-commercial risk insurance should be extended to cover all Islamic countries. In addition there should be encouragement to make bilateral agreements for investments protection between the surplus and deficit countries.

c) The council for Islamic research or any other body should be requested to study the legitimacy of the debt/equity swap from the *shari'ah* point of view, particularly if negotiations with lenders could lead to the reduction of the outstanding debt to its original or principal value and foregoing accumulated interest. Or to examine its legitimacy even if it has some interest as a measure for helping Moslems to avoid sinful dealing with interest.

5.2 Investment in Financial Asset

Types of financial assets that could be utilized as tools for external funds mobilization includes - but is not limited to the following:

1. Property rights or common stock in existing companies: this would include the purchase of common stock in one or more companies so as to diversity risk.

2. Participation bonds with differing maturity dates: these are investment bonds based on participation in the outcome of operations or activities which can be used to finance certain operations such as trading activities, or to finance investments in fixed assets in on going projects. This can be further subdivided to:

   2.1 Bonds convertible to stocks upon request of the holder in accordance with certain terms and exchange ratios.
   2.2 Bonds that have a fixed maturity price (The par value).
   2.3 Bonds that have a maturity value that may go up or down with the net worth of the company.
   2.4 Bonds for finance of infrastructure activities: these bonds secure a relatively stable return and can be used to finance public utilities whose services can be sold - as electricity - with mark up on cost.

3. Unit investment bond: this is a bond that represents an investment in a number of projects or activities so as risk is diversified including foreign exchange risk and a certain balance is achieved between dividends or annual returns and the capital gains that may materialize.

As for common stocks, the subject has been studied in the number of papers and conferences and the general agreement is that dealing in them is legitimate whether buying or selling at market value as long as the project concerned is adhering to *shari'ah* rules. What is needed to encourage people to deal with this the establishment the proper institutions, a subject that will be considered shortly.

As for the participation bonds that have a set maturity date a few points may be raised:

a) **Duration of the bond:** Such a duration may be limited by the nature of the activity itself such as a trade transaction, a specific deal or service or the finance of working capital to meet an expected increase in demand. In this case, the result of operation and calculation of repayment would not raise any serious problem from either an accounting view point or from the *shari'ah* point of view. However, for other activities such as industrial, agricultural or even service investments which have long productive lives, the determination of the participation period should take into consideration: construction or gestation period, and the expected time horizon for the project to reach full productivity as well as the attractiveness of investment. Of course this would be reflected on the basis upon which the return would be calculated, and the possibility of calling the bond before its maturity date and the expected value in case of sale before the maturity date assuming certain demand and supply conditions exist which will reflect, to a considerable extent, the quality and the rate of such return.

b) **Basis of calculating the periodic return:** The periodic return would depend on the actual results of activity whether profit or loss. The question which arises here is at which stage in profit calculation should the share of these bonds be based. In our view, this has to be linked with the expected value of the bond at maturity. This means one of two things: **First,** the bond will be redeemed at par value. In this case the share of the bond or profit realized should be calculated on the basis of the operating profit and before deduction of depreciation or any other reserves. All these reserves will be deducted from the gross operating profit and will increase the net worth of the firm but will not benefit the bond holder in spite of the actual contribution made with his money in achieving these results. One exception that can be made is the special reserves which may be directed to the enforcement of low expected profits during the period of the bond and in this case it is be the right of the bond holder to get his share in the reserve at maturity but not before that. **Second,** the bond will be redeemed at a certain value based on net worth of the activity at time of maturity. In this case, the basis for calculating the periodic return will be net profit i.e. after deducting various reserves. Of course this has to be done after adjusting taxation laws so as to allow the return on bond to be treated as a cost of finance on the borrowing company. The bond holder is going to get his share in the increase or decrease in the value of the bond. As a capital gains (or losses) at maturity date.

c) The bond might be a convertible one which means that it can turn into equity right in the firm. In this case, the value of the bond could be linked to a certain number of stocks based on their par value. Alternatively, numbers of shares that can be acquired by the bond could be determined on basis of market value of bonds and shares at the time of taking the decision of conversions.

As for public utility bonds, Jordan has an interesting experience where a bond's par value is guaranteed by the government as a means to encourage investors. It is more appropriate - from overview - to replace such guarantees by government commitment to buy back the bonds at market value. Alternatively bonds may be extended for further periods at the holder's discretion. The government may give certain incentives to local investors to buy there bonds - e.g., tax incentives. Application of the above recommendations would induce public officers in charge of infrastructure projects to improve the performance of such projects in order to secure the continuous flow of investment funds for expansion, replacements and improvements. This flow can only be secured with good rates of return and/or expected capital gains at maturity. On the other hand these recommendations would automatically establish the right of bond holders representatives (Auditors) in reviewing cost and revenue accounts. Returns over and above the guaranteed par value in local currency may not mean much for external inventors in the light of prevailing inflation and instable exchange rate in many Islamic countries.

Unit investment bonds could be the appropriate starting point for the flotation of the proposed tools. It is recommended that the "Unit" includes a diversified package of short term bonds, medium term bonds and long term securities. The latter represents an element of stability and the possibility to achieve capital gains. Foreign exchange generating activities ought to be included in the package as form of hedging against foreign exchange shortage as well as exchange rate fluctuations.

The "Unit" value would be determined and announced periodically by the issuing organization based on a weighted averaged of market prices of the package's securities at time of valuation. Subject to further detailed verification from the *shari'ah* point of view, it is recommended that investment in these Units would be close ended and the structure of the portfolio should be fixed during the term of the Units. Before allowing an increase in investment funds, full valuation - with liquidation option - should take place for existing units.

Needless to say that securities in the package should be free from *riba* transactions and any other illegitimate products, services, dealings or financing tools.

5.3 Development Grants

Published statistics indicate a continuous decrease in development grants flow whether in absolute terms or as a percentage of donor countries' national income. The share of developing countries in these flows in likely to decrease as a result of redirecting a good deal of these flows to help eastern Europe move towards a market economy. As such it becomes extremely important to maximize the benefits from available funds. This may require the "transfer" some of the developmental projects - including public utilities - to income generating activities where development bonds could be used to generate at least part of the required finance.

On the other hand it is proposed that part - if not all - the surplus that may be realized from the mutual insurance fund operations (to be discussed shortly) should be channeled to the most needy Islamic countries to finance development activities that will not generate enough income to induce private inventors. The *zakat* fund, due on investment profits in host countries, could also be directed for the same proposed subject to the control of Islamic Organizations. *zakat* funds however should be used to finance those projects and their property right could be transferred to eligible poor and needy - in accordance with what is agreed upon by *shari'ah* Jurists - These include housing projects and small scale industries.

Generally speaking with the gradual success of Islamic based finance for several activities - including infrastructure ones - the urgent need for development grants will be reduced - *zakat* surpluses in some Moslem countries could supplement these forms together with benevolent loans.

5.4 Institutional Frame

As a pre-condition for the success of the proposed mechanism, certain institutional arrangements have to be initiated. In the host country (or issuing country) and on the multilateral level in Islamic countries.

The first level would include Islamic banks, private investment companies and public enterprises that adhere to Islamic transaction concepts and guidelines. Those are going to study - or evaluate studies prepared by others about investment opportunities, verify return expectations, formulate financing plans, propose appropriate financial tools and manage the portfolio on the domestic level in case of a successful flotation.

On the multilateral or international level specialized companies (S.C.) preferably attached to the International Islamic Development Bank in the beginning will undertake the marketing and promotional tasks for various issues, check the studies and review the availability of domestic finance if needed. These companies-will also undertake follow up, auditing and ensure host countries and their companies adherence to disclosure requirements. Such requirements should be designed in a way that enable investors or their agents to carry out accurate, regular economic valuations of the financed companies.

The S.C.'s can also play the role of the secondary markets until there are sufficient and capable stock markets in Islamic countries. This role will include the regular publication of information about prices, dealings, supply and demand trends, etc. of listed securities.

These companies may perform some underwriting functions as a necessary promotional initiative. They may issue their own "Unit" investments that would include a package of diversified securities form different countries and activities. These units may have a certain appeal for the conservative or risk averse investors as such units present a suitable tool for the investment of Islamic banks excess liquidity and mutual insurance funds. Companies revenue from its operations - on the domestic or international level - could be based on a certain percentage of the value of the operation - flotation cost - or a margin of the securities profits once realized.

In addition to the need for these S.C.'s it is necessary to establish voluntarily based mutual insurance funds which insure investments against non-commercial risks and foreign exchange risks. It may extend its coverage to partial or full compensation in case of principal investment loss within the *shari'ah* approved rules for mutual and cooperative insurance. Funds accumulated would be invested in low risk securities or assets. Profit generated - as proposed earlier - may be directed to development aid for the least developed Islamic countries.

Shari'ah control over the processes of issues, flotations, dealings, etc. should be performed by an international independent authority with appointed representatives in host countries. The authority would have the right to review, examine and access to all documents deemed necessary for performing its obligations. This body's expenses would be financed from flotation or marketing commissions. As for the collection of the *zakat* on investments and profits generated, it should be collected either by independent Islamic organizations or Islamic banks in the host countries previously mentioned.

6. MARKET REGULATIONS

Capital markets, like all other markets, are subject to the general rules that characterize Islamic markets for goods, services or factors of production. The application of these well known general rules in the case of stock markets leads to a number of points that may be worth emphasizing:

- Stocks should not be sold for more that its par value before invested money is transferred to productive assets.
- Disclosure roles should secure enough flow of information to establish the link between the financial asset value and real assets productivity.
- Margin trading should be prohibited.

Such guidelines together with the general rules regarding prohibition of monopoly and speculative trading, would mean market stability and help prevent the possibility of stock market collapses which are becoming a feature of modern stock market operations.

One point that may require some further consideration relates to whether stocks should be nominal or issued to the bearer. Nominal shares restrict circulation and liquidibility. It may also hinder some investors who may not prefer to reveal their identity or interests. On the other hand nominal shares facilitate *shari'ah* control and limit speculation opportunities. Dealers may be authorized within certain a regulatory framework to carry out title transfers within certain dates special ledgers might be kept for that purpose pending final transfer of title in the issuing companies. Dealers could also be permitted to manage private portfolios with no need to disclose owner identification.

As for government's guarantees regarding the capital or return on investment - it may be advocated - provides that tax payers do not carry the burden for such guarantees. It is difficult to name the public fund or resource for honoring such guarantees of which would not represent a deduction from the citizens share.. Government funds are not private property - they are owned by the general public. As an alternative the government may guarantee the serious implementation of projects, flexibility of transactions, fair taxation policies, and adjust taxation systems to adhere to *shari'ah* principles as it was mentioned earlier - all what may be classified under investment incentives.

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3

THE ROLE OF EQUITY PARTICIPATION IN FINANCING ECONOMIC DEVELOPMENT

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1. INTRODUCTION

In the literature on development finance, there is a growing interest in the subject of equity participation as a means of promoting development. The limitations of debt finance are increasingly evident at both the micro and macro level, especially given the growth of bad debt as far as business is concerned, and the problem of national indebtedness involving many Third World countries. Borrowing has its uses of course, but inevitably leads to problems if it is used as a means of financing risky ventures or projects which are of a long term nature. In contrast, equity finance means that it is the provider of capital who takes on the risk. The fact that there is flexibility in the pay-off, which is related to the project being backed, actually serves to reduce risk and enhance the likelihood of successful outcomes.[1]

Equity finance raises a- number of moral and ethical issues, which are usually neglected by western finance specialists. As with other branches of economics, it can be instructive to take account of such issues, rather than merely rely on a positive approach. Equity financing can be conducted in a very moral manner, and the principles of risk sharing and cooperation through participation is certainly preferable to the conflict of interest which often exists between borrower and lender in a debt financing situation. Unfortunately, however, there are also negative and morally objectionable factors. Equity markets are renowned for speculation and other undesirable behavior, especially in the thin and volatile markets which are often found in the Third World countries. Whether equity markets function in a just or unjust manner will clearly depend on the motives and

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behavior of the participants. It is to these behavioral issues that we must now turn.

2. BEHAVIORAL ISSUES IN EQUITY INVESTMENT

Conventional neoclassical economic theory assumes that individuals are maximizers of utility, with the objective function for equity investors incorporating a trade-off between risk and return. Less risk is preferred to more risk, and higher return to lower returns, but the investor cannot maximize both.

Although individuals are assumed to be primarily motivated by the maximization of their own utility, the latter may not only involve personal material gain. The social value of investment may also be of concern to equity investors, and the placement of funds in socially worthwhile ventures may be preferred to those of less or even negative social value: The satisfaction which the investor gets from participating in a socially desirable project will itself represent utility, and may compensate for lower material returns.[2]

Recognition of the social responsibilities of equity investors has both positive and negative implications. On the positive side there is the benefit of participation, cooperation and partnership which is advantageous for all parties. The depth and closeness of the relationship between the provider and user of funds is much greater than in the case of debt finance, and the construction of such lasting relationships must be considered highly desirable from the developmental point of view.[3]

On the negative side the investor must recognize that absolute freedom to dispense with funds cannot be in the social interest or even in the interests of the individual investor. Moral and ethical factors must be brought into the reckoning. Speculation, for example, is in nobody's interest, and neither are dishonest dealings. Not only must the investment itself be undertaken in a morally acceptable manner, but the purposes for which the funds are used should be socially and ethically desirable. The former implies behavioral constraint, the latter the question of responsibility over resources which are, most people believe, ultimately provided on trust and not subject to absolute individual ownership rights.[4]

Good information is essential if investors are to take the optimal decisions, not only from the point of view of profitability, but also with regard to social and moral responsibility. Full disclosure of company dealings is essential for investors, and proper reporting of financial and business activity. All parties must be well informed and briefed about each others affairs. There can be no place for secretary between business partners. Poor information cannot be an excuse for unacceptable business and financial practice, but it can be a contributory cause.

3. METHODS OF EQUITY FINANCING

Equity finance implies that investors take a direct stake in the businesses they are backing. This gives investors a voice in how the business backed is run, although day to day decision making, and even long term business strategy is in the hands of the managers themselves. The managers are however ultimately responsible for their actions to the shareholders in the business who provide the funding. How this responsibility is exercised will depend on the form of business enterprise, whether a partnership, a private company or a publically quoted joint stock concern.

Each of these forms of business organization has its merits, but the most appropriate form will depend on the size and nature of the business and the financial and economic environment in which it operates. Partnerships are especially appropriate where businesses are small but where is a need to bring in external risk capital. This may be due to the limited resources of the concern itself, but where the owner wants to avoid excessive reliance on debt finance. If a partnership is created then trust will be needed on all sides. It usually involves a large commitment for the participants, even for the so called *"sleeping partners"*, whose prime function is to provide finance rather than management. Partnerships are difficult to terminate, and there is limited flexibility in terms of bringing in new partners or changing partners. Such developments involve the complete legal and financial restructuring of the business.

The formation of a private company with several unequal shareholders may be appropriate for medium sized businesses where the management does not want to incur the expense of becoming a publically quoted company. There is greater flexibility than with a partnership, but with the shares not marketed, there is less danger of losing control to unknown buyers. Such companies may be a useful way of structuring family businesses where there is a case for formalizing financial relationships. It may also be appropriate where there are no developed stock markets and little advantage in going public in terms of gaining access to additional financial resources. This is the case in many developing countries, where even when stock markets exist, they are thin and lack depth.'

Cooperative forms of business organization are also found in many developing countries, and have often been actively encouraged by socialist governments. These have become less fashionable in recent years, but have their merits, especially in terms of widening business participation and the cross fertilization of ideas in decision taking. They can be vehicles for risk sharing and the spreading of responsibility, and often work well in appropriate social settings. The main weakness of cooperatives is in terms. of being useful in harnessing savings or investment funds independently of government. There are of course notable exceptions, but most have been unable to attract large private capital backing largely because private investors or substantial net worth usually want some control over how their funds are deployed, and wish to maintain the option of disinvestment.

Ordinary share issues are of course in many respects the best way of raising risk capital, and the preferred option for large businesses which can afford the expenses associated with going to market. The main attraction is being able to tap a large capital market and raise funds on much more favorable terms than is possible with bank borrowing or private placements. Investors are satisfied with anticipated dividends well below market rates of interest on loanable funds, as their concern is at least as much in possible capital gains as with the income yield.

Businesses do not have to guarantee a return as they do in the case of bank borrowing. The risk seeking investor knows the return is uncertain, but provides funding in the expectation that his or her judgement will be proved correct, and the risk taken will be rewarded. The hope is of course that the return, including the capital gain, will be greater than the interest on a bank deposit, but if this is not the case, then the investor has to some extent his or her own judgement to blame.[6]

4. REQUIREMENTS WITH EQUITY FINANCING

Given the attractions of equity financing, what pre-requisites are there to ensure that such facilities can be made available to as wide a range of medium to large sized businesses as possible? Clearly one important pre-condition is a developed stock market where shares can be traded without impediment. This implies a sufficient number of buyers and sellers in the market so that dealing can take place at all times. A market will clearly fail if a seller cannot find a buyer at any price and vice versa.

The number of buyers and sellers is important, as in thin markets with few traders, prices can be very volatile. A seller may have to lower the price substantially in such a market in order to attract a purchaser. In a developed market, with many competing purchasers, prices will be much more stable. A flood of selling will of course lower share prices, but not to the point where the market collapses. Unfortunately in thin markets, the risk of collapse is very real, and this in itself deters entrants to the market, and keeps it thin. It can be far from easy to break out of such conditions into relative stability where company performance determines share prices and not limitations of the market itself.

Width and depth are therefore essential features for market maturity, width referring to the range of companies quoted, and depth to the pool of potential investors. In many developing countries banks and investment companies are the main quoted shares on the stock exchange, most industrial concerns either being within the state sector or private family businesses. This limits the scope of the stock market, and means that its use is very restricted as a vehicle for risk capital financing.

In such markets the number of private investors will also be limited, as most potential participants are not merely interested in banks and investment companies. The market attracts the wrong type of investor, only those interested in prices and share dealings, not those concerned with the underlying companies whose shares are being traded. Hence speculators tend to be over-represented in the market, and not those who take a long term view of equity investment as a potentially profitable hedge.

It is far from easy task to get ordinary members of the general public interested in stock market transactions rather than merely a rich elite. One way of attracting interest may be through a privatization program, be selling off previously state owned industries. Such sell-offs have become increasingly popular in recent years, both as a means of raising government revenue and freeing industry from the constraints of state control. Ideologically it has been a way of encouraging "popular capitalism".

Another way forward is by encouraging the development of financial products such as insurance, unit trusts and investment trusts. It is then these institutional investors who participate in the equity market using the funds they collect, not the general public. In many developed stock markets it is the institutional dealers who dominate rather than small private investors. Insurance companies were historically the main source of funds, as they had a huge client base, and a need to protect their assets on a long term basis, and hedge effectively against inflation. Only a wide spread of equities could provide such safeguards; fixed interest bank deposits cannot give adequate protection in real terms in the long run.[7]

5. A ROLE FOR UNIT TRUSTS

In recent years unit trusts or mutual funds have enjoyed increasing popularity with the general public as a relatively safe means of participating in equity markets indirectly. The 1980s witnessed an unprecedented growth of the unit trust industry worldwide, and although there was some slowdown after the 1987 international stock market crash, the 1990s are predicted to be a period of further rapid growth.

The post-1987 growth is partly due to tax changes, such as the inclusion of unit trusts for eligibility in Personal Equity Plans in the United Kingdom. This means no capital gains tax is payable up to a pre-determined limit, and there is income tax exemption on the dividends paid. The main attraction of unit trusts is as a hedge against inflation however, as already indicated, a means of maintaining the real value of assets. The value of the units being directly linked to the prices of the underlying equities can fall as well as rise, but these swings are in the nature of short term cycles. In the long term, the value of units invariably rises, which means the selling price of the units is at least maintained in terms of its purchasing power.

There are three distinct categories of unit trust, capital growth funds, income funds and balanced funds. Capital growth funds, as their name implies, are designed to maximize the appreciation of the unit holders' capital value over time, but are not primarily concerned with the return on capital. Recovery funds are one example of a capital growth oriented trust. Unit holders' funds are put into companies that are experiencing financial difficulties, but are believed to have good future prospects once they are rescued. This is of course a high risk strategy, as many of the companies will not survive even after the capital injection. Those that do recover often perform extremely well however, which can mean a rapid rise in the value of these assets. It is this that brings the growth in the value of the units, despite the losses. The ability of unit trusts to have a wide spread of assets means that losses are not catastrophic. Some failures are inevitable, but portfolio diversification ensures a favorable outcome overall.[8]

At first sight income unit trusts are much less attractive than time or savings deposits with banks or building societies as the returns are significantly lower. Investors usually contrast the initial income on the units with the interest on bank deposits, and it is rare for the former to be more than fifty per cent of the latter. With unit trusts it is always necessary to take a long term view. The return in the first year underestimates the long term benefits, especially as even with income unit trusts the initial return will seldom cover the difference between the buying and selling price, which makes the. units unattractive as short term investments.

In the longer term the value of income units appreciates, which increases the flow of income as the stock of assets on which it is based is worth more. The capital appreciation will of course be less than with capital growth units, but it is greater than is the case with bank deposits, which maintain constant money values, and hence are of declining real value. The interest income from a bank deposit does not increase in the long run, which means that after a five to seven year period the return from an income unit trust is greater, and the investor also has the advantage of seeing his capital appreciate. For those who want even greater capital appreciation, but with a somewhat lower income, a balanced unit trust may be the best fund to buy into. Such unit trusts are particularly well suited for the first time investor, who seeks to avoid excessive risk.

6. UNIT MANAGEMENT IN DEVELOPING COUNTRIES

The scope for unit trusts is of course much greater in the context of the developed stock markets found in the world's major financial centers. Unit managers have a huge variety of quoted stock to select from when making their portfolio choices, and there are no worries about the tractability of stock. Responsibility for a particular trust's performance rests with the unit manager and he or she cannot blame imperfections in the market. The financial pores compile league tables of the best and worst performing unit trusts in each category, and these are published and avoided read by the investing public when making their choices. Hitherto many investors used stock brokers even when buying and selling unit trusts, and relied heavily on the advice of these specialists. Increasingly the investing public has become better educated and informed, and make their own purchases directly, often by clipping press advertisements. By purchasing direct discounts of the purchase price can be obtained, and there is no need to pay brokerage fees.

In developing countries the main problems in constructing unit trust portfolios are the limited range of quoted stock, the tendency for the whole market to be volatile at the same time, and the risk that the market will be suspended in the event of a major crisis. These factors make it more difficult for the unit manager to reduce risk on behalf of investors in the trust, and make it virtually impossible to create differentiated funds aiming at income or capital growth. Funds have to be marketed as balanced, but their can be little real balance if the main holdings are of bank stock or of shares in investment companies. This makes the unit trust a virtual portfolios of financial portfolios, far removed from the underlying investments.

Further problems arise where there are foreign exchange controls which imply that unit holders investments must be confined to the home market. In the European Community, the United States and Japan there are no remaining controls of this type which means unit trust portfolios can be constructed from quoted stock in markets anywhere in the world. The constraint is the information available to, and knowledge of the unit manager, but he or she can act without regard to narrow national considerations. Specialist funds have been established which specials in particular areas of the world. These are marketed appropriately to investors who wish to have global exposure as part of their portfolio diversification to minimize risk, but who want to be involved in those countries and markets where prospects appear especially promising. Hence in London most of the main unit trust groups offer Far Eastern funds, North American funds and even units geared to particular markets such as Hong Kong or Singapore. Such choices cannot be offered where there are foreign exchange controls that impede the free mobility of capital internationally.

One way of overcoming the shortage of investment opportunities as far as quoted company stock is concerned in developing countries is to widen the range of instruments in which unit trusts can invest. A number of Western unit trusts specialize in "gilts" or government stock. The participation of institutional investors in such issues in developing countries would strengthen the market for government paper. However, governments would have to recognize the need for supply restraint otherwise there would be little incentive on the demand side for institutional investors to enter such markets.

The unlisted securities market is another obvious direction for unitized investment. Such markets are by nature risky, being based on stock issued by smaller and less established companies. By acquiring a spread of investments, unit managers can reduce risk, and introduce new capital to the markets which would otherwise be unavailable. Unit trusts can also participate in markets where there is only periodic or irregular trading in securities, provided the degree of exposure is kept within pre-determined limits, and unit holders are made fully aware of the risky ventures for which their capital is being used. Regular financial reporting is essential, as it is crucial that investors are fully informed about how their funds are being used.

7. VENTURE CAPITAL AND DEVELOPMENT

The subjects of venture capital and equity investment are usually treated quite distinctly, as the former concerns new or infant small businesses, while the latter concerns large well established companies. Equity investments are always risky, but for "blue chip" companies the degree of risk is low, and if investment vehicles such as unit trusts are used, the risk element is even further reduced. In contrast placing capital with new or untested ventures is a high risk business, where the probability of failure may exceed that of success, but where the rewards can be considerable if a "winner" is backed. The risks are almost like those in gambling, but the motivation is worthy, and it is not merely unproductive wagering on the basis of chance.[9]

From the developmental point of view the distinction between venture capital and equity investment is less clear cut, as stock markets in developing countries are invariably more risky, and there are fewer companies which can be identified as "blue chip" investments. Most manufacturing concern still fall into the infant industry category, and even the larger independence private sector companies are small by western standards. Much or even most investment could be classified as on a venture capital nature, as it is subject to a high degree of risk.

The paradox of course is that it is those of substantial means who are best suited to participate in venture capital finance, as they can afford the losses, but the numbers of such people in most developing countries is extremely limited. This implies a restricted domestic supply of venture capital, as most citizens are in low income categories. As a consequence a strong case can be made for opening up such capital markets for foreign participation, where that is not already the case.

One way forward is to encourage the formation of venture capital financing companies, perhaps though tax concessions to investors, or through direct government participation in such enterprises. State subsidies are probably necessary if venture capital companies are to get off the ground that can provide assistance on reasonable terms to new businesses. Such subsidies can be justified in terms of an infant industry support policy which aims to promote domestic economic diversification. It may also be an optimal way of matching state participation with private initiative in a joint context rather than the government attempting to do everything on its own, with little public support, as has so often been the case in many developing countries.

It requires some ingenuity to conceive of ways in which the private investor of limited means might participate in venture capital financing. One solution would be to form a unit trust specializing in the funding of venture capital companies, with portfolio diversification across a number of countries and sector to reduce risk. The trust would hold a portion of its assets in liquid form both to provide security and to ensure that funds were available to take advantage of favorable opportunities as and when they arose. The liquid holdings would be government securities rather than cash, so that returns could be earned on all assets to increase the attractiveness of the trust to investors.

8. RISK REDUCTION WITH PREFERENCE SHARES

In recent years there has been much less interest in traditional investment instruments such as preference shares, which many regarded as having been superseded by the growing sophistication of western financial markets. Investors themselves are more interested in risk reduction by the purchase of unit trusts than by the acquisition of preference shares, as each purchase ties them to a particular company. Company managements are less concerned about the voting power of . equity shareholders, given the large and diversified shareholder interests in most major companies. The advantage of issuing non-voting preference shares is not regarded as significant, and the disadvantage in giving one group of shareholders a preferential stake is seen as a much greater burden. Banks dislike competing preferential claimants, and' other shareholders resent being only second claim. The excessive issue of preference shares can result' in a loss of confidence in a company.

In the case of developing countries a stronger case can be argued for preferential shares as a means of raising financing as fewer alternative routes are available. The small investor may like the idea of having a prior claim on the assets of an established local company, and may be less concerned with voting rights. Where no unit or investment trusts exist in a local market, or where the choice is very restricted, preference shares can present a welcome alternative as a means of risk reduction. One issue that must be clarified from the outset however is whether the preference is a prior claim to the assets in the event of insolvency, or a prior claim to income in the event of no or only a small dividend being declared. It is the latter which is of most interest to potential investors, assuming the company is easonably regarded.

Unlike preference shares rights issues remain popular in western financial markets, partly because they involve lower financing costs than new equity issues. The right to buy fresh stock at an advantageous price is given to existing shareholders, a move which is usually well received if a good case can be made for a further capital injection. From the company's perspective the advantage is that the shareholding is not diluted, and there is no need to incur expensive advertising costs or the cost of issuing a new prospectus.

Given the company loyalty amongst shareholders in many developing countries in spite of the volatility of market prices, a strong case can be argued for rights issues as an appropriate means of raising additional funding. The same can be argued for warrants, which are attractive for those seeking extra risk, but perhaps wanting to avoid the hazards of futures and options dealings. There are few stock markets in the Third World where such dealings are undertaken in any case, and even when they are, it is largely in markets dominated by speculators and arbitragers. Warrants require less knowledge for sensible dealing, and there is less risk of the uninitiated being duped.

9. WORRIES ABOUT EQUITY AND LOAN FINANCE

The main worry about equity finance for management is the fear of a loss of business control. This could involve a take-over by a hostile predator or a buy-out unfriendly interests that might ultimately plan to install new management. The workforce might fear that their company might be acquired by an asset stripper, interested only in the salable value of the property and not the business itself. Such unwelcome developments are a common occurrence in the stock markets of mature industrial countries, indeed there are financiers who have made their fortunes through such activity, to some extent at the expense of others.

In developing countries the financial markets have not usually reached the stage of maturity where such actions would bring rewards. Asset strippers are more likely to find easy pickings in the property market, where their activities can be less easily identified, than in the higher profile financial markets. There are few with the resources to mount hostile take-overs, and interventionist governments, conscious of their political constituencies, are less likely to sanction such activity. Industrialists and company workers are likely to be part of a strong urban political lobby, which governments see it in their interests to protect. De-regulation does not mean a completely hands-off approach. For this reason companies have less to fear from equity market developments.

Although there are genuine concerns about some of the ramifications of equity financing, alternatives such as loan finance have even grater drawbacks. Bank lending on an interest basis is invariably more inflexible, and there is the constant worry over debt and fear of insolvency. The burden of interest payments can often exceed the actual repayments of the debt, and these charges are often variable, but dependent on macro-economic circumstances and not on the financial position of the business being funded. When inflation rises for example, money interest rates also usually rise, and hence the costs of debt serving. This can affect businesses adversely at a time when input costs are also rising and result in bankruptcy in extreme cases.

With equity financing there is much grater flexibility, and less likelihood of insolvency. If conditions get tough, then businesses can cut the dividends paid to shareholders, or even pay no return. Shareholders recognize that they may be expected to share in the bad times as well as the' good. Of course with no dividend they may be tempted to sell their shares. In such circumstances share prices will usually be depressed, but shareholders have the option of cutting their losses if they wish, or if personal circumstances dictate. If they hold on they may make capital gains when conditions- improve. If they sell, then the buyers of the shares will make the capital gains. In any case the system is self equilibrating as long as the market continues to function.

In practice business will always wish to strike a balance between debt and equity financing, and this is where the concept of gearing is important. Debt financing is appropriate for short term working capital and trade finance. It oils the wheelless of any business undertaking. For longer term finance of investment and capital expenditure, equity financing is more appropriate. Such activity is sometimes financed by taking short term loans and rolling them over so that they become virtually indefinite lines of credit. Such an approach is not advisable, as it is this that results in growing debt burdens. There may be times when it is necessary to reschedule borrowing due to unforeseen developments, but this should not be the intention at the outset when the loan is contracted. Participatory finance, based on risk sharing, is much more preferable for long term ventures, given the inevitable uncertainties as the time period increases. Fixed commitments to loan repayments on commercial terms over long periods are never advisable, even at the international level, as the Third World debt problems dramatically illustrated.[10]

10. CONCLUSIONS

There is a strong case for equity finance as s source for long term investment funding on the practical level rather than reliance on bank borrowing. Such finance, being participatory in nature, is also more equitable, as risks are shared, rather than placing the entire burden on the enterprise being financed.

The main difficulty as far as most developing countries are concerned is the underdevelopment of equity markets. When markets are thin and lack depth, prices tend to be volatile. This 'attracts the wrong type of investor, those with speculative motives, rather than long term suppliers of finance who regard equities as a potentially profitable hedge. The saver of modest means has little choice of investment instrument. Most merely hoard, or place funds in savings and time deposits with banks. Unit trusts are one means of encouraging such savers to diversify their asset holdings, and provide capital that could make a contribution to the finance of long term development. This could be a useful source of risk funding. Such units could be based on quoted stock, or on more direct participation which would not necessarily involve securitization.

There are many innovative options which it is worth exploring. It is clear that traditional debt finance is not the best means of promoting development, indeed it has been actually harmful in many instances. Given these experiences it is certainly encouraging to see that alternative approaches are now being actively pursued.

For Islamic countries such as Malaysia the increasing interest in participatory finance is certainly welcome, not only on economic grounds, but in terms of moral and religious values. In Islam profit and risk sharing are essential concepts in the economic laws in the interests of both social justice and sound management. Participatory finance means that economic efficiency does not need to conflict with equitable distribution as western neo-classical economics asserts. Development can bring harmony, not conflict. Participatory finance is not merely capitalism with a human face, but a means of promoting growth that can be consistent with most value systems, including that of the Islamic World. It is a way forward that includes the best feature of the capitalist economic system, but which may ultimately replace it in a more morally concerned world.

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Section II

DOMESTIC FINANCING OF DEVELOPMENT

4

A SIMPLE MODEL OF INCOME DETERMINATION GROWTH AND ECONOMIC DEVELOPMENT IN THE PERSPECTIVE OF AN INTEREST-FREE ECONOMY

M. FAHIM KHAN*

1. INTRODUCTION

Several attempts have been made to develop macro economic models for an Islamic economy. These models usually, being income determination models, have been developed primarily to study the stability aspect of an Islamic economy like any macro economic model developed in the secular framework. No attempt has been made so far to describe macro economic models developed in the secular framework. No attempt has been made so far to describe the macro economic framework of an Islamic economy in the context of growth and development, though, in the secular framework, we do find related macro models with growth through the concept of full employment equilibrium suggesting that manipulation of aggregate demand may improve fuller utilization of productive capacity and hence generate growth in the economy. Also, Leif Johansen discussed the macro economic framework in relation to growth in the economy by explaining the price impact in the model and hence showing that casual demand encourages growth by increasing the profitability implicit in the rise in price level. Such an attempt in Islamic economy, though very much needed, has not yet been made.

The secular attempts referred to above related macro economic models to growth and development through manipulation of aggregated demand. I feel that an Islamic economy will potentially

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have a macro model where growth and development can be manipulated through supply side.

In one of my earlier papers relating to Development Strategy in an Islamic framework (7) it was emphasized that growth in Islamic economy can be manipulated through supply side by mobilizing human resources through the peculiar nature of Islamic financial system. No formal macro model, however was presented in this respect. In the present paper I want to develop a macro model to show that the Islamic Financial System generates an implicit macro framework that leads the economy to full employment and then continues it towards further growth and development. The paper will utilize the conventional ISLM Framework to link a simple income determination model to growth in the economy. The ISLM Framework will be developed under the assumptions of Islamic economy. The ISLM . framework will particularly highlight the investment function in Islamic economy and money demand functions and then will link this framework to the process of economic development in the economy.

2. THE MODEL

We assume an economy with unemployed resources so that supply of output is perfectly or almost perfectly elastic and all prices remain constant. The aggregate supply curve for output is horizontal and so is the labor supply curve (at least a very big chunk of the total labor stock).

We assume an Arthur Lewis type economy.1There is surplus labor available with an almost infinitely elastic supply at a constant wage,[2] say W.

An economically active population can be divided into two categories, (a) those who work as what we may call entrepreneurs (working for themselves to earn a profit and not earning a wage or salary), and (b) those who work as what we call labor (working for someone else). We thus write Human Resource equation as:

$H = E + L$

Where H is stock of economically active human resources,

E is that part of human resource that is active as entrepreneurs[3], i.e. working for (uncertain) profits,

L includes all those who are either working for someone else for wages in a modern sector or are disguised unemployed in the subsistence sector.

L has two types of labor (a) those employed in the modern sector (call this labor as L1 and (b) those employed in subsistence or traditional sector (call this labor as L_2). Bulk of L2 is disguised unemployed in the sense that their removal form the traditional sector is possible without affecting the output of the traditional sector.

The output that L2 shares in the traditional sector is sort of average product in the sector. This average product determines a floor for the minimum wage that L1 will demand in the modern sector.4 We may call this W. which is assumed to remain constant as long as there is a surplus stock of labor in the traditional sector.

The employment of labor in the modern sector (L_1) is generated by the demand for labor from the entrepreneurs (E) which, in turn, depends on the following:

i) Marginal productivity of labor
ii) Reservation wage W referred to above

The employment of human resources (H) into E depends on the following:

a) Opportunities for the human resources to avail to work for themselves;
b) Expected profits (P) from entrepreneurial activities;
c) Availability of the capital requirement for the activity;
d) Willingness and ability of human resources to avail of an entrepreneurial opportunity yielding a certain expected return (P) by beating certain risks.

Since W is assured in the subsistence sector to all the population, the human resources will take up entrepreneurial work only if it ensures a certain minimum expected profit (P) for them. The reservation for expected profits is a function of W.

$$P = F(W) \qquad (2)$$

Expected profits (P) from possible entrepreneurial opportunities motivate resources to organize profitable enterprise. Such enterprises once initiated may also generate demand for labor (L).

There may also be a minimum capital requirement to generate a minimum reservation of expected P desired by the entrepreneurs. However, the more capital is available to an entrepreneur, the more profits (P) he expects to make.

A typical entrepreneur may perceive a potential entrepreneurial activity as below:

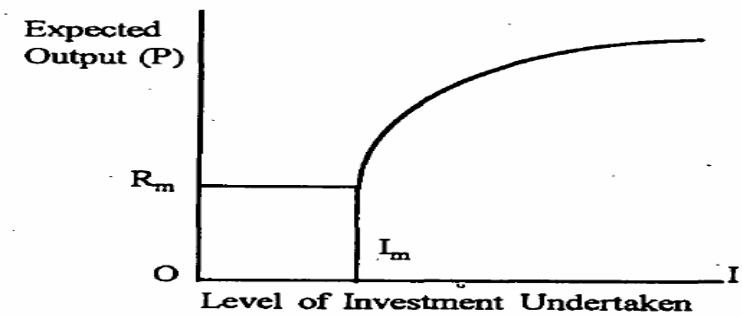


Fig. (1)

R_m = Minimum expected output that may motivate a typical human resource to take up an entrepreneurial activity.

I_m = Minimum level of investment required to generate R profit in the activity.

The curve implies diminishing marginal output on investments as more and more funds are used by the same entrepreneur.

We further assume the following:

a) Savers and entrepreneurs are different agents. Savers are owners and suppliers of investible funds and entrepreneurs are users of these funds.

b) There is no cost charged or profits made by institutions for financial intermediation. (This is only for simplifying the analysis. The assumption can be withdrawn without affecting conclusions).

c) There are no funds available on an interest-basis.

d) Owners of funds can supply funds to the entrepreneurial human resources only on a profit/loss sharing basis. Under this arrangement owners of funds agree to share the actual profits according to a pre-agreed ratio and to share the losses (if any) in the proportion of their funds in the total investment of the enterprise. (If the entrepreneur has no investment of his own, all losses will have to be borne by the supplier of the funds).

e) There is a tax (Z) on the ownership of money balances or all such assets that are susceptible for investment or are susceptible to growth or generating income. The tax is exempted in initial stages of development if it is given as a loan to a potential or a low income earning entrepreneur. (As an economy grows even the loans to entrepreneurs may become taxable).

f) Growth in GNP comes by mobilizing human resources by motivating them to take entrepreneurial activities when wage paid jobs are not available. The supply of finance on a profit-loss sharing basis provided the motivation and incentive to the human resources to take up entrepreneurial activities.

The entrepreneurial sector competes with the wage paid sector and an equilibrium is simultaneously achieved in the wage paid labor market and in the entrepreneurial labor market.

g) Entrepreneurial sector serves a catalytic role. When it moves it makes the other sector (the wage paid sector move) and hence the entrepreneurial sector plays a catalytic role for growth in the economy.

This model of growth in GNP has two basic elements:

- There is no interest in the economy.
- All finances/investments are available on profit-loss sharing system.

What type of macro framework will result in the economy if the above strategy is to be implemented and what implications will such a framework have for growth to be discussed in the rest of the paper?

The above mentioned elements are primarily expected to affect investment demand and money demand. The reformulation of macro framework, therefore, concentrates on reformulation of these two sectors only.

3: INVESTMENT DEMAND

Determination of Profit-Sharing Ratio and Demand for Funds at Micro Level.

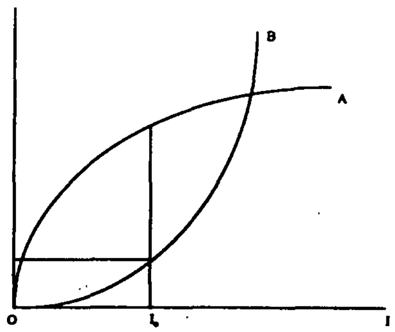
An entrepreneur, intending to avail himself of a particular entrepreneurial opportunity, generates demand. for investible funds. The effective demand of the entrepreneur for investment funds depends on expected profits (P) that the entrepreneur can earn from the potential entrepreneurial activity. This P, in turn, depends on:

- Total profits (R) expected from the entrepreneurial activity.
- Share in the profits claimed by the owner of funds.

The profits that the supplier of funds will expect to receive on his investment may increase at a constant rate implying a constant expected rate of return on his funds or it may increase at an increasing rate because the risk may increase for the supplier of funds as he supplies more and more funds to the same entrepreneur. There may be a limit beyond which the supplier of funds may not be willing to supply the funds irrespective of the expected profits. This limit may depend on various factors including the human capital of the entrepreneur seeking the funds.'

On the other hand, an entrepreneur may expect certain profits from his enterprise at different levels of investment as has already been shown in Figure (1).

The expectations about the profits for the entrepreneur, as well as for the supplier of funds from the investment in a potential enterprise, can be shown together in the following diagram:



level
Fig (2)

Curve A shows the total expected profits that the entrepreneur expects to make from his enterprise with different levels of investment.

Curve B shows the expected profits that supplier of funds wants to claim for his investment in the enterprise.

The entrepreneur will effectively demand that amount of investment funds which leaves him the maximum expected profit after paying the share of the supplier of funds. In the above diagram the effective demand would be I_o. At this level of investment, the enterprise is expected to make a total profit Po out of which supplier of funds expects to claim Q.. The ratio of Qo to Ro at Io os a_o. This is an optimum point for both the parties and becomes a basis for entering into a mutual contract. The contract between the parties will then be made to include the following:

a) Supplier of funds will supply an amount of I_o to the entrepreneur to invest.

b) Supplier of funds shares in the actual profits. Share of the supplier of funds in the actual profits of the enterprise will be determined according to the pre-agreed ratio a_o.

c) If entrepreneur has made no investment of his own, all losses will be adjusted against the investment made by the supplier of funds.

4. INVESTMENT DEMAND FUNCTION AT MICRO LEVEL

The 'a' - value is agreed upon ex-ante and determines the planned level of investment. The changes in `a' will affect the effective demand of investment funds from the entrepreneur. The changes in `a' may occur as a result of shifts in A or B or both.

Curve A may shift up or down depending on the shifts in the level of human capital, technology available to human resources and various environmental factors affecting the entrepreneurial productivity of human resources.

The ratio of expected profits at each point of the curve B to the expected profits at the corresponding points on curve A would be referred to as profit-sharing ratio for the corresponding levels of investment.

Curve B may shift up and down depending on various factors such as availability of more investible funds with the owners of funds, improved credibility of the users of funds, reduced risks due to an improved political and economic climate etc.

An upward shift in Curve A (other things remaining the same) means reduction in `a' as the ratio to Q_O/R_o goes down at all levels of investment. This may lead to an increase in the entrepreneurs effective demand for investment funds.

An upward shift in Curve B, on the other hand, means an increase in `a' at all levels of investment and hence may lead the entrepreneur to reduce its effective demand for investment. It should be noted that Curve A and Curve B are determined independently of each other.

The equilibrium point for an entrepreneur to enter into a contract with the owner of the funds will occur when the marginal productivity of investment in the enterprise becomes equal to incremental increase in the expected profits claimed by the owner of the funds. (For further elaboration see Appendix).

We thus draw the conclusion that the entrepreneurial demand for investible funds will be negatively related to the profit-sharing ratio `a'. This relationship, we may express as:

$$I = F(a) \quad F a < 0 \tag{3}$$

This will be referred to as investment demand function. `a' varies

between 0 and 1. It is possible for `a' to become zero.

When `a' = 0 implies that the owner of funds supplies his funds to the entrepreneur with no share in profit. This also implies that he will also not share or bear any losses and the entrepreneur is obliged to return the full amount at sometime in future. The possibility that the owner of funds may supply their funds at a = 0 may occur due to several reasons:

a) Expected profits are too low and risk of loss is considered too high to be compensated by the share in the expected profits.

b) The action of helping a poor entrepreneur and allowing him to keep all the profits till his enterprise is developed to the extent that it can afford paying a share in the profit.

c) Avoiding the penalty (Z) on money balances as already mentioned.

It is possible that there may be a lower limit on `a' which we may refer to as `a' below which 'a_m' may not decline except to become zero. This will happen when optimum value of `a' happens to be the value that generates such low expected return for the owner of funds which they find not worth accepting because of the larger risks involved. In such a situation, owners of funds rather prefer to advance their funds at a =0 for reasons already explained.

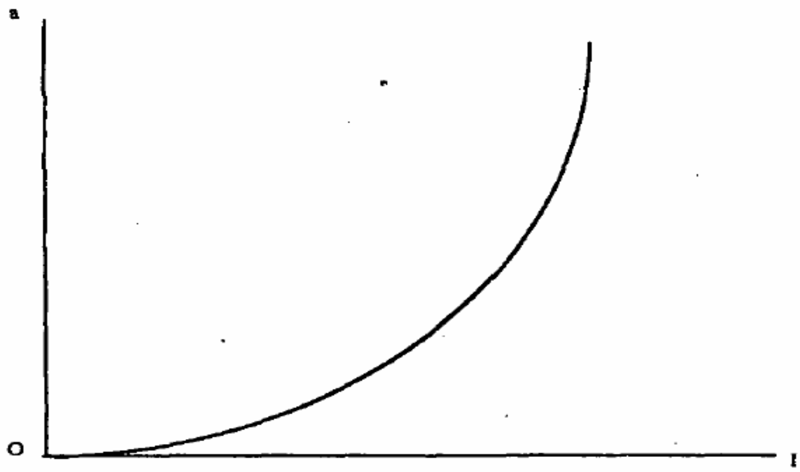
It is not possible for `a' to become unity though it may approach to unity. This is because a = 1 implies that owner of funds will take all the profits that the entrepreneur makes which will not be a rational situation from the entrepreneur's point of view and hence he may cease to effectively demand any amount of investible funds. `a' may be approaching to unity if R is very large and/or supply of investible funds is very scarce.

5. INVESTMENT FUNDS MARKET: MACRO PERSPECTIVE

At this state, it is important to recognize that the economy may have projects of varying degrees of risk. On the other hand, economy may also have fund owners with varying degrees of risk aversion. In other words, there will be 'n' sets of projects having different levels of riskiness a_1, a_2 .. .. a_n. The demand for these sets of projects and supply of funds available for each set of project determines respective equilibrium level of 'a' for each set of project. In the economy thus, there will be 'n' sets of `a'. To keep the analysis simple, we assume homogeneity with respect to the riskiness and hence we get rid of the third dimension to reflect a_i.

We assume large number of entrepreneurs and large number of suppliers of funds. An entrepreneur chooses a supplier whose return-risk preferences (Curve B) enable him to agree upon an optimum value of 'a' yielding him maximum expected profit (P).

In this process of search, it is possible to enter into a contract jointly with more than one suppliers, in order to arrive at optimum investment-profit-sharing-ratio package. We will, therefore, refer to the supply of investible funds in terms of units of investment funds (rather than owner of investment funds) available at different levels of 'a'. At macro level, curve B thus is replaced by an upward supply curve as shown below:



Supply of Units of Investment Funds
Fig. (3)

On the other hand, the available investment funds look for more productive entrepreneurs so that they are able to claim more profit. The most productive entrepreneur believed to be generating the highest return (R) at all levels of investment would be chosen first. At this stage, we may not distinguish between entrepreneur and enterprise. In the presence of surplus stock of human resources, we assume that each entrepreneur represents a single enterprise. Hence, we need not distinguish between profitability of an enterprise and productivity of an entrepreneur. Competitive conditions can be assumed to ensure that profitability of enterprises is equalized over all enterprises in the economy. The investment funds market, thus, will determine three things:

i) Profitability of marginal enterprise in the economy (R);
ii) Investment level in the economy (I);
iii) Profit-sharing ratio (a) for the owner of the investment funds.

Because of the assumption of large numbers of enterprises/. entrepreneurs in the economy, we can also assume that the profitability (R) of the enterprises in the economy at the margin will not be affected by the changes in the level of investment (I) and profit-sharing ratio (a).

Hence at macro level, while the investment will continue to be negatively related to the `a'-value, as shown in equation (3) the (total) profits per enterprise (R) will remain fixed in the background in a short run perspective.

5.1 Goods Market Equilibrium

Let us take the simplest model of goods market:

$Y = C + I + G$ (4)
C = Private Consumption
I = Investment Demand
G = Government Expenditure
Y = Aggregate Demand (Equal to Aggregate Supply)
$C = b_o + b(1-t)Y$ (5)
$I \quad i_o - i_a$ (6)
$G = G$ (Exogenously given)
$Y = A_o - A_1 a$ (7)

Where $A_o = \dfrac{b_o + i_o + G}{1-b(1-t)}$

$$A_1 = \frac{i}{1-b\ (1-t)}$$

Equation (7) shows a negative relationship between `a' and Y. This is an IS curve in our framework with positive slope.

6. MONEY DEMAND

6.1 Money Demand Function

Demand for real money balances will depend on the level of real income and the expected return on financial assets.

It depends on the level of real income because individuals hold money to finance their expenditures which in turn depend on their income.

$$L = b^{Y} \qquad (8A)$$

The demand for money depends also on the expected return on financial assets. The higher the expected return on the financial assets the less worthy it is to hold money.

This part of the demand for money may not be directed at speculative demand for money. This part of demand for money, in an Islamic environment has the following elements.

Besides the transaction demand for money, there is a demand for meeting the short term borrowing needs of others. With the importance attached to *Qard-ul-Hasan* and with the embarrassment attached with not helping a brother in need, the Islamic environment would require every one to keep some cash for meeting the short-term borrowing needs of others. The money necessary for such situation, however, will depend on cost of holding money which of course is the expected rate of return on investment. The lower the rate of return the higher the demand for this purpose. The demand for money motivated by altruistic considerations in fact, will be a function of both income (Y) and rate of return (0). While it will be positively related to Y, it will be negatively related to Q. This part of the demand for money for some cash for altruistic purposes can be written as:

$$A = a_2Y - hQ \tag{8B}$$

The equations (8A) and (8B) can be combined to write:

$$LA = kY - hQ \tag{8}$$

As far as speculative demand for money is concerned, theoretically it can exist on the same based economy. The expected rate of return will be more volatile than the fixed interest rate and hence increase the urge to speculate. Though speculation will always be on an expected rate of return but it can always be translated into the profit-sharing ratio prevailing in the market. Thus, the higher the profit-sharing ratio the lower will be the speculative demand for money and vice versa.

There is generally an impression given by Islamic economists that speculative demand for money cannot exist in an Islamic economy because of the prohibition on gambling.

Since there will be a natural urge to hold money in periods of low expected returns in order to be able to invest in periods of high expected returns and since such an urge cannot be institutionally controllable, some speculative demand for money is inevitable. It can, however, be said that the speculative demand for money will be shadowed by the altruistic demand for money. In periods of low expected return on investment the urge to hold money for altruistic purposes will be more than in periods of high expected return. There is some institutional control on speculative demand for money in the form of *zakah*. That will only reinforce the altruistic motive for holding money. The speculative motive will, therefore, still keep the form of demand function the same as shown in equation (8).

Hence, the demand for real money balances increases with the level of real income and decreases with the expected rate of return on financial assets. We can write demand for money function as:

$$LA = KY - hQ\ ,\ k > o\ ;\ h > o \qquad (8)$$

L = Demand for money

Q = Expected profits on financial assets for the owner of the asset.

But we know that Q = aR.

Since R is exogenously given to money holders as far as money demand is concerned, we can write equation (8) as:

$$LA = kY - haR$$

$$\text{or } LA = kY - h'a \qquad (9)$$

where h' = hR

6.2 Money Market Equilibrium

Assuming a fixed money supply (M) and a constant price level (P) implying fixed real money balances F we write money market equilibrium as:

$$kY - h'a = \frac{M}{P} \qquad (10)$$

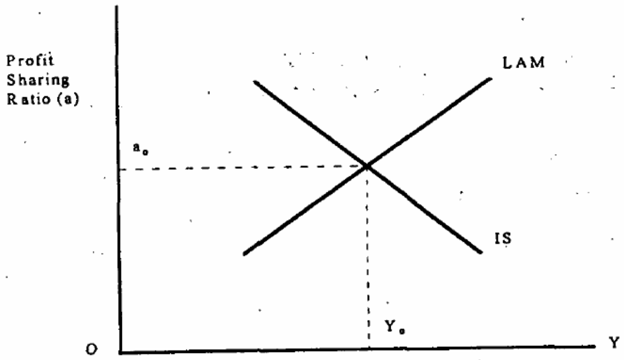
This gives a relationship between a and Y as below:

$$a = \frac{I}{h'}\left(kY - \frac{M}{P}\right) \qquad (11)$$

This is the equation which will be referred to LAM curve in order to distinguish it from the LM curve that represents interest-based speculative demand for liquidity. LAM curve is based on the demand for liquidity that is motivated by profit-cum-altruistic considerations.

6.3 Income Determination - 'ISLAM' Framework

IS and LAM curves determine equilibrium level of income as usual except that we have profit-sharing ratio (a) instead of interest as shown below:



National Income
Fig. (4)

6.4 Slope of LAM Curve

LAM curve is represented by the equation.

$$LAM - \frac{1}{h'}\left(kY - \frac{M}{P}\right) \qquad (12)$$

I

s 'there a vertical section in the LM curve ?

The answer depends on whether 'h' can be zero i.e. whether demand for money can be insensitive to changes in 'a'. (Equation for money demand being M = kY - h'a). 'a' may cease to have any effect on demand for money when Q (the expected rate of return for the owners of the financial assets) is very low. At very low Q, the owners of financial assets may not prefer to invest at positive 'a' as a matter of risk aversion. Positive `a' means also the responsibility to bear the losses. The low Q may not tempt the financial assets owner to bear the responsibility of loss implied in this Q. On the other hand there is a cost in holding money. The holders pay 1 on the amount held. In such a situation where holders of money do not like to invest on a profit/loss sharing basis and also want to avoid the penalty Z, they may prefer to lend the money to those who need it. Money lent, in our framework, does not share any profit and is liable to be returned in full at some future date. This may also be referred to as investment with a = 0 (i.e. neither earning any profits nor bearing any losses).

The money demanded will remain insensitive to `a' until Q reaches a cawtain level (Q) beyond which owners of financial assets become responsive to changes in `a'. With R (expected total return on investment) as given, this implies, that there is a corresponding `a' as well below which h'a is zero. Hence it is possible to have a vertical section below a certain a. There may not be any vertical section, if R is not low.

Is there a horizontal section in LAM curve? The answer depends on whether it is poss<xle for money demand and financial assets to be perfect substitutes of each other. In terms of lower Q, we have already discussed that it is not possible that any addition to money supply may add to the money demand because of the existence of a cost (Z) of holding money.

Thus, the LAM curve cannot be horizontal at lower values of Q. It may be vertical up to a certain level of `a' and after that it will have a positive slope. However, there is a limit to the value of `a' as it cannot be equal to or greater that unity. If R is very high, there is scarcity of capital and there is excess supply of human resources willing to take entrepreneurial jobs, the `a' may rise to a very high level, still leaving enough P (expected return for the entrepreneurs from the investment) to induce him to remain in the entrepreneurial job. As `a' approaches to unity, the LAM curve will become flatter and flatter. At higher levels of `a' with R being very high, Q will also become very high which enables the entrepreneur to demand more money as they can afford to pay Z on their money balances out of the Q earned on the finances already invested. Hence the bulk of any addition to the money supply at this stage may simply add up to the money demand. The horizontal section of LAM curve is possible at very high (close to unity) level of `a' values. Such a horizontal section may not occur at a very low level of R may mean P to be less than P_m (a thousand point of entrepreneurial human resources to remain in entrepreneurial jobs).

Thus, we may observe two extreme positions as below:

1. When Q is very low due to lower values of R, LAM curve may be vertical below a certain level of `a'..

2. When Q is high because of higher R, LAM curve will be horizontal as `a' approaches to unity.

In between these two extreme situations, the slope of LAM curve will depend on the slope of money functions which is an empirical question.

In this framework, it is important to recognize that the slope of LAM curve will be different at different stages of economic development. Whereas the vertical LM curve will occur at initial stages of .development, the horizontal section of the curve may occur at advanced stages of economic development.

6.5 Slope of the IS Curve

Can the IS curve have any horizontal section?
To see this we reconsider the IS equation viz:

$$Y = A_o - A_1 a \qquad (12)$$
$$\text{Or } a = A - A'Y \qquad (13)$$

$$\text{where } A' = \frac{1 - b\,(1-t)}{i} \qquad (14)$$

b = Marginal propensity to consume
t = Rate of income tax
i = Responsiveness of effective demand of investment funds to the profit ratio

IS can be horizontal if A, is infinity or `a' is zero. This can be possible either when i is infinity or when b(1-t) is equal to unity. For i to be infinite, it implies that more and more investment funds can be offered by the owner of funds without any change in `a' and the entrepreneurial human resources are available to utilize the increased supply of financial resources without a change in T.

. For b(1-t) to be equal to unity implies that there are no taxes on income and the marginal propensity to consume is equal to unity. Let us consider under what circumstances any of these two conditions may hold good.

It may be convenient to start by considering investment demand as a function of Q (the expected return on investment to be paid by the entrepreneur to the owner of the funds). We ask the question: Is there any level of Q at which investment may continue to be done without decline in Q? In our framework this can occur as below:

i) For a given R on investment for an entrepreneur there will be a level Q which leaves just that amount of P which is threshold point for human resources to stay in an entrepreneurial job.

ii) There is surplus stock of human resources, which implies an infinitely elastic supply curve of entrepreneurs at P_m. This surplus stock cannot compete to raise Q because that would mean a return to them below P.

iii) Any additional supply of financial assets in this situation does not have to offer a lower Q to get themselves deployed with an entrepreneur.

iv) Hence investment can continue to take place at Q because of the surplus supply of human resources. It is not necessary that new entrepreneurs always have to come from the surplus stock in the subsistence sector. Labor already employed in the modern sector can take entrepreneurial jobs vacating wage-paid jobs in the modern sector to be filled by the surplus labor in the subsistence sector. The investment function, thus, may have a horizontal section.

Infinitely elastic portion in the investment curve may occur without the presence of the surplus stock of labor. This may occur in a situation where R and, P are such that they leave Q which is not acceptable to the owner of funds. Accepting Q (expected return for owners) also means responsibility of bearing the loss, if it should arise. The risks may be too high to be compensated by Q. But owner of investible funds cannot keep the funds idle in view of the existence of the tax Z. An easy alternative to them would be to give their financial resources temporarily to an entrepreneur with `a' = O which would mean neither sharing the profit nor bearing the losses. Besides avoiding tax Z, the various considerations may also complement the motivation of advancing one's resources, on `a' = O when R, P and Q are too low. These considerations have already been elaborated in section 3.2.

In this case a horizontal section in the investment curve will occur at `a' = O as shown below:

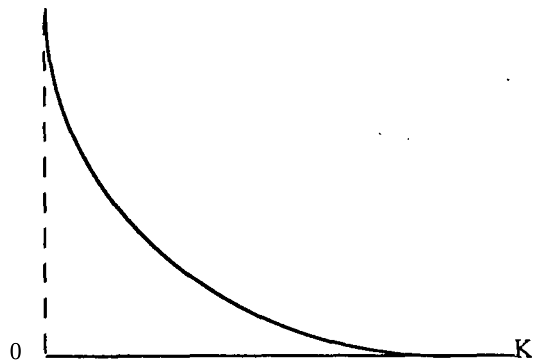


Fig. (5)

Now we come to consider the conditions when [1-b(1-t)] may approach to zero and hence may cause IS curve to have a horizontal section. The expression [1-b (1-t)] can approach to zero only if b approaches to unity and t approaches to zero. This can occur, generally, at very low levels of personal income. We can safely say that in the initial stages of development when R is very low [1-b (1-t)] may approach to zero. This is because when R is low, P and Q will also be low and P will not be low if W is not low. Hence low P, Q and W imply low personal incomes in the economy which in turn may make 1-b (1-t) approaching to zero.

. The conclusion of all above is that slope of IS curve may be horizontal at some low level of R if the economy is in the initial stages of development.

Since R is given per entrepreneur, the investment function expressed in (a, I) space will be as below:

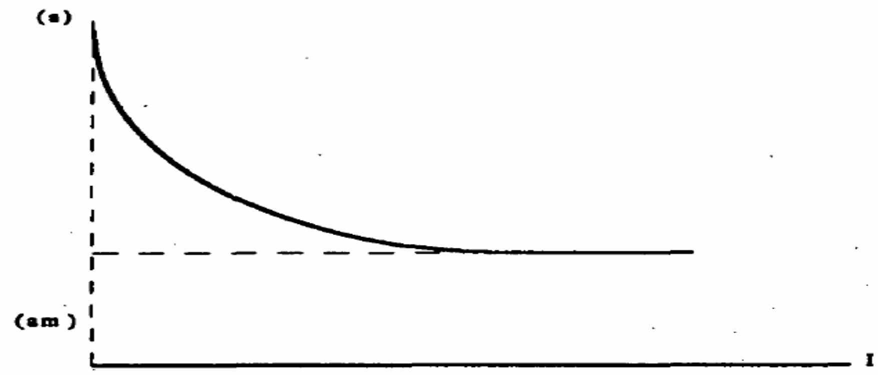


Fig. (6)

This is turn implies that there can be a horizontal section in the IS curve in the initial stages of development when there is surplus stock of human resources and return on investment in quite low.

At advanced stages of economic development when surplus labor has been absorbed and R is not to low the IS curve will have a negative slope as shown in the equation (13) where the magnitude of slope will depend on the values of marginal propensity to save and the responsiveness of investment to the values of 'a'.

Is there a vertical section in the IS curve?

We again revert to equation (13) viz.

7. ECONOMIC DEVELOPMENT AND THE MACRO FRAMEWORK

7.1 Efficacy of Monetary Policy vis-a-vis Fiscal Policy

LAM has been shown to be vertical for having a steep slope when 'a' is very low and rates of return (Q and P) are also lower. In such cases, fiscal policy will be ineffective whereas monetary policy will have full impact on GNP. When returns (Q and P) are higher and `a' is also closer to unity, the LAM curve has been shown to be flatter. The monetary policy, in this case, will cease to be very effective and government spending (preferably to help improve the productivity of human resources) will produce more effective results on growth and employment.

It means that in our framework, the government will have to rely more on monetary policy when the economy is in the initial stages of development. But as the economy grows, government may use both policies. Ultimately when the country has sufficiently developed, government may have to rely only on fiscal policy.

This appeals to common sense. In the initial stages of development, (meaning low incomes of capital, low income of labor and low income for entrepreneurs), the lack of taxable capacity may substantially limit government spending. Monetary policy may be a better alternative. When a country has sufficiently developed, people own a lot of financial assets and they are earning high rates of return on them, pumping more money may not be as helpful to the economy as government spending that may achieve certain social goals are well while expanding the GNP.

7.2 Process of Economic Development

We start with the following situation.. The economy is at a very low stage of development. There is a stock of surplus labor. R is very low and so is W, P and Q. This implies a horizontal IS curve.

Government has to rely on monetary policy. Hence, government decides to increase the money supply. It instructs the monetary authority to purchase government shares in private enterprises. The monetary authority selects suitable enterprise and purchases the shares (a) from the owners of the funds of these enterprises. This increases money supply in the economy. Increased money supply looks for new entrepreneurs. (No portion of it can be held because of the tax Z).

New entrepreneurs with new investment opportunities -are generated, implying some absorption of the surplus labor from the subsistence sector. The output and employment in the modern sector increases without affecting the output of traditional sector because of the presence of surplus labor.

The aggregate demand and hence output increases by the full effect of the new investment. As more and more money is injected not does only employment and output increase but the entrepreneurial productivity improves through learning by doing and through the competition that newly entered entrepreneurs pose to the existing entrepreneurs. In the process R improves. This is in turn raises Q as well as P. This means demand for money goes down. The IS curve becomes horizontal at a higher level of `a'. The above process continues with IS curve shifting in horizontal jumps till all surplus labor is absorbed. Now R is at a higher level than that from we started and there is no surplus so that `a' has to be reduced to attract human resources to employ additional supply of investible resources. But reduced `a' will also affect money demand. A choice has to be made between monetary policy and fiscal policy depending on which of the two will be more powerful given various parameters. R keeps on improving till we reach a stage where IS curve becomes vertical. Monetary policy loses its significance. Fiscal policy becomes important. Now it is time for government to take up big development projects of its own. This will further increase R forcing `a' to come down and once again, we are on a downward sloping IS and an upward sloping LAM. The process continues till a stage comes where the government's role ends up in the economy and self sustaining growth may take place.

7.3 Low Income Trap

In the horizontal section of the IS curve, it is possible that even the money supply may not be effective if demand for investible funds from the entrepreneurial human resources ceases to exist. This may happen when the entrepreneurial liabilities of human resources are extremely limited due to illiteracy or due to extremely bad infrastructure (absence of roads etc) or extreme political instability etc.

In such a case, mere injection of money supply may not be enough. It will have to be supplemented by measures conducive to generate entrepreneurial demand for investible resources.

ENDNOTES

1. See Arthur Lewis [3]

2. This may be a subsistence wage as assumed Arthur Lewis or a Market-cum-reservation wage of labor in a labor surplus economy as in Khan's framework [1]

3. This includes self-employed.

4. For further elaboration of this hypothesis see Fahim Khan [1]. The theory basically is that of Arthur Lewis [3].

5. For more discussion, see Khan [2].

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Appendix

DEMAND FOR PROFIT SHARING CAPITAL

Consider an entrepreneur demanding capital for an enterprise. With Y as output/ income, K as capital and L as Labor, we write production function as:

$$Y = F(K,L) \text{ ——————— } (1)$$

Since labor and capital are sharing the income of the project and hence do not impose fixed costs, this production function also represents net income function for the project.

Assuming that the entrepreneur is the only labor in the project and hence the labor component is faked we can write the production function as:

$$Y = F(K) \qquad (2)$$

As a typical production function we assume that this production function has a declining marginal productivity of capital, i. e. F' (k) > O, F" (k) < O.

The function, in other words, has the following form:

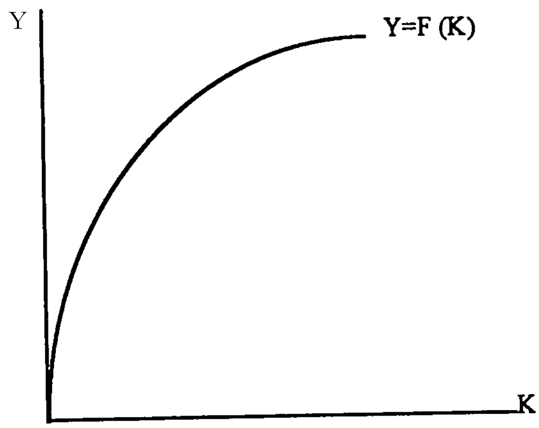

Fig. (1)

. On the other hand the provider of capital expects to receive 'a certain return on his capital. The expected return, of course, will be directly related with the total amount he invests. In the very simplest form, this relationship can be linear relationship of the type:

$$C = rK \qquad (3)$$

Where C is total return that the provider of capital expects to earn on his capital K whereas Y is based on his own utility function.

In the interest-based framework, the provider of capital demands Y from the user of his capital. In the Islamic framework, the provider of capital cannot demand Y. It can only fix a share in the income or profit of the project.

Let this share be called 'a'. Since income, i. e. 'y' is not fixed and varies at different levels, of K, therefore, the profit-sharing ratio becomes a function of the amount of capital.

Using equation (3) and (2) we can write:

$$a - \frac{C}{Y} - \frac{rk}{F(K)} \qquad (4)$$

This equation shows, that profit-sharing ratio will vary as more and more capital is invested because C is increasing at a constant rate and Y is increasing at a declining rate.

This fact can be more clearly seen in the following diagram:

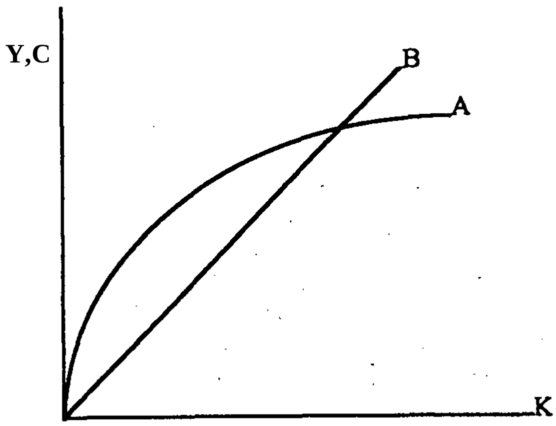

Fig. (2)

The curve A is the production function representing equation (2). The line B shows the total return expected by the capital owner at different amounts of capital to be provided by him. This is a straight line representing equation (3).

Two things are clear from Fig (2).

Firstly, the income sharing ratio (a) is different at different levels of (K). The value of (a) can be observed at any level of K as a ratio of the corresponding value at line B to the ratio of the corresponding value at curve A.

It can be noted that beyond a certain level of K, the income sharing ratio starts increasing until it reaches a level equal to ILO. This will occur at KO.

Secondly, it will not be in the interest of the entrepreneur to demand any amount of capital from the capital owner. A profit maximizing entrepreneur will demand only that much capital from the capital owner that will allow him to retain maximum profit. In terms of Figure (2), he would demand that much amount of capital against which the distance between curve A and line B is maximum. (The distance between curve A and Line B measures the income to entrepreneur after paying the share of capital owner from the income of the enterprise.)

Hence, the assertion* September 11, 1931 that under the profit-sharing system there will be infinite demand for capital is not valid per se.

The argument can be taken a step further.

Under a profit-sharing arrangement, the supply schedule for capital funds may not be a linear function as shown by equation (3). Since capital owner bears all losses of an enterprise, a capital owner would not like to give as much capital demanded by the entrepreneur at a constant rate of return 'r'. Giving all his money to one entrepreneur would mean putting all his eggs in one basket. He would like to

* Several scholars make the assertion that profit-sharing system would mean infinitely elastic demand for investment.

spread his investment among different. enterprises unless an entrepreneur is willing to offer a higher than 'r' return - higher enough to compensate the risk of putting more capital in one enterprise.

Thus a higher supply of capital for the same entrepreneur would mean a higher income-sharing ratio with the same entrepreneur. In other words, we will have to rewrite equation (3) as:

$$C = g(K) \qquad (4)$$

with $g'(K) > O$
$g''(K) > O$

The profit maximizing entrepreneur then faces the following profit function:

$$R = Y - C$$
$$R = F(K) - g(K)$$

Optimum demand for capital by entrepreneur will be for that level of K where,

$$F'(K) = g'(K)$$

This can be shown in the following diagram as well:

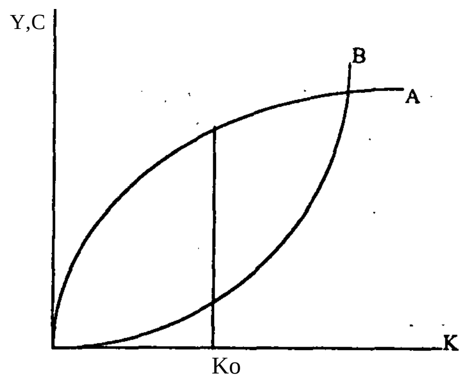

Fig. (3)

5

CAUSES OF FISCAL PROBLEMS IN MUSLIM COUNTRIES AND SOME SUGGESTIONS FOR REFORM

MUNAWAR IQBAL*

1. INTRODUCTION

A poor state of public finance is a feature common to most of the Muslim countries. In many of these, the situation has reached alarming proportions. They have been living beyond their means for too long. Huge budget deficits have been left uncorrected for decades. Instead of taking prudent decisions either to cut government expenditure or to mobilize additional revenue, politically easy means of bridging the gap by either printing more money or borrowing from domestic and international markets were resorted to. The result has been an increase in the rate of inflation on the one hand and a huge build-up of public debt on the other. Both of these are repugnant to Islamic economic principles. Inflation distorts allocation of resources and renders the whole payment system inequitable. Public debt, obtained on interest is even worse. It 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 secular framework would be prudent only if the expected rate of social return from the project being financed through borrowing is higher than the cost of obtaining the resource. However, this simple and rather obvious principle is often ignored in practice. Islamic modes of financing automatically guard against such economic imprudence but unfortunately Islamic countries have made no attempt to mobilize resources on the basis of Islamic techniques nor introduced any discipline to their expenditures in line with Islamic principles. As

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a result, many Muslim countries. are on the verge of bankruptcy and are constrained to tow their "donors" line both in economic and political policies.

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 and human infrastructures. It is painful to note that a majority of the population in these countries is living in slums or undeveloped rural areas without even. safe drinking water, not to speak of electricity, sewerage or other civic facilities. The rates of literacy are extremely low; health facilities are severely deficient; housing problems are very serious and transport facilities are extremely limited. 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. Where has all that money gone? What went wrong? How serious is the problem? These are some of the questions that will be addressed in this paper. In section two, we present the long run trends on the state of public finance in Pakistan as a case study. We have tried to highlight the aspects which may be similar to those found in other Muslim countries. In section three an attempt has been made to identify the reasons that have led to present fiscal problems. In section four we present some reform proposals with the hope that these will provide a basis for discussion and dialogue which may lead to the formulation of some guidelines for a viable strategy for fiscal reform in Muslim countries in the light of Islamic teachings. Section five summarizes the main findings of the paper and presents the main conclusions.

TABLE 1

SUMMARY OF PUBLIC FINANCE IN PAKISTAN

(Rupees in Million)

	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
Total Revenue	8050	9763	14166	17426	19264	21910	26482	30704	38504	47002	51930	59181	72230	77403	89772	103878	118921	143509	150067
Tax Revenue	6103	7353	10347	12812	15544	17759	21585	25093	32509	38846	43003	49029	53646	55963	62978	82927	92998	106258	109659
Non-Tax Revenue	1974	2410	3819	4614	3720	4151	4897	5611	5995	3156	8927	10152	18644	21440	26794	20946	25293	37251	40408
Total Expenditure	11010	16255	23185	34355	32329	35171	40898	48994	54629	63639	71014	87121	100002	116819	134463	152402	179851	190329	206316
Current	8256	10619	15164	21183	19963	20133	25545	30500	32824	37839	44545	57738	71945	83769	94686	116242	129511	142329	56000
Development	2754	5636	8021	13172	12366	15038	15353	18494	21805	25800	26469	29383	28057	33050	39777	36160	50340	48000	-249
Revenue Surplus/Deficit	-206	-856	-998	-3757	-699	1777	937	204	5680	9163	7385	1443	345	-6366	-4914	-12369	-11220	1180	
Overall Budget Deficit	2960	6492	9019	16929	12480	12829	13893	17318	14461	14613	17175	25654	25147	36777	41749	64710	58587	44780	
GDP (mp)	54673	67492	88102	111183	130364	149748	176334	194915	234179	277395	321794	363884	421245	482108	547126	608145	685867	781432	
PERCENTAGE OF GDP (mp)																			
Total	14.72	14.47	16.08	15.67	14.78	14.63	15.02	15.75	16.44	16.94	16.14	16.26	17.16	16.06	16.41	17.08	17.25	18.37	
Tax-Revenue	11.16	10.90	11.74	11.52	11.92	11.92	12.24	12.88	13.88	14.00	13.36	13.47	12.74	11.51	11.51	13.64	13.56	13.60	
Non-Tax Revenue	3.56	3.56	4.34	4.15	2.85	2.77	2.78	2.88	2.56	2.94	2.77	2.79	4.43	4.45	4.90	3.44	3.69	4.77	
Total Expenditure	20.14	24.08	26.32	30.90	24.80	23.48	23.20	25.14	23.33	22.94	22.07	23.94	23.74	24.24	24.58	25.06	26.22	24.36	
Current	15.10	15.73	17.21	19.05	15.31	13.44	14.49	15.65	14.02	13.64	13.84	15.37	17.08	17.38	17.31	19.11	18.88	18.21	
Development	5.04	8.35	19.11	11.85	9.49	10.04	8.71	9.49	9.31	9.30	8.23	3.07	6.66	6.36	7.27	5.59	7.34	6.14	
Revenue Surplus/Deficit	-0.37	-1.27	-1.13	-3.38	-0.54	1.19	0.53	0.10	2.43	3.30	2.29	0.40	0.08	-1.32	-0.90	-2.03	-164	0.15	
Overall Deficit	5.41	9.62	10.24	15.23	9.57	8.57	7.88	8.88	6.18	5.27	5.34	7.05	5.97	7.63	7.63	10.64	8.54	5.73	

Source: Pakistan Economic Survey, Various Issues.

2. ANALYSIS OF THE TRENDS OF PUBLIC FINANCE IN PAKISTAN.

Pakistan has been facing serious budget problems throughout its history. Table 1 gives the data on Pakistan's public finance for the period 1971-72/1988-89. These figures present a summary picture of the public finance situation in the country. Total government revenue remained at a level of 15-17 per cent of GDP throughout the period. As compared to this total expenditure has been in the range of 23-25 percent of GDP. This has produced a constant overall deficit to the tune of 8 per cent of GDP on the average.

While the overall figures of expenditure have been in the range of 23-25 per cent of GDP, the composition of this expenditure has changed. There has been an upward trend in current expenditure and a corresponding downward trend in development expenditure. The ratio of development expenditure to GDP has registered a secular decline. In a mixed economy like Pakistan, the government performs a wide range of economic functions. Provision of infrastructure is the most important activity reserved for the public sector. The development expenditure in the government budget basically caters for this role. Therefore, the declining trend in development expenditure has serious implications for the long run development potential of the country.

It may be noticed from Table 2 that the two largest items of expenditure are defense and interest payments which, taken together, account for almost half of total government expenditure. As compared to this, the share of health and education is 1.0 and 2.6 per cent respectively. The literacy rate is less than 30 per cent which is among the lowest in the world. On the other hand, the infant mortality rate at 105 per thousand is among the highest in the world. Electricity is available to only 35 per cent of population and only 23 per cent have access to sewerage facilities. About 40 per cent of the population does not even have access to clean drinking water. Housing conditions are also very poor. According to the 1980 Housing Census, there were 3.5 persons per room.

On the revenue side of the government budget, we notice that the tax revenues have stagnated at around 13 per cent of GDP. Within the total tax revenue, indirect taxes account for 87 per cent while the share of direct taxes is only 13 per cent. Since, the incidence of indirect taxes on the poor is relatively higher as compared to direct taxes, this feature renders the tax structure inequitable. Moreover, both in direct and indirect taxes, the base is very small and the tax rates are rather high. For example, in a population of 113 million, the number of people assessed for tax is only about 1.5 million and among them also the upper 5 percent pay 96 percent of total income tax collected. Similarly, in the case of customs duties, more than 50 percent of imports are exempted while rest of imports are taxed at very high rates. In case of excise duties, narrowness of the base is even

TABLE 2

STRUCTURE OF GOVERNMENT EXPENDITURE

(Rupees in Millions)

	1979-80	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89 (P.A.)	1989-90 (R-E-)
Current Expenditure'	32,324	71,945	83,769	94,686	116,242	133,645	153,066	163,733
Defence	12,655	26,798	31,866	35,606	41,335	47,015	51,053	57,926
Interest	5,070	14,128	16,529	16,734	23,955	33,238	38,132	45,291
Current Subsidies	3,821	4,668	5,368	5,368	5,809	7,950	13,277	11,037
Gen. Administration	3,011	5,955	6,560	7,379	10,393	8,542	10,192	10,277
Social Services	3,979	9,815	10,485	12,375	15,452	17,325	19,304	19,657
All Others	4,288	10,581	12,969	13,886	19,298	19,575	21,108	19,545
Development Expenditure	21,805	28,057	33,050	39,777	36,160	46,728	48,110	55,000
Total Expenditure	54,629	100,002	116,819	134,463	152,402	180,373	201,176	218,733
				As percent of Total Expenditure				

	1979-80	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89 (P.A.)	**1989-90 (R.E.)**
Current Expenditure	60.1	72.0	71.7	70.1	76.4	74.1	76.1	74.9
Defence	23.2	26.3	27.3	26.5	27.1	26.1	25.4	26.5
Interest	9.3	14.1	14.1	14.7	15.7	18.4	18.9	20.7
Current Subsidies	7.0	4.7	4.6	4.2	3.3	4.4	**6.6**	5.1
Gen. Administration	5.5	6.0	5.6	5.5	6.8	4.7	5.1	4.7
Social Services	7.3	9.1	9.0	9.2	9.2	10.1	**9.6**	9.0
Others	7.3	10.6	11.1	10.3	10.3	10.9	10.5	8.9
Development Expenditure	**39.9**	28.0	28.3	**29.6**	23.7	25.9	23.9	25.1
Total Expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

* Current Subsidies arc included in current Expenditure and
Source: Finance Division
Development Expenditure

P.A. Provisional Actuals
B.E. Budget Estimates

more pronounced. Only seven items contribute 87 percent of total excise tax. In case of sales tax 80 percent of the proceeds come from levies on imports, 10 percent from excisable products and only 10 percent from other items.

The National Taxation Reform Commission estimated that for the year 1984-1985, income tax to the tune of Rs. 18,528 million was evaded as against Rs. 7,000 million actually assessed. Even if we take a more conservative estimate, it is safe to assume that only one third of the tax actually due is collected.

Finally, coming to the analysis of the third area of public finance activity i.e.. public debt, we notice a build-up of public debt. Relevant data is given in Table 3. The overall size of public debt has increased at quite high rates. From Rs.150 billion in 1980/81, the outstanding public debt has risen to Rs.657 billion in 1988/89. This gives an annual growth rate of 20 percent which far exceeds even the growth rate in the nominal GDP. Consequently, the ratio of public debt to GNP has risen from 50 percent in 1980/81 to 82 percent in 1988/89. Within the total public debt, the domestic debt has increased at a much faster rate than foreign debt with the result that its share in total public debt has increased from-42 percent in 1980/81 to 55 percent in 1988/89.

TABLE 3

SIZE AND COMPOSITION OF PUBLIC DEBT

Year	Foreign debt	Percent Share	Domestic Debt	Percent Share	Total Public Debt	Percent of GNP
1980-81	87,650	58	62,483	42	150,133	50
1981-82	96,798	55	79,089	45	175,887	51
1982-83	. 118,262	54	101,727	46	219,989	55
1983-84	127,832	51	122,683	49	250,515	54
1984-85	147,926	50	149,916	50	·297,842	57
1985-86	178,839	46	203,119	54	381,958	65
1986-87	206,796	45	248,477	55	455,273	71
1987-88	-247,034	44	290,146	56	577,180	72
1988-89	294,000	45	362,683	55	656,683	82

Source: Ministry of Finance, Pakistan

The domestic debt has increased at an annual average rate of about 25 percent.

Besides the high rate of growth, domestic borrowing has also become increasingly costly. This has resulted in rising interest payments on domestic debt. The government is offering increasingly higher rates to attract domestic savings. It should also be pointed out here that the higher rates of return on government schemes have not led to additional resource mobilization. They have only displaced private sector deposits. This can be easily verified by the ratio of private savings to GNP which has not shown any upward trend. It has hovered around an average of 10 percent.

External debt increased at an average annual rate of 16.4 percent during 1980/81-1988/89. The cumulative debt now stands at U.S.$ 15 billion which is. about 37 percent of GNP. Debt service payments consume 25-30 percent of export earnings of the country thereby putting a large burden on country's balance of payments.

These trends in public debt have important implications for future policy making in Pakistan and similar countries. In the aftermath of recent developments in Europe, the Soviet Union and the Middle East, it is expected that foreign loans to many Muslim countries will become more and more difficult. Faced with a financial crunch, governments are in general prone to seek out the politically easier "solutions". Since raising taxes and prices of public utilities is politically unpopular and cutting expenditures is difficult because of powerful pressure groups, it is feared that the governments would tend to resort to more deficit financing and domestic borrowing. These methods are politically attractive but economically are extremely dangerous. Deficit financing would, in general, lead to higher rates of inflation and domestic borrowing would lead to higher rates of interest and lower private investment.. These would adversely affect the future growth rates which would in turn increase the overall deficit and the country would go deeper and deeper into the red. In this background, it is extremely important to have a hard look at the causes of fiscal problems and to adopt bold reform measures.

3. CAUSES OF FISCAL PROBLEMS

The reasons that led many Muslim countries into serious fiscal problems may vary from one country to another. However, there are some factors which may be common to many countries. Identification of the exact causes of the problems is essential before any reform is contemplated. In this section we discuss some of the more common reasons for fiscal deficits. Though we are guided by the experience of

Pakistan, many of these reasons may be present in other Muslim countries as well.

3.1 Big Government Philosophy

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. 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 government could 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. Around the same period, governments started realizing that 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 and 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. The dominant philosophy and the strong desire to develop as fast as possible pushed them into the direction of having large public sectors. They did not realize that the assumptions on which big government theories were based did not prevail in their economies. (The recent theoretical developments have shown that they do not prevail even in the developed countries).

While these countries committed themselves to big government expenditure, they were not able to mobilize sufficient resources through taxation because: (i) The proportion 6f "cash economy" in these countries was very small which made it difficult to collect taxes; (ii) There were difficulties of 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 because (iv) Taxation is politically unpopular and governments, especially those which lack public support or stability avoid this option.

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

3.2 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. Table 4 gives data on external debt in some Muslim countries. It may be noticed that in 11 out of the 20 countries the total external debt is more than half of the size of their GNP. The debt servicing eats up around 30% of their exports of goods and services on average. This, of course, is a very serious situation. But this is not the end of their malaise. In addition to external debt, they have hugged domestic debt as well. Since all of this debt has been borrowed on the basis of interest, interest payments take a huge chunk out of government expenditure and is the second largest item of expenditure. In case of Pakistan, it eats up more than 25% of total government expenditure and is the second largest item of expenditure after defence.

TABLE 4

LONG TERM DEBT AND DEBT SERVICING FOR SELECTED MUSLIM COUNTRIES (1987)

COUNTRY	DEBT OUTSTANDING		DEBT OUTSTANDING	
	Total Amount (Million US$)	% of GNP	Total Amount (Million US$)	% of Exports of Goods $ Services
Algeria	23025	37.2	6325	65.2
Bangladesh	8990	51.4	371	27.1
Burkina Faso	778	41.5	26	6.8
Cameroon	3775	31.0	637	30.1
Egypt	34828	105.3	2307	31.8
Indonesia	45066	69.3	6423	34.2
Iran	1396	1.4	953	5.7
Jordan	3969	72.0	611	26.8
Malaysia	21569	72.1	3957	18.7
Mali	1831	98.2	32	9.4
Morocco	17112	102.1	1370	32.7
Nigeria	23343	97.4	1219	15.6
Pakistan	14668	44.9	1341	26.8
Senegal	3251	74.8	294	32.3
Sudan	7711	95.3	132	28.8
Syria	3324	14.0	395	32.3
Tunisia	5801	74.1	968	28.8
Turkey	30763	46.6	4557	31.7
Uganda	1137	30.2	72	20.8
Yemen A.R.	2376	51.2	171	78.0

Source:. Handbook of International Trade and Development Statistics, UNCTAD, 1989.

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, a good part of these loans was used to finance extravagant government consumption. 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. These inherent problems of interest-based borrowing are now widely recognized and a number of reform proposals are being discussed.

3.3 Huge Defense Outlays

The third major reason for fiscal deficit in Muslim countries has been huge expenditure on defense. In Pakistan, it is the largest item of government expenditure and constitutes more than 30% of total government expenditure. There are a number of other Muslim countries where defense has taken 25% 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 a considerable amount of money, nor have been able to motivate their populations to render necessary sacrifice that their situation demand.

If defense expenditure is met from the general budget as is being done, then interest payments and defense taken together account for about 40-50% of total government expenditure in many Muslim countries, and in some cases even more. There is not much left to fulfill other functions that governments have taken upon themselves. Therefore, expenditure exceeds revenues and budget deficits persist.

3.4 Inelastic/Narrow Tax Structure

As mentioned before, the governments in many of these countries took a very large portion of public expenditure as more or less given. When it came to mobilizing revenue to finance that expenditure they were unable to do that. Judging from the experience of Pakistan, the reasons for low revenue have been: (a) low tax base; (b) high tax rates; (c) widespread corruption; (d) tax evasion due to difficulties in defining tax bases clearly; (e) subsidized provision of public services; (f) complicated laws and procedures and (g) strong feeling of public animosity towards the system. Many of these facts apply to other Muslim countries to a large extent.

Table 5 presents time series data on total government expenditure and total government revenue in selected Muslim countries. It can easily be inferred from these figures that persistent deficit is not anything special to the case of pakistan. Most of the Muslim countries suffer from it. The reasons seem to be quite common as well. The inelasticity of total revenue is quite evident from the figures in Table 5. When we look to the structure of tax revenue, we again find significant similarities. The share of direct taxes in total revenue has, in general, been smaller than the indirect taxes, in most cases by a significant margin. (See Table 6). Inelasticity of tax revenue is a result of narrow tax bases.

TABLE 5

TOTAL GOVERNMENT EXPENDITURE AND REVENUE IN SELECTED MUSLIM COUNTRIES (% OF GDP)

Countries		1978	1979	1980	on	1982	on	1984	1989	1986	1987	on
Algeria	 Rev	NA NA	NA NA	NA NA	NA NA	NA NA	NA NA	NA NA	34.5 37.8	36.7 322	33.7 29.8	31.9 29.1
Bangladesh	F p Rev	10.31 11.2	12.281 0.8	10.11 11.4	13.91 11.8	12.83 12.1	11.33 11.1	10.95 9.3	12.11 95	NA &9	NA 9.2	NA &7
Burkina Faso	Exp Rev	13.8 14.5	15.99 13.5	1624 15.6	15.4 14.1	17.5 15.1	13.8 14.1	166 14.1	13.4 15.1	15.4 15.7	1.7 17.6	NA NA
cameroon	Exp Rev	17.4 111.5	16.5 19.4	15.7 164	20.7 175	20.5 1&0	20.9 23.4	*N.A.* 24.7	NA NA	NA 222	NA 16.6	NA NA
Egypt	Exp Rev	4242 3&4	443 37.0	NA NA	46.0 47.1	55.5 46.5	45.1 44.2	46.7 43.2	43.7 4&0	45.9 40.1	41.1 2&1	NA NA
Indonesia	Exp Rev	19.4 17.5	20.6 19.9	223 21.4	24.1 23.2	20.8 19.6	21.2 20.1	1&9 20.0	21.9 21.4	2⁴.7 20.2	NA NA	NA NA
Iran	E p Rev	41.4 31.4	33.2 2&1	342 20.6	33A 23.1	30.8 25.1	2&1 21.8	23.9 19.9	23.4 19.4	NA N.A.	NA NA	NA NA
Jordan	gap Rcv	4&8 23.6	59.8 23.4	49.6 21.8	469 25.1	47.8 261	46.1 265	40.5 262	44.1 25.7	421 2&7	468 27.4	NA NA
Malaysia	Exp Rev	25.2 23.2	222 225	28.5 264	3&4 27.5	361 266	31.1 26.6	27.6 25.8	NA 269	34.4 27.7	29.0 227	NA 23.8
Mali	Exp *Rev*	1&0 15.2	17.4 126	244 125	228 11.5	27.9 128	30.7 12.9	30.7 14.1	349 16.8	27.8 15.7	27.8 15.7	NA NA
Morocco	Exp Rev	34.4 242	34.9 255	349 24.9	40.3 266	3&6 27.1	33.9 25.9	3.9 25.5	33.0 25.3	333 24.5	30.3 25.4	NA NA
Nigeria	Exp Rev	NA NA	NA NA	N.A. NA	NA NA	NA NA	NA NA	14.5 105	129 11.4	18.2 15.7	23.6 15.7	*N.A.* NA
Pakistan	 Rev	17.5 14.3	1&6 15.1	17.5 163	19.2 164	17.2 15.7	19.4 15.9	19.6 169	19.4 15.8	21.9 16.4	21.0 16.3	20.7 17.1
Senegal	Exp Rev	19.8 20.1	20.2 20.0	244 25.4	265 23.3	30.5 22.5	2&3 20.7	349 19.8	NA NA	NA NA	NA NA	NA NA
Sudan	Exp Rev	NA NA	NA NA	NA N.A.	NA NA	NA NA	NA NA	23.7 9.3	21.6 9.2	21.4 9.6	24.8 10.4	223 *8.6*
Syria	Exp Rev	421 227	39.21 23.6	48.2 26.8	38.6 226	NA NA	NA NA	NA NA	NA NA	369 24.1	28.1 224	NA NA
Tunisia	E p Rev	34.0 31.4	33.8 320	31.8 31.6	32.5 31.9	37.8 343	39.0 33.6	39.1 365	32.0 33.7	38.8 34.5	35.2 31.5	NA NA
Turkey	Exp Rev	23.1 20.5	24.1 19.7	23.9 20.1	226 21.3	NA NA	242 20.0	24.9 14.9	25.0 17.6	21.11 1&0	21.9 17.9	213 17.5
	Exp Rev	93 9.0	61 26	5.5 29	9.1 20	13.9 8.2	140 11.1	17.8 13.9	17.4 122	15.0 9.4	NA NA	NA N.A.
E g a n d a	Exp R -	21.6 19.4	33.3 1&3	34.4 21.0	39.2 20.9	 18.5	3&6 20.0	33.4 186	2&0 17.2	25.4 1&7	31.4 . 17.5	30.7 221

Source: Government Finance Statistics yearbook 1985.

TABLE 6

STRUCTURE OF GOVERNMENT REVENUE IN SELECTED MUSLIM COUNTRIES (1988) (% OF TOTAL REVENUE)

COUNTRY	Direct Taxes	Indirect Taxes	Non-Tax Revenue	Total Revenue as % of GDP
Algeria	21.8	54.9	23.3.	30.0
Bangladesh	11.9	71.5	16.6	9.5
Burkina Faso	23.6	55.7	20.7	17.6
Cameroon	36.7	37.6	25.7	233.4
Egypt	29.1	32.6	38.3	38.1
Indonesia	55.9	33.1	11.0	N.A.
Iran	22.9	22.7	54.4	N.A.
Jordan	9.8	53.4	36.8	27.4
Malaysia	32.9	37.3	29.8	22.7
Mali	12.5	78.4	9.1	15.7
Morocco	24.0	65.8	10.2	25.4
Nigeria	39.9	12.0	48.1	15.7
Pakistan	11.9	64.3	23.8	16.4
Senegal	23.0	71.5	5.5	19.8
Sudan	14.0	63.6	22.4	9.5
Syria	32.3	35.0	32.7	22.4
Tunisia	22.1	52.5	25.4	31.5
Turkey	39.5	42.0	18.5	17.5
Uganda	6.0	94.0	0.0	9.4
Yemen A.R.	19.7	40.3	40.0	22.6

Source: Computed from data given in World Development Report 1990 and Government Finance Yearbook 1989.

3.5 Tax Evasion

The problems of tax evasion are also common knowledge. These are not easy to quantify, but their magnitude is generally believed to be substantial. In the case of Pakistan, it was estimated that the tax evaded was 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 tax rates on the other. Moreover, lack of clearly identifiable and easily assessable tax bases has made tax evasion quite easy.

4. STRATEGY FOR FISCAL REFORMS

Through the analysis in previous sections we have tried to emphasize the seriousness of fiscal problems in Muslim countries. We have also tried to identify the major problems in the area of public finance. In this section, we will make a few suggestions to tackle those problems. Before doing that, however, we would like to caution that the problems are very complex and long-standing. There are no easy solutions. Any reform effort will need both political will as well as public support. People have to be convinced of the need to make the sacrifices that they are asked to make. There is an urgent need to overhaul tax systems and to rationalize expenditure patterns. Fiscal reforms are being introduced all over the world. While it would be useful to take notice of various proposals for reform, it is high time that Muslim countries start to formulate their policies in the light of Islamic teachings.

4.1 Defining the Proper Role of Public Sector

Any reform proposal must start with defining the proper role of public sector. From a purely economic point of view, the experience of three decades following World War II, which were characterized by

***Report of the National Taxation Reform Commission:**

large public sector outlays, has shown that the big-government philosophy has serious flaws. The growth of public spending was justified on grounds that the government must promote economic growth, sustain economic activity and bring about a better income distribution. Yet the experience of many developed countries shows that economies have not become more stable because of governmental intervention; income distribution has not improved and the rate of growth has not accelerated because of the larger government involvement: Economic historians also state that the period between 1870 and 1913 was one of the most dynamic periods for the economies of the modern world. The rate of growth was normally very high, and must modern infrastructure such as railroads, roads and schools was built. Yet the level of public spending was remarkably low. For example, in France it was only about 10 percent of national income. Similar percentages are found for the other countries (Tani, 1990). These percentages raise doubts about the necessity for high levels of public expenditure in promoting economic growth. In view of these facts and the recent theoretical developments in the field of public policy, more and more governments are now encouraging the private sector, privatizing public enterprises and reducing regulations which limit private sector activities.

Muslim countries must take note of these developments. In addition, they must refer to Islamic principles in order to define a proper role for the public sector. In the recent literature on Islamic economics, there has been some discussion about the role of public expenditure in an Islamic state and 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. (See for example: Siddiqi, 1986 and Kahf, 1983). This literature is quite instructive. While there is wide-spread support for the right of a Muslim government to impose additional taxes, Islamic scholars are much more strict with regard to seeking clear and proper justification for any additional taxes and the utilization of public revenue.

4.2 Creating Earmarked Heads of Public Expenditure

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 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 are examples of such expenditure. After meeting these expenditures from the general pool, a 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. 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 three heads, namely:

a) Poverty Elimination Programs (PEP)
b) Defense
c) General Expenditure

4.3 Resource Mobilization for Poverty Elimination Programs

This head of expenditure would be reserved for programs and schemers the benefit of the 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. Major source of funds for these schemes would be *zakah*. It should be pointed out here that if applied properly, *zakah* should generate between 2-3 percent of GNP [Zarqa, Anas, 1986].

If this amount is not enough, as would be the case in most of the Muslim countries at present, additional taxes on the rich may 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.[2] 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 see these taxes being spent on the poor, the level of tax evasion can also be expected to go down. This will be especially so in the long term as the rates of these taxes decrease with decreasing level of poverty.

We would also like to mention here that if *zakah* on government property is calculated and at least part of this is transferred to this head, the resources available for poverty elimination programs will increase substantially. However, this needs some *"ijtihad"* on the part of contemporary *fuqaha*. We feel that this is very much in order. The circumstances under which earlier jurists exempted government property from the levy of *zakah* have drastically changed. At their times government property constituted a relatively small proportion of national wealth. And since the general assumption was that government spends money on serving public interest only, perhaps they were justified in exempting government property from the imposition of *zakah. ' In* the present day-world the circumstances are

1 We are not recommending imposition of all these taxes. These are some of the possibilities. Each of these taxes has its merits and demerits. Detailed analysis of individual taxes is not possible in the paper.

2 See Zarqa (1986) for an excellent description of these schemes.

very different. Some of the changes which necessitate a fresh look on the issue are the following:

a) In the present day world, government owns a much larger proportion of national wealth. In some cases mineral wealth and other natural resources constitute more than 80 percent of national wealth.

b) Some categories of wealth which from an Islamic point of view are "community property" i.e. water, fire (energy), natural vegetation (forests) and salt (mines). Individuals should have free access to these for meeting "personal" needs. However, such resources are now under government control.

c) Governments have now taken up many new functions upon themselves. In many cases the government is -engaged in production activities.

d) Even if we assume that all government expenditure is for public welfare (though we think this is very unrealistic assumption under the present circumstances), still *zakah is* meant for specific purposes and the right of the poor is unquestionably the top priority for *zakah* disbursement. Exempting government property, which is a very large proportion of national wealth and in some cases of national product, from the payment of *zakah* deprives the poor of a right bestowed upon them by Allah.

Therefore, we suggest that *zakah* should be assessed on government property and the share of the poor and needy should be credited to the head earmarked for Poverty Elimination Programs. .

4.4 Resource Mobilization for Defense

Defense is a responsibility that every government must accept. There is hardly any doubt that from Islamic point of view, the performance of this responsibility 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.

In this regard every Muslim country should give very serious consideration to a plan of compulsory military service. This will, on the one hand, help in reducing the number of standing defense forces required and hence reduce defense expenditure and, on the other hand, help people in performing one of their religious duties. It is also important to realize that many countries are not under imminent threat, yet they have to be prepared for any emergency. A relatively small standing army with a back-up of reasonably trained reserve force can cope with the situation.

Another idea worth a serious consideration is the concept of "productive forces". Whatever standing army a country decides to have in the light of its circumstances, during peace time it can partly be used for "productive" activities such as running military farms, factories and other projects. This suggestion may invite objections on the ground that this will compromise the "professional " status of the forces. If it actually does, we would readily withdraw this suggestion. However, on the face of it, it does not seem so unacceptable as long as the scheme is implemented in a planned manner without overdoing it. A sizable number of military personnel in the armed forces are in ancillary services such as engineering, medicine, maintenance, driving, cooking etc. If they take part in "productive" projects, preferably under military management, their war-preparedness would not be affected.

After the proper size of standing and reserve forces has been worked out and all possible measures to reduce expenditure without compromise on having battle-ready forces have been taken, then whatever expenditure seems necessary may 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 for 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 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 a defense build-up ensuring national and territorial integrity, is jeopardized by "excessive" defense spending [Chapra, M. U., 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 premium that the nation has to pay depends on the level of risk to which it is exposed. In order to raise necessary funds under this head, we have the following suggestions:

a) Since defense is a collective duty of all members of the community, a defense tax with a very broad base may be imposed. We suggest that a poll tax at moderate rates may be imposed. This is a direct tax with a very broad base and beings easily recognizable there is very little chance for tax evasion.

b) The purpose of building a strong defense is to protect the faith, life, property and honor of the people against foreign aggression. One of the calamities that may befall someone's life or property is war. Just as people insure against other risks, they can insure against this calamity by building a strong defense. Therefore, we suggest that a small "defense premium" may be imposed on all property including agricultural land, dwellings, factories, movable property etc. The level of the defense premium will depend on the risk of war to which a country is exposed. Therefore, the premium should be adjusted according to that risk. Since the base is very wide, the rate of the premium will be very low and will not be burdensome.

c) Voluntary contributions have always made a significant contribution towards expenditure for defence in Islamic states. This source should also be tapped.

d) The share of "in the path of Allah" in *zakah* collections can also be spent under this head, whenever needed.

e) If the resources mobilized through the above measures are not enough, then the proposed rates may be adjusted by introducing moderate progression in the rates.

4.5 Resource Mobilization for the General Pool

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 *dawah,* 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. Had the Muslim governments been restricted to performing the only functions assigned by *shari'ah;* the effort required for generation of resources for these activities through taxation would have been much smaller. However modern governments may have to provide a number of other public benefits for the good 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 *maslahah* and the fulfillment of *fard kifayah* provide additional justifications for their provision by the government [Siddiqi, 1986].

While the provision of these goods by the government may be well justified, their provision through budget deficits and corresponding borrowing can hardly be justified. Huge public debt that has been built in their name which 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 them could. But the path of borrowing and deficit financing was chosen because it was politically easer. However, by doing so, the very justification for their provision by the government, i.e., public interest, was sacrificed. A radically different approach for a number of items of expenditure under this head need to be adopted. Some suggestion in this regard are given below:

a) First and foremost, 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.

b) 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 the case of most of the public utilities such as telephone, gas, electricity etc., this can easily be applied the private sector can also participate in the provision of these goods on a commercial basis. Many infrastructure projects, such as the building of airports, railroads and highways can financed through user charges. As a general rule, public utilities should be priced so as to cover their costs.

c) Using development charges to undertake development projects in certain areas is also possible. Just as private companies develop residential areas and sell off 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.

d) In some infrastructure projects, Islamic modes of financing can be applied. All such opportunities should be used.

Even after using the above mentioned techniques some projects which have substantial positive externalities and their "exclusion" are not possible will remain. These have genuine claims over general pool of tax revenue. However, the application of above mentioned principles would reduce such claims by a very substantial amount. Resources for these remaining claims may be generated through taxation.

4.5.1 Two "Unconventional" Sources for Financing" Public Goods

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 draw attention to two possible sources of financing for the provision of public goods. Public goods we remember are goods and services from which the community at large benefits. Interestingly, in a modern economy the community as a whole also generates resources by using paper and credit money as a medium of exchange. This is known as seigniorage. This arises because of a joint-action by the community at large i.e. accepting paper/credit money in settlement of mutual claims. Since the community at large generates this, it seems most appropriate to use this for the provision of goods and services for that community.

Secondly, 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 the 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 taxation in kind. We feel there is huge potential for mobilizing this kind 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.

4.6 Limiting the Role of Public Borrowing

As mentioned before, most of the Muslim countries have relied extensively on public borrowing to fill the budget deficit. The resulting public debt has grown into a monster. Beside other problems, interest payments are consuming a sizable part of the 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 when interest is charged.

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 government lives within its means. The constrains this imposes on government spending in the short-run is more than offset by the much smaller debt-servicing burden in future. This would ensure sustained and steadier economic growth supported by real resources, freedom from external pressures and a dignified position in the comity of nations that an Islamic state rightly deserves.

It is, therefore, suggested that all Muslim countries should impose a constitutional -ban on future interest-based borrowing. Some people may argue that in the early Islamic period, Prophet *(SAW)* himself resorted to borrowing in order to meet national requirements. In this regard, we must remember that such borrowing was on interest-free basis and that too was done in o
extremely difficult circumstances. There are exceptions to every rule. Therefore, while imposing constitutional ban on future interest-based borrowing, such exceptions can be included in the law. However, these should be clearly defined and restricted to very exceptional circumstances.

The existing debt should be converted into interest-free loans or to equity where possible. It may be pointed out here that debt=equity swaps are being undertaken all over the world. It should also be noted that citizens of Muslim countries have substantial amounts of capital invested abroad. Stopping this capital flight and attracting the capital invested abroad is perhaps the best bet for these countries. Therefore, special policies should be designed for this purpose. The remaining part of existing debt should be paid off on emergency basis to give new policies a better start.

We would like to re-emphasize that there are a number of ways for the government to fulfil 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 made to offer that sacrifice. It must be remembered that borrowing does not eliminate the need for sacrifice. It only postpones it and increases its magnitude.

5. SUMMARY AND CONCLUSIONS

It is an unfortunate fact that most of the Muslim countries are suffering from budget deficits. The problems are both serious and complex. Governments have been living beyond their means for too long. 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.

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 a structural change in 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 concentrating all efforts to mobilize that amount 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. They must first be convinced about the genuineness of all government expenditure. And once they are convinced of that, they must pay all of it. The present practice of meeting a very substantial portion of government expenditure through borrowing must be discontinued.

The distinction between current expenditure and the development expenditure should be kept in view while mobilizing resources. The present practice of generating as many resources as possible from all sources and then meeting current expenditure out of the available resources and transferring the residual to the development budget is not correct. In our view, the two kinds of expenditure need to be mobilized through distinctly separate approaches. For determining 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 islamic Financing Techniques.

Introduction of some ear-marked heads of expenditures will help to ensure fulfillment of those functions without ignoring some other important public needs. Defence and Poverty Elimination Programs are appropriate candidates for such ear-marking.

Infrastructure for industrial development should be provided on the basis of development charges. The government should develop industrial estates in different parts of the country. Instead of tax holidays which are not effective, the government should provide full infrastructure and then charge the costs through the allotment of industrial plots on the basis of actual costs. In areas where incentive has to be provided for regional development, concessional price can be charged.

In case of public utilities and attempt should be made first to ensure efficient low cost production. Once that has been ensured the user charges should be fixed so as to recover full costs.

The role of *awqaf* in the provision of public goods such as education and health should be promoted. Voluntary contributions should also be encouraged. Contributions in terms of community service have great potential in Muslim countries. This should also be harnessed.

To conclude the paper we would like to re-emphasize that these countries need a thorough overhaul of their revenue and expenditure structures rather than ad-hoc fine tuning.

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IS EQUITY FINANCED BUDGET DEFICIT STABLE IN AN INTEREST FREE ECONOMY?

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The purpose of this paper is to analyze the stability of an equity financed budget deficit in an interest free Islamic economy. To this effect a small closed economy theoretical macroeconomic model broadly consistent with the Islamic tenets is developed. This study found that under a strong wealth effect an equity financed deficit is not necessarily unstable and that government expenditure policies may contribute positively in terms of enhancing the output of the economy.

1. INTRODUCTION

Over the past decade, there has been a growing literature on *Islamic economics* involving theoretical macroeconomic models [e.g., Al-Jarhi (1983), Haque and Mirakhor (1987), Kahf (1985), A. Khan (1982), M. Khan (1986), M. Khan and Mirakhor (1989), Mirakhor and Zaidi (1988), Naqvi (1982) and Zarqa (1983)]. Indeed, most of these studies have provided a better conceptual and analytical understanding of how a banking system may operate in an Islamic economy. For instance, the study by M. Khan (1986) has shown that the *Islamic Banking Model*, based on *equity participation,'* may be dynamically more stable than the traditional banking model with fixed interest rates. In particular, M. Khan (1986, p.19) noted that the *Islamic Banking Model* may be 'better suited to adjusting to shocks that result

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in banking crises' because in such a model the shocks are 'immediately absorbed by changes in the values of shares (deposits) held by the public in the bank'. In another paper, M. Khan and A. Mirakhor (1989) developed an IS-LM model of closed Islamic economy wherein they have shown that monetary policy, using *Mudaraba financing,* may have a positive impact on the growth rate of output of the economy. Their results were reinforced by A. Mirakhor and I. Zaidi (1988) in an open-economy version of that model.

Although tremendous progress has been made in developing theoretical macroeconomic models for an Islamic economy, most of these models, nevertheless, examined issues pertaining to the Islamic banking system or the efficacy of the monetary policy. The issues related to fiscal policy, as an instrument to finance government deficit in an Islamic economy have not been adequately addressed in the literature.[2] In this context S. Ahmed (1989, p.163) noted:

> A notable omission [in the Islamic macroeconomic literature] is how the government would finance its expenditure in an economy with no fixed-interest debt.

On the same issue, Pryor (1985, p.205) wrote:

> I have seen no thorough discussion of fiscal policy in the Islamic economic system and of the degree to which the government could engage in deficit spending.

The purpose of 'this paper is to present a simple theoretical macro model of an Islam<x economy with explicit government budget constraints. Though the model developed in this paper closely follows Metzler (1951), Christ (1968, 1979), Scarth (1979) and Blanchard (1981), it, nevertheless, differs from them in terms of integrating the basic features of an Islamic Economy. For instance, our model has no fixed interest bearing assets which makes it largely consistent with the basic tenets of Islam.[3] Moreover, the private agents in our model hold assets only in the form of profit and loss sharing (PLS) equities and

non-interest bearing money. Government, however, can finance its deficit through *money creation* or *equity finance.*

It is well known in macroeconomic literature that a bond (fixed interest bearing asset) financed government deficit leads to macroeconomic instability [e.g., see Christ (1979) and Scarth (1979)]. Some economists have, therefore, questioned the worthiness of such policies used by policy makers in Western economies to finance their large deficits. With this objective in mind, we believe an important contribution of this paper is to develop a macroeconomic model for an Islamic Economy in order to analyze the stability implications of an *equity financed* budget deficit. In fact, the conclusion that emerges from our analysis is that under certain assumptions, namely, a strong wealth effect, our model for the Islamic economy is stable.

The paper is organized as follows. Section 2 describes the objective, importance and implication of fiscal policy in an Islamic economy. Section 3 sets up the macro model with explicit budget constraints for an Islamic economy. The dynamic stability conditions of the model under *equity financing* and *money creation* are examined in Section 3. Section 4 provides the steady state comparative static results of fiscal and monetary policy under alternative budget financing. Finally, Section 5 summarizes the conclusions.

2. OBJECTIVE AND THE ROLE OF FISCAL POLICY IN AN ISLAMIC ECONOMY

In his comment on the role and function of the state, Ziauddin Ahmad (1989: 5) writes:

> The Qur'an and the *sunnah* provide basic guidance in determining the role and function of the state. The following functions can be derived directly from these two sources: (a) defence of the territorial integrity of the state; (b) maintenance of law and order; (c) dispensation of justice; (d) civil administration; (e) propagation of good and suppression of' evil; (f) assurance of at least a basic

minimum standard of living for all citizens, and (g) prevention of gross inequalities in income and wealth.

Thus, it appears that the state should play an important role in providing and improving the welfare of its citizens. Furthermore, the state should be actively involved in promoting and enhancing the general economic conditions and proper utilization of the useful resources of the society by creating necessary 'infrastructure and other public goods' or through fiscal measures.

Having outlined the basic role of the state and the objectives of fiscal policy in an Islamic society, the important question is how the state is going to achieve these objectives. More specifically, how is the government budget going to be financed or if the budget is not balanced, then is deficit-financing permissible in an Islamic state? All these issues will have important implications in constructing the government budget constraint in the next section. Ziauddin Ahmad (1989: 15-16) has best explained and clarified these questions. He writes:

> The Islamic teachings allow a great deal of flexibility to the government in shaping its budgetary policy. There is nothing *mansus* (prescribed specifically by the Qur'an and *Sunnah)* about the budget of a state being balanced or unbalanced or the quantum of budgetary deficit". The only binding constraint is that it cannot resort to borrowing on the basis of interest to cover its budgetary deficit.

On the issue of government spending and deficit, S. Ahmed (1989, p.163) writes:

> Government spending that is permanent or recurring, such as normal compensation of employees, would be financed by taxation... Temporary spending for specific projects would be financed by loans from the private sector on a profit- and loss-sharing (PLS) basis. The central bank [on behalf of the state] would be allowed to directly invest in the real sector

on a PLS basis also and choose how much of the government's equity to monetize through the usual kinds of open market operations, with the only difference being the nature of the securities being traded.

Because of the important place of *zakah* in the *Islamic Financial System*, the government budget is divided into two broad categories, namely, *welfare budget* and *general budget.' Zakah* receipts and voluntary contributions are used to finance the expenditures of the *welfare budget* which may include such items as cash grants to the poor and unemployed and financing other social welfare programs (education and health care for the poor). Financing of the *general budget is,* however, made by tax revenues (direct or indirect), borrowing money from* the banks *(money financing)* with no interest and trading government shares *(equity financing)* on a PLS basis.

3. THE MODEL OF AN ISLAMIC ECONOMY

Consider a closed economy with a fixed price system implying a horizontal supply curve. We assume that there is *composite* good and two asset markets. The two assets are *equity* (which are titles to physical capital) and *outside money.* Following M. Khan (1986), we also- assume that savings and investment activities are performed through the banks only and that these banks can be considered as firms engaged in collecting funds which are then invested to make profits. Furthermore, both the value of the investment deposits (shares) held by the private agents and the corresponding yield on those shares are not fixed or predetermined. In fact, these rates can take negative values as well.' Moreover, at any given time, both private agents and government hold these shares in a given proportion. Following Metzler (1951), we also assume that the central bank, on behalf of the government, is authorized to engage in buying and selling of these shares to finance government deficit.

With these assumptions, we examine the following macro model with explicit government budget constraints:

$$
\begin{array}{llll}
(1) & S & = & (aY)/\pi;\ 0 \le a \le 1 \\
(2) & M & = & L(\pi)\ (\lambda S); \qquad L\pi < 0 \\
(3) & Y^{AD} & = & C(Y^{d}, A) + I(\pi) + G;\ 0 < C_{yd} < 1;\ C_A > 0;\ I\pi < 0 \\
(4) & A & = & \lambda S + M; \qquad 0 \le \lambda \le 1 \\
(5) & Y^{d} & = & (1 - t)Y; \qquad 0 \le t \le 1 \\
(6) & G & = & R + G_g; \\
(7) & R & = & z[Y^{d} - C(Y^{d}, A)]; \qquad 0 \le z \le 1 \\
(8) & G_g & = & tY + \dot{M} + (1-\lambda)aY + \dot{\lambda}S
\end{array}
$$

where the variables are defined as follows:

Y = aggregate national output;
Y^{AD} = aggregate demand for national output;
Y^d = disposable income;
C = private consumption;
I = private investment;
R = transfer payments from *zakah* fund;
G_g = government expenditure from general budget;
G = total government expenditure;
A = private wealth;
M = money balances;
$\dot{M}$ = absolute rate of change of real money balances;
S = market value of total shares held by private owners and government;
λ = proportion of the total shares held by private owners;
$1-\lambda$ = proportion of the total shares held by government;
$\dot{\lambda}$ = absolute rate of change of the proportion of the total shares held by private owners;
π = rate of return or yield on shares;
a = proportion of income going to capital as profit;
z = ***Zakah*** rate..

We now explain the structure of the model.

Equation (1) simply shows that the value of shares is equal to the capitalized value of profits of the banks. As no capital gains and that banks are not holding any reserves and additional net worth, equation (1) can be thought of as bank's balance sheet with *(aY/7r)* as assets and S as liabilities..

Equation (2) is used to determine the money market equilibrium. This equation, basically determines the rate of return (n) such that the desired proportions of money and shares held are equal to actual proportions. By substituting S from equation (1) into (2), one can obtain the following money market equilibrium condition wherein the rate of return on shares is inversely related to the money demand.

$$(9) \qquad 0 = L(\pi) - (M\ \pi)/(\lambda aY);$$

Equation (3) represents the goods market equilibrium condition. This equation can be viewed as the summary of the IS curve, wherein the private demand depends positively on disposable income and wealth and negatively on the rate of return. Because of fixed output prices, the adjustment process in response to excess demand in the goods market is assumed to be sluggish. Equations (4) and (5) define private wealth and after-tax disposable income. Substituting equations (1), (4), (5), (6) and (7) into (3) and assuming slow adjustment of the goods market, we obtain the following dynamic equation for excess demand for national output:

$$(10)\ \dot{Y} =$$

$$\alpha \left[(1-z)\cdot C \left\{ (1-t)Y;\ \left(\frac{\lambda aY}{\pi} + M \right) \right\} + I(\pi) + z(1-t)Y + G_g - Y \right];$$

where a is the positive adjustment coefficient and Y is the absolute rate of change of the national output.

As mentioned earlier, the total government expenditure as represented by equation (6) is divided into a welfare allocation and a general allocation.[6] Equation (7) shows the transfer payments or welfare expenditures which are made from funds received through *zakah* levy. It may, however, be noted that the *welfare expenditure* [equation (7)] is exactly matched by the *zakah* collection. This is in contrast with Ziauddin Ahmad's (1989) exposition of *dual budget,* who has not ruled out the possibility of deficit in the *welfare budget.* The allowance of financing such deficit from the *general allocation* may diminish the important distinction between the *welfare budget* and the *general budget.'* The term inside the bracket of-equation (7) represents the total savings (the difference between disposable income and private consumption). The total value of *zakah* fund is simply a fraction (roughly 2.5%) of the total savings.[8]

Equation (8) is the basic government budget constraint identity. The funds generated for this budget are entirely expended for the purpose of general government expenditure as . discussed earlier. These funds are, however, raised from three different possible sources, namely, *tax revenue (tY), money financing* or outside money *(M)* and selling of existing shares (XS) held by the government.[9] Since, at a given point in time, it is unlikely that - the state will completely replenish its entire asset holdings of the shares to finance the deficit, the government will thus earn some revenue as dividends from its stock holdings which is denoted by *(1-r)aY in* equation (8).

It is important to note that the inclusion of the budget constraint now implies that both policy variables *(M or* X) simultaneously cannot be set exogenously. In fact, Scarth (1988: 104) argued that. one of the policy variables *(M or* X) 'must be determined residually by 'the setting of the other policy instruments, the outcome of the economy, and the need to satisfy the financing constraint'. Furthermore, the presence of time rate of change in either proportion of shares (,.) or money **(M)** makes the model necessarily dynamic. As such, we will have two dynamic budget constraints, one in the case of *equity* (or share) *financing* and the other for *money financing.* These two dynamic budget constraints are, respectively, given below:

$$(11a) \quad \dot{\lambda} = \left(\frac{\pi}{aY}\right)[\, G_g - tY + (1-\lambda)aY \,];$$

$$(11b) \quad \dot{M} = [\, G_g - tY + (1-\lambda)\, aY \,].$$

Equation (11a) is obtained by substituting S from equation (1) into (8) and then setting M equal to zero. On the other hand, by setting 1l equal to zero in equation (8), we obtain the second dynamic budget constraint [equation (11b)]. Thus the compact dynamic system in the case of *equity financing* consists of equations (9), (10) and (11a) while for *money financing* the dynamic model includes equations (9), (10) and (11b). Before a meaningful investigation of the stationary (or long run) multipliers of the system can be done, it is necessary to analyze the dynamic stability of the model.

4. DYNAMIC STABILITY ANALYSIS AND THE LONG RUN MULTIPLIERS

The main focus of our analysis is to study the implications of *equity financed* budget deficit on the stability of the system. However, a comparison of these results with that of *money financed* budget would enhance our understanding of the dynamic adjustment pattern of an Islamic economy. In this section we analyze the stability conditions under alternative modes of financing. We first discuss the case of *equity financing.* In order to examine the effectiveness of fiscal policy under *equity financing,* we also derive the income/expenditure multiplier.

Equity Financing: For equity financed deficit the dynamic model consists of the following equations:

$$(9) \quad 0 = L(\pi) - (M\,\pi)/(\lambda aY);$$

$$(10) \quad \dot{Y} = \alpha \left[(1-z)\cdot C \left\{ (1-t)Y; \left(\frac{\lambda aY}{\pi} + M \right) \right\} + I(\pi) + z(1-t)Y + G \right.$$

$$(11a)\quad \dot{\lambda} = \left(\frac{\pi}{a\,Y}\right)\left[\, G_g - tY + (1-\lambda)aY \,\right];.$$

Linearizing the above system around its steady state values ($\bar{Y}$, $\bar{\lambda}$ and $\bar{\pi}$),

we get

$$(12)\quad \begin{bmatrix} \dot{Y} \\ \dot{\lambda} \\ 0 \end{bmatrix} = \begin{bmatrix} -A_1 & A_2 & -A_3 \\ -B_1 & B_2 & B_3 \\ C_1 & C_2 & -C_3 \end{bmatrix} \begin{bmatrix} Y-\bar{Y} \\ \lambda-\bar{\lambda} \\ \pi-\bar{\pi} \end{bmatrix} + \text{other exogenous terms}$$

where

$$A_1 = \alpha \left\{ 1 - (1-z)\left(C_{yd}\,(1-t) + \frac{C_A \lambda a}{\pi} \right) - z\,(1-t) \right\} > 0;$$

$$A_2 = \alpha(1-z)\frac{C_A \lambda a Y}{\pi} > 0\ ;$$

$$A_3 = \left\{ (1-z)\frac{C_A \lambda a Y}{\pi^2} - I\pi \right\} > 0\ ;$$

$$B_1 = \left\{ \pi \left(\frac{G_g - ty - a(1-\lambda)Y}{aY^2} \right) + \frac{\pi t}{aY} + \frac{\pi(1-\lambda)}{Y} \right\} > 0\ ;$$

$$B_2 = \pi > 0\ ;$$

$$B_3 = \left\{ \frac{G_g - tY - a(1-\lambda)Y}{aY} \right\} > 0\ ;$$

$$C_1 = \frac{M\pi}{a\lambda Y^2} > 0 ;$$

$$C_2 = \frac{M\pi}{a\lambda^2 Y} > 0 ;$$

$$C_3 = \left\{\frac{M}{a\lambda Y} - L\pi\right\} > 0$$

This 3x3 system has three roots $(\xi_1, \xi_2 \text{ and } \xi_3)$. Thus the necessary and sufficient conditions for stability require that both the determinant (n) and trace should be negative while the sum of the principle minors be positive. However,if one of these conditions is violated unambiguously then the system would be necessarily unstable. Analyzing these stability conditions in the context of our model, we get

$$C.1)\quad \det(A) = \Delta = \xi_1\xi_2\xi_3 = A_1(B_2C_3 + C_2B_3) - A_2(B_1C_3 - C_1B_3) + A_3(C_2B_1 + C_1B_2) \gtrless 0 ;$$

$$C.2)\quad trace(A) = \xi_1+\xi_2+\xi_3 = -A_1 + B_2 - C_3 \gtrless 0.$$

$$C.3)\quad \Sigma principle\ minors = \xi_1\xi_2 + \xi_1\xi_3 + \xi_2\xi_3 = (A_1C_3 + A_3C_1) + (A_2B_1 - A_1B_2) - (B_2C_3 + B_3C_2) \lessgtr 0.$$

The above results clearly indicate that the dynamic system considered is not categorically unstable because none of the stability conditions are unambiguously violated. In fact, under certain suitable conditions the system may converge to a stable time path. Analyzing these conditions carefully one may observe that the influence of terms A, and A_Z are crucial for stability and in both these terms the wealth effect on consumption $(C_A > O)$ is important. This leads us to make the following proposition.

these conditions carefully one may observe that the influence of terms A, and $A2$ are crucial for stability and in both these terms the wealth effect on consumption ($C_A > 0$) is important. This leads us to make the following proposition.

Proposition 1: The dynamic macro model of an Islamic economy with equity financed deficit may be stable if the wealth effect on private consumption is sufficiently strong.

In order to analyze the dynamic adjustment pattern of our model, we consider the phase diagram representation of equations (10) and (11a). The slopes of y - 0 and Y - Q *loci* are given by:

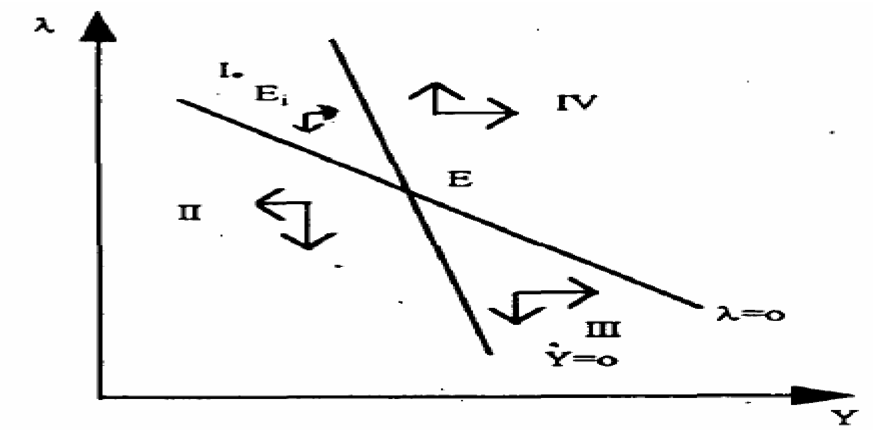
$$\text{(13)} \quad \left.\frac{dY}{d\lambda}\right|_{\dot{\lambda}=0} = \frac{1}{\left\{\dfrac{G_g - tY - a(1-\lambda)Y}{aY^2} + \dfrac{t}{aY} + \dfrac{(1-\lambda)}{Y}\right\}};$$

$$\text{(14)} \quad \left.\frac{dY}{d\lambda}\right|_{\dot{Y}=0} = \frac{(1-z)}{\pi\left\{1-(1-z)\left(C_{yd}\,(1-t) + \dfrac{C_a \lambda a}{\pi}\right) - z\,(1-t)\right\}}$$

Figure 1 describes the characteristics of the adjustment path associated with an increase (decrease) in the proportion of total shares held b . the private (government) sector. The locus, y - 0 and Y - 0 passes through point E which represents the new steady state. Notice that the relative slopes of these *loci* reflect the assumed numerical values of the parameters. The analysis of the steady state presented above revealed that the dynamic system is not *categorically unstable. This* result is again reinforced in figure 1 because at least some of the arrows point towards the equilibrium point *E.* Thus, point *E* could be considered as locally stable intertemporal equilibrium. A point such as *E1.* in quadrant I can be considered as describing the initial *steady state.* Since below the Y - 0 locus, Y would increase and above X - *0 locus* X decrease, the dynamic path terminates at *E.* At point E1., aggregate demand falls below natural level L 'output and climbs back gradually to this level in response to the changes in relative share holdings of the private sector (y). Such a pattern of dynamic adjustment implies the significance of private sector's wealth in determining the deviation of actual output from its natural level.

Figure 1

REAL OUTPUT (Y) AND RELATIVE PRIVATE SHARE HOLDINGS (y): AN ADJUSTMENT PATTERN UNDER EQUITY FINANCED DEFICIT



Whether or not the wealth effect on consumption is sufficiently strong is essentially a matter of empirical investigation which is beyond the scope of this paper. We, however, can refer to the Qur'an and the writings of Islamic scholars to seek information on the issues of spending and acquiring wealth by private individuals in an Islamic society.

On the issue of acquiring wealth, the Qur'an says:

> And when the prayer is ended, then disperse in the land and see of Allah's bounty, and remember Allah much, that ye may be successful. (62:10).

And when the prayer is ended, then disperse in the land and see of Allah's bounty, and remember Allah much, that ye may be successful. (62:10).

And when it is said unto them: spend of that wherewith Allah hath provided you, those who disbelieve say unto those who believe: shall we feed those whom Allah, if He willed, would feed? Ye are in naught else than error manifest. (36:47)

In the context of spending wealth, Ziauddin Ahmad (1989, p.7) writes: The Qur'an proclaims that:

in no case will man attain piety unless he spends freely from his wealth in the way of God for the needy and poor. (3:92)

Of course, Islam does not promote conspicuous consumption which, in fact, is discouraged. What is, however, encouraged is not to hoard wealth but share it with others.

Assuming that the model under *equity financed deficit is* stable, we can then calculate the steady state long-run multipliers. We now set y and Y equal to zero to define full-equilibrium in the above dynamic model represented by equations (9), (10) and (11a). y is now interpreted as the resulting proportion of equities or shares held by public that will eliminate the budget deficit. Thus the three endogenous variables in the model are now Y, y and μ. Taking a total differential of this and writing it in matrix form we get:

$$(13)\quad \begin{bmatrix} -A_1 & A_2 & -A_3 \\ -B_1 & B_2 & B_3 \\ C_1 & C_2 & -C_3 \end{bmatrix} \begin{bmatrix} \partial Y \\ \partial \lambda \\ \partial \pi \end{bmatrix} - \begin{bmatrix} -\alpha \\ \dfrac{-\pi}{aY} \\ 0 \end{bmatrix} \partial G_g + \textit{other exogenous terms};$$

where all variables and parameters are as defined earlier. Since our interest in this paper is on the expenditure multipliers, we have ignored the other exogenous terms in equation (13). The long-run expenditure multiplier with respect to income *M* is given below:

$$(14)\quad \frac{\partial Y}{\partial G_g} - \frac{\alpha(B_2C_3 + C_2B_3) + (\pi/aY)(A_3C_2 - A_2C_3)}{\Delta} \gtrless 0.$$

Clearly, the sign of the expenditure multiplier is ambiguous. However, if *Proposition I* is true, implying the presence of strong wealth effect among the private individuals, this will then make both the denominator (due to CA) and the numerator negative, giving a positive expenditure multiplier in case of *equity financing*.

We now turn to the case of *money financed* deficit.

Money Financing: The Money Financing model consists of the following dynamic equations:

$$(9)\quad \bar{0} - L(\pi) - (M\ \pi)/(\lambda aY);$$

$$(10)\quad \dot{Y} - \alpha \left[(1-z) \cdot C \left\{ (1-t)Y; \left(\frac{\lambda aY}{\pi} + M \right) \right\} + I(\pi) + z(1-t)Y + \right.$$

$$(11b)\quad \dot{M} - [\, G_g - tY + (1-\lambda)aY \,].$$

Like before, linearizing the above system around its long-run values ($\bar{Y}$, $\bar{\lambda}$ and $\bar{\pi}$), we get

$$(13)\quad \begin{bmatrix} \dot{Y} \\ \dot{M} \\ O \end{bmatrix} = \begin{bmatrix} -A_1 & A_4 & -A_3 \\ -D_1 & O & O \\ C_1 & C_4 & -C_3 \end{bmatrix} \begin{bmatrix} Y - \bar{Y} \\ M - \bar{M} \\ \pi - \bar{\pi} \end{bmatrix} + \textit{other exogenous terms};$$

where

$$A_4 = \alpha(1-z)C_A > 0;$$

$$C_4 = \frac{\pi}{a\lambda Y} > 0 \; ;$$

$$D_1 = [\, t + a(1-\lambda) \,] \; ;$$

and the other variables are as defined earlier.

Analyzing the three stability conditions for the money financing model, we get

$$C.1a) \quad \det(A) = \Delta = \xi_1\xi_2\xi_3 = -D_1(A_4C_3 - A_3C_4) < 0 \; ;$$

$$C.2a) \quad trace(A) = \xi_1 + \xi_2 + \xi_3 = -A_1 - C_3 < 0 \; ;$$

$$C.3a) \quad \Sigma principle\ minors = \xi_1\xi_2 + \xi_1\xi_3 + \xi_2\xi_3 = (A_1C_3 + A_3C_1) =$$

Given the parametric assumptions of the model, it is evident that the dynamic system under *money financing is necessarily* stable. Our results for an Islamic Economy, in this case, are consistent with the traditional Keynesian type of macroeconomic model.

5. CONCLUSIONS

In this paper, we have constructed a fixed-price closed economy macro model with explicit budget constraint in order to investigate whether or not an *equity* (or shares) *financed* deficit is stable for an Islamic economy. Most of the earlier studies based on fixed interest rate system concluded that the bond financed budget deficit is *necessarily unstable.* The implications of such a finding could be crucial, from the policy point of view for the economies which use bond as an instrument to finance the deficit. It has been argued that the policy makers in many Western economies 'still hope that bond financed fiscal policy can be used for growth and employment targets, with only transitory effects on the national debt.' Scarth's (1979) research, however, found no strong support for this hope.

Our study, based on a macro model broadly consistent with the tenets of Islam, however, found that the *equity financed* deficit is not necessarily unstable and fiscal policy measures may have positive effect on the growth rate of the economy, provided there are strong wealth effects on private consumption.

ENDNOTES

1. Here the *principle of* ***equity participation is*** defined as a system where the deposits of the individuals are held on a profit and loss sharing basis. In other words, as noted by Khan (1986), these deposits held by the depositor should be treated as shares whose nominal values (and hence rate of return) are not predetermined or fixed by the banks.

2. One exception has been the study done by Ziauddin Ahmad (1989) which did address the issue of fiscal policy, and public finance and provided extremely useful information in this context. His detailed study, however, is primarily descriptive and did not develop any macro model to analyze the role of fiscal policy in terms of an analytical mode.

3. For example, see M. Khan (1989, pp.39-40) for a detailed discussion of this issue.

4. *Zakah is* a special tax on the individual's savings and wealth which is then distributed to the poor citizens *of* the state. The *zakah* rate varies between 2.5% and 20% depending upon the type of assets held by the individual.

5. For example, see Khan (1986) for a discussion on this issue.

6. These two terms for government budget are borrowed from Ziauddin Ahmad (1989).

7. It is worth pointing out that Ziauddin Ahmad (1989) has emphasized the importance of such *dual budget* in an Islamic framework.

8. It should be noted that *zakah is* levied not only on savings but also on wealth such as gold, silver etc. In order to keep our model simple we have limited our analysis of *zakah* as levy on savings only. As a matter of fact, at the present time in Pakistan the government levies a 2.5% *zakah* . only on the savings account.

9. One can interpret the term (yS) as *equity financing* for the following reason: y indicates the growth rate of the 93 proportion of shares held by the private individuals and when this term is increased (because of legal authorization of the central bank), it increases the share holdings of the private individuals and reduces the share holdings of the government. By virtue of this operation, the government is being able to generate funds to finance its deficits. This operation can be viewed as an open market operation in the traditional sense but with one important difference being that unlike the bond, the instrument- used in this operation does not have a fixed return.

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Section III

FINANCING DEVELOPMENT IN SELECTED MUSLIM SOCIETIES

7
THE BASIC NEEDS FULFILLMENT GUARANTEE IN ISLAM AND A MEASURE OF ITS FINANCIAL DIMENSION IN SELECTED MUSLIM COUNTRIES

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1. INTRODUCTION

Growth in the gross national product or GNP has of late been replaced by the basic needs fulfillment (BNF) as a primary development objective in many of the Third World countries.' This is a policy shift with a real revolutionary potential. It has been hailed in the current literature as a pragmatic response to the continually worsening income disparities and ever spreading deprivation in these countries,. despite their GNP having shown a more than satisfactory rate of growth over the decades.[2]

However, one must realize that a BNF program is intrinsically fragile and intricate, constrained as it is by a host of complex socio-political considerations. It does not obviously intend to conflict with or detract from the requirement of a GNP expansion. The BNF simply aims at 'minimizing poverty with growth'.[3] But in doing so, it may often turn out to be a program of wide ramifications. The BNF may require, for example, a revision of development priorities, stinging redistributive measures, shifts in the choice of technology, reallocation or relocation of resources, and complex structural readjustments in the economy4. These and the like are changes which are not only inter-

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linked, but which may also not infrequently be concurrent. To integrate them together in a unified development program may be difficult and challenging. Their net result, or individual impact, may not always or entirely be welcome to the entrenched status quo ante interests. As a consequence, political expediency may often feel hesitant to implement a BNF program despite an initial enthusiasm to implement such a program.

The Islamic economists writing on the subject in recent years have, however, remained undaunted, if not unaware, of the above mentioned complexities or limitations in the way of putting a meaningful BNF program into action. They have generally limited their discussions to the judicial aspects of the issue with scant attention to its operational side. One reason for this indifference may be the non-existence in the modern world of an economy being run strictly according to the *shari'ah* norms.

However, even in their theoretical constructs, the present day Islamic economists have not been very clear about two things: (i) the content and the size of a basic needs package, and (ii) the financial dimension of a BNF program in the present day Muslim (if not Islamic) countries. Both are intimately related aspects of a BNF based development strategy, and the present paper seeks to analyze the issue from these two angles.

The scheme of this paper is as follows; section two deals with the conceptual aspect of a BNF program from an Islamic viewpoint. Here we shall give reasons for our reservations about an absolute concept concerning basic needs[5], and shall argue that a relative measure is more logical and helpful both for inter-temporal and inter-nation comparisons. Such a measure is also more realistic and convenient for analyzing the financial dimension of the program in various Muslim countries.

Section three discusses this financial dimension in a rather restricted form.[6] The exercise covers seven Muslim countries viz Bangladesh, Egypt, Indonesia, Malaysia, Morocco, Pakistan and Turkey. The selection is purposive and well spread across the globe. The countries included have very diverse historical backgrounds, -natural resources, population sizes and political systems, and are at' quite different milestones on the road to economic development. Taken together, their population is more than half a billion. This constitutes over 50% of all Muslims in the world, and around 70% of those living in the Muslim majority countries where, given the will, an Islamic version of a BNF program can be put into operation.

It must be mentioned that both in the matter of sample selection and the designing of the tools for analysis the nature and form of the available data have played their role. Furthermore, the study is of a static nature; it is related only to the year 1987. Essentially, it seeks to sharpen concepts and develops a technique of analysis. Providing concrete policy prescriptions is not its objective.

In section four, we present a summary of some important points of the discussion and make a few concluding remarks.

2. BASIC NEEDS CONCEPT

The idea that the basic needs of all should be satisfied before the less essential needs of a few are met has its origin in religious scriptures including those of Islam.' The principle has won a very wide acceptance (Streeten p. 8). However, the religious import of the idea which we shall explain using the Islamic case as illustration, seems much different from the restricted, somewhat technical, meaning it has assumed in the current discussions on poverty, income distribution, and levels of living in the area of development economics.8

From the viewpoint of Islam, and other religions too, the issue of the spiritual poverty of the believers at present may not be less important than the problem of the material deprivation which afflicts their vast majority.[9] Still, one can presumably separate the two for analytical treatment with advantage, more so because the *shari'ah* sees an intimate link between them. Promotion of the material well-being of the poor through the BNF is expected to improve not only their ethical performance but, depending on the content and range of the program, of the rich as well.[10]

Islamic scholars seem to be almost unanimous on the point that the fulfillment of basic needs and poverty reduction are the two prime goals of the *shari'ah's* distribution scheme. The holy Qur'an reminds us time and again that even though people may differ from one another in regard to the quantum "of rizq sustenance granted to them, all creatures of the Almighty have an equal right to a livelihood from His inexhaustible treasures of the earth (and the heavens).[11] Elaborating on the point, Siddiqui holds that a guarantee for the fulfillment of the basic needs of everyone is imperative to Islam. He quotes extensively from the text, the *Sunnah,* Caliphal precedents, and the juridical writings in support of the proposition. To him, the sanctity of this guarantee is such that he recommends its inclusion in the constitution of an Islamic state so as to grant the individuals a right to claim its fulfillment through the law courts. [12] Siddiqui writes:

"This guarantee. applies to each and everyone irrespective of age, sex, race, color, language, caste or creed. It applies to Muslims as well as to non-Muslims. The only criterion for eligibility is need, without sufficient means to fulfil it. Some members of the society are permanently placed in this category because of some debility, e.g. the invalid, the blind and the chronically ill, the very old and the very young etc. Some are temporarily found in this condition such as the unemployed and those with insufficient incomes. . These types of people are guaranteed fulfillment of their basic needs through a number of direct and indirect means." (page 252, emphasis ours).

Evidently, the need-income relationship in Siddiqui is equivocal and imprecise. To him, the only qualification for the Islamic guarantee to become operative is the existence of a need, non-violative of the *shari'ah* norms one may add, and the insufficiency of income, irrespective of reasons, to meet the same. There is an explicit delinking of the `basic' from need, thus rendering the related income insufficiency a highly indeterminate variable in the Islamic fulfillment scheme. Siddiqui attempts to fortify his position by erecting a strong *shari'ah* fence around his notion of needs which he then terms as `basic' to everyone in the society. In that, he tends to break the link - so common in the secular literature - between the `basic needs' and the concept of `poverty' marked on an income scale. Naturally, Siddiqui's list becomes too broad and its focus shifts from the 'basic needs' to unquantifiable Islamic living in oblivion of resource availability at the micro or macro level.

Ziauddin Ahmad adopts a similar approach in formulating his views in 'Islam and Fulfillment of Basic Needs.[13] Although he starts with a narrow version of the basic needs - "adequate food, clothing and shelter etc. for - living comfortably" (p.53) he lands himself in a state of inconsistency when he adds: "Needs, however, include not only the necessities for sustaining life but also comforts for making life more pleasant and less difficult" (p.55). Things become more complicated when he introduces another dimension: "The desired welfare in an Islamic society can be achieved - also by the fulfillment of basic needs that are necessary for the spiritual upliftment Islam stands for" (p.57). The writer ultimately provides us with his final version of the basic needs as including "food, clothing, shelter, and medical aid - domestic services - education, marriage - employment opportunities and transportation facilities" with some qualifications (p. 57).[14]

Even though both Siddiqui and Ahmad mention explicitly the stage of economic development and income level as factors affecting the Islamic need fulfillment guarantee, the overall argument - its content, drift and thrust - tends to lessen the relevance of these constraints in each case.

Fortunately, there is a succinct recognition in Islamic economic literature that the concept of basic needs can have a narrower connotation related to poverty expressed in terms of income level, as opposed to the global view of the essential requirements for a decent Islamic living as they are identified with in the Siddiqui - Ahmad formulations. It is also generally held in the writings on the subject - both secular and Islamic - that the concept of basic needs has to be a flexible one. Their range and standard in a particular society would have to be periodically spelled out in accordance with the level of economic development reached (Hasan p. 40). This being so, one must avoid the overdrawing of the `basic needs' list ignoring the operational constraints, specially the financial ones, that delimit it.

Even as we detach the concept of `basic needs' from the stated *shari'ah* requirements for a comfortable living and take a restricted view of them so as to consider their non-fulfillment the result of the income insufficiency of an appropriate category of the `poor'[15], two types of issues still remain unsettled. First, what are, or should be, the contents of a `basic needs' basket and whether the concept of this basket would be `absolute' or `relative'? Second, will the basket be made available to the deprived by a scheme of income transfers, through a direct provision of goods and services, or by raising their earning capacities, and what agencies or institution would perform these functions?[16]

The time and space. constraints do not permit here a detailed *discussion* of all such questions. However, we shall take 'up the first of these at some length, and may touch. upon a few others in a cursory way..

2.1 Absolute vs Relative Version

As alluded to earlier, the concept of a `basic needs' approach to development emerged-as a consequence of the failure of the standard growth approach to check the spread of poverty and. destitution in the developing economies. Removal of poverty, through a reversal of priorities, became an issue of serious concern in many countries for a variety of reasons - social, economic and political.[18] To formulate meaningful programs for the purpose `poverty' had to be defined in precise terms, and the `poor' had to be identified accordingly. This was attempted through specifying a basket of goods and services which could fulfil at the minimum the `basic needs' of food, clothing, shelter, medical care, and education to grant the, recipients a living standard which society could accept-as tolerable, if not decent.

The contents of the basket varied according to the dictates of the local requirements, but the `needs' it was meant to fulfil were virtually the same in each case. A money equivalent of the basket was then defined as the `poverty line' and those having incomes below this minimal were identified as the `poor'.[19] Inflation being a perpetual feature of all modern economies, the money value of the basket can be raised periodically to obtain its current equivalent.

The idea of a physical basket of goods and services is considered to be an absolute version of a `basic needs' concept. "Removing malnutrition in children, eradicating disease, or educating girls are concrete specific achievements that meet the basic human needs of the deprived groups, whereas reducing inequality is abstract. There is, of course, nothing wrong with an abstract moral objective, but if policies are judged by evident reduction of suffering, meeting basic needs scores better than reducing inequality.... "To consider basic needs is to move from the abstract to the concrete, from the aggregate to the specific". (Streeten, pp 17-18 and 21). ,

Another objection to a `relative' notion is that it defines poverty only in such a way that it may never be reduced, despite any rise in the absolute income levels, unless the measure of inequality is itself changed.[20] As an economy develops and the production of material goods and services increases we must push up "the socially agreed minimum" to ensure the presence of the poor in every society. Thus by definition, a class of poor is created in all historical formations unless we are in a regime of perfect equality (Naqvi, P.344). The absolute version, on the other hand, envisages a list of items of consumption regarded as an irreducible minimum, and material prosperity may then lead to an elimination of the class of the needy and the poor. The apprehension presumably is that while an absolute version of poverty would allow us to get rid of the curse once and for all, the relative notion would burden our conscience perpetually by maintaining poverty as a socio-historical category.

Last but not the least, an interesting observation against the "relative" poverty is that it is not considered justified in the *shari'ah,* "as this type of subjective poverty may increase one's unhappiness and greed with an associated urge for exploitation of the less fortunate people." (Mannan, p.308).[2]

In sum, a `relative' interpretation of basic needs expressed in terms of money incomes is generally criticized on the grounds that (i) it is abstract, (ii) it makes poverty eradication a perennial problem, and (iii) it may tend to promote certain trends in social psychology unwelcome to the *shari'ah.* We shall argue that these grounds are extremely shaky, if not redundant, and will show that a `relative' concept of basic needs is more purposive and operable compared to its `absolute' version.

First, it is not appropriate to conceive of `absolute' poverty as some level of income not sufficient to meet the specified basic needs, and consider only income inequalities beyond that as an issue concerning `relative' poverty. The dichotomy is infirm. Moreover, it carries an air of `relativity', with it. For, the contents and quality of a basic needs basket cannot be determined in isolation of the per capita income of the community. In the context of the present situation of most of the Muslim states - especially those which for historical and other reasons are overpopulated, like Bangladesh and Pakistan and where GNP per capita is small - even if we distribute the available income evenly after deducting the revenues needed for defence and civil administration, the availability of goods and services would presumably be just or a little more than sufficient to meet the minimum needs listed in the Siddiqui-Ahmad formulations, Where will the resources come from for developmental purposes? The line of demarcation between the `absolute' and `relative' components of poverty is related to and must shift with time within and between nations according to the levels of income reached and the state of its distribution.

Indeed we should consider the relativity issue, initially, in the context of basic needs -not of incomes - if we wish to avoid the confusion the discussion so often tends to run into. We believe that it is extremely difficult, if not possible, to quantify basic needs in some `absolute' sense without being arbitrary.

To begin with, take the case of food requirements. Recent literature on the subject is full of controversies as to what constitutes malnutrition or more importantly how to ascertain the 'relative' degrees of under-nourishment. The empirical research conducted by individuals, institutions and international organizations on the issue poses perplexing interpretive problems.[22] For, "we do not know how many calories are needed for people to live their daily lives". [23] It is also not settled if protein deficiency is a distinct problem from inadequacy of calories in a diet, or if the removal of the latter would mitigate the former as well, except in some exceptional situations.[24] Nor is one sure if calories requirement in the diet would be the same for people engaged in different kinds of activities requiring relatively more (or less) energy.[25] It is not only the difficulties of definition, the non-availability of the relevant data complicates the problem further.

Despite these difficulties, one is able to make an estimate of at least a minimum number of people suffering from malnutrition[26] but the phenomenon is not demonstrative of the food supply inadequacy at the local or international levels. It only epitomizes the problem of highly uneven distribution of the available supplies.[27] The poor cannot afford to buy (or produce) the needed food because of the purchasing power insufficiency which is essentially expressive of `relative', not of some arbitrary `absolute', poverty on ail income scale. In physical terms also, an element of relativity is imparted by the mode of obtaining specified amount of calories. The type of diet e.g. meat or cereals (and their prices) would play an important role.

Since all stomachs are of almost the same size the difference in the diet intakes of the rich and the poor is expected to be of a limited nature,[28] and one may probably stretch for an `absolute' view of the requirement. But that cannot clearly be the case with the other basic needs. For example, the size and quality of a shelter, and the range and level of the accompanying services relating to water, electricity, sewerage, transportation etc; can only be thought of meaningfully in `relative' terms. Provision of education and medical services - their quantum, type and standard - is all the more difficult to conceive of on an absolute basis. In any case, when we aggregate all the basic needs, as we must, using a money measure, we are but transported to the realm of poverty indicated on an income scale. And poverty in this sense cannot be divided, as argued, into `relative' and `absolute' components.

Poverty is by its very nature a relative concept.[29] "Whatever doctors, nutritionists, and other scientists may say about the objective conditions of deprivation, how, the poor themselves perceive their deprivation is also relevant. This perception is a function of the reference group from which the poor take their standards of what comprises the necessities for a decent minimum level of living" (Streeten, P.19).

This brings us to our second point. The above mentioned perception of relative poverty need not be expressive of the envy which Mannan mentions as distasteful to the *shari'ah* if the living standards of the reference group are improving, the desire of the poor as a group that their lot should also show up a little, is almost a biological basic need which can be devoid of grudge or envy.

Third and the last, the relative view, of course, defines poverty in such a way that it can never be eliminated, however much the absolute levels of income rise .[30] But what is alarming about that? Which society, and at what point in time has been, or presently is, without its poor or free of a perception of poverty? Not even the most affluent ones can claim to be entirely devoid of the malady. And why should not an electric hare be used to spur on the greyhounds of public concern if that would make them run on road to social welfare towards an ever distancing destination? Islamic economics with a special focus on distributive equity would presumably welcome such a built-in spur. (Compare Streeten P.20).

3. FINANCIAL DIMENSION

The merit of the basic needs concept is that it takes us from the general to the specific and focuses attention directly on the sore point of destitution in society. But the decomposition of the underlying poverty notion into the `absolute' and `relative' parts is entirely capricious. There rarely is a way of defining the appropriate standards of nutrition, shelter, clothing, health or education without a reference base. Furthermore, this reference base cannot be the same in the U.S.A. and Pakistan. Nor can it remain unchanged over time in either country.

The time when the objective of BNF (absolute) will have been attained and also the criteria to judge it, may both be fairly clear. But that alone can hardly help. Required for policy formulation and result appraisal is the firmness and clarity of relationships between the needed inputs and the desired outputs. Unfortunately, there is no production function which spells out these relationships. Precisely what financial, fiscal or human resources would achieve the desired results is rarely known. The situation in the developing countries is characterized with a multiplicity of forces which interact in a complex and intractable manner.

In contrast, the `relative' view of BNF is realistic and workable. It does not seek to identify the biological and psychological components of poverty. The concept may vary between climates, cultures and locations. Yet comparisons over time and between nations can be made. It also maintains the link with the issue of distributive justice and keeps it perpetually in focus.[31] The essential requirement is to specify the basic needs and express their fulfillment norm in money terms so as to measure the magnitude of relative deprivation. For this purpose we have taken the mean expenditure of each country covered by the study on five basic needs - food, clothing, shelter, medical care and education in the reference year 1987. Assuming that the bottom 40 percent on the income scale spend all their earnings on these needs, their average expenditure is compared with the national norm to illuminate the financial dimension of the problem.

Of course the average basic needs basket shall not be the same in content and quality for all the seven countries under study. Still, it is considered fairly realistic to assess the magnitude of deprivation in each case by its own, and make comparisons on that basis. The method avoids the difficulties of standardizing the basket as also the problem of currency conversions to a common base.

Here the deprivation norm moves up with the national mean expenditure on the basic needs. Notice that this norm is different from that for relative poverty which rises with the mean national income. In the latter case the focus on the basic needs may be blurred.[32] Thus ours is a 'roll up' approach to basic needs fulfillment as opposed to the `once and for all' illusory solution provided by the 'absolute' poverty removal approach.

To fix ideas, let us suppose that in a given country, for any period t, Xyt is the mean national income, Xbt is the average expenditure on specified basic needs, and on them Xbpt is the minimum desired expenditure for the poor identified as those whose average income Xpt is less than Xbpt.. Clearly, therefore:

$$Xpt < Xbpt < Xbt < Xyt$$

In the 'absolute' BNF approach Xbpt is defined as the poverty line, and if after n years of effort the incomes (or their average?) of all those below the line are raised above Xbpt level, poverty could claim to have vanished once and for all, even if the gap between Xyt and Xbpt or Xbpt and Xbt grows with the passage of time!

. In contrast, the 'relative' BNF approach, as conceived by us above, would insist on measures to close the gap between Xpt and Xbt in the first instance, and narrow it down between Xpt and in the long run in a continual 'roll up' process with temporal growth in the GNP. [33]

Secular economics has not so far given any serious consideration, even in principle, to the desirability of a periodic review of basic needs of the poor and their upward revision on a continuous basis, but the Islamic norms of distributive justice would presumably prefer the relative (roll up) approach to a static 'once and for all' secular view of poverty removal.[34]

3.1 Measurement: Two Indices

To have an idea of the financial dimension of the BNF in the selected seven Muslim countries we have attempted to construct two main indices:

i) The Basic Needs Gap Index (BNGI); and
ii) The Budget Effort Index (BEI)

Conceptually, the BNGI is designed to measure the Basic Needs Gap that exists between the consumption level (Xpt) of the target group (i.e. bottom 40% of the population) and the national average consumption level (Xbt). The BEI, on other hand, is designed to measure the extent of financial resources required by the government to meet the Basic needs Gap in 1987 given budget for that year.

In this study we measure these two indices for the selected seven Muslim countries. We start with the percentage GNP share of the target group in 1987. This share (col. 9, appendix I) is estimated as a weighted average for the period 1975-2000, using the group's population at the two time points as weights.[35]

As mentioned earlier, here we assume that-the target group spends it entire share of GNP (i.e. its entire income) on the basic needs. This assumption is more than reinforced by an observation in Ahluwalia and etal 1979 as quoted in Todaro (1985):

"...almost 40 percent of the population of the developing countries live in absolute poverty defined in terms of income levels that are insufficient to provide adequate nutrition..." [36]

The BNGI rests on the extent of short fall in the target group's income from the national average expenditure on the specified basic needs. The gap is expressed as a ratio of the letter to obtain the required index. Symbolically:

$$BNGI\ [abY - PpY]abY \quad (1)$$

where:

- a : is the average propensity to consume in the economy C/Y
- b : is the proportion of aggregate consumption expenditure on basic needs (aY)
- Pp : is the proportion of the average national income going to a given ratio p (in our case 40%) of the bottom end population
- Y : is the average (i.e. per capita) national income

Simplifying (1), we get:

BNGI = [1 - Pp/ab] (2)

If Pp tends to zero, the index tends to 1, showing a situation of extreme destitution for the (Pp) proportion of the population. On the other hand, if Pp approaches ab, the index would tend to zero, indicating a continually easing situation for the same proportion of population from the BNF viewpoint. It follows that the lower the BNGI on a (0-1) scale, the better will be the BNF position of the economy and vice versa. In a `roll up' approach to BNF, as envisaged in the above discussion, the performance improvement indicated by the progressive lowering of the BNGI will be indicative of improved income distribution coupled with economic growth, if `p' is fairly large. This is confirmed by a negative correlation (r = 0.63) in our case between the BNGI and the per capita national income. The higher is the income the lower is the BNGI in general. However, it is just about 0.39 showing that the rise in per capital income has a weak influence in reducing income inequalities (compare with quotation in note 31).

Table 1 below shows our findings in terms of BNGI for the seven selected Muslim countries for the year 1987. We have arrived at these findings using the World Bank data for 1987 (World Development Report, 1989).

TABLE 1

BASIC NEEDS GAP INDEX (BNGI) : 1987

Country	(a)=Aggregate Consumption Spending (Priv+Gvt) as ratio of GNP	(b) =Expenditure on BN* as a ratio of Aggregate Consumption	Pp	BNG I
	1	2	3	4
Bangladesh	0.98	0.87	0.444	0.478
Egypt	0.91	0.70	0.338	0.469
Indonesia	0.71	0.74	0.324	0.381
Malaysia	0.63	0.57	0.328	0.086
Morocco	0.86	0.71	0.305	0.50
Pakistan	0.90	0.84	0.326	0.570
Turkey	0.76	0.73	0.239	0.886

The above table shows that there are significant income disparities in the countries under study as indicated by the Pp which measures the per head income of the poorest 40% (col. 11, appendix I) as a proportion of the average GNP (col. 2, appendix I). In Turkey the value of Pp is the lowest at (0.239). Consequently, the BNGI in that country stands at (0.586) which is the highest in the group. With a per capita income of U.S. $ 1210, Turkey ranks among the lower middle income group countries but a highly skewed income distribution puts her poorest 40% population much below the national average. Although Bangladesh is the poorest country in the group, her BNGI (0.478) is lower than Turkey's (0.586). This indicates relatively less unequal income distribution in the former case. On the other hand, Malaysia with a U.S. $ 1810 per capita income, is also a lower middle income country like Turkey, but its track record in combating poverty is the best in the entire group as indicated by its BNGI being the lowest at (0.086). This performance of the Malaysian economy is neither accidental nor is it the sole outcome of the trickled down effects of growth. Rather, the Malaysian economy owes this better distribution (and hence a lower BNGI) to the New Economic Policy (NEP) which was introduced in the early 1970s with the specific goal of improvement in income distribution.

.After having measured the BN gap, the next logical step is to estimate the resource requirement to bridge the same. This is done within the frame of the national budgets of these countries. Using the World Bank figures which express the government budget of a country as a percentage of its GNP, we attempt to measure the resource requirements for each country in the group for 1987. We do this by constructing a Budget Effort Index (BEI) for each country (col. 17, appendix I). The BEI is measured as follows:

BEI - BNG as % of GNP Govt.
Budget as %' of GNP

Table 2 below gives the BEI estimates:

TABLE 2

BEI INDEX ESTIMATES : 1987

Country	BNG as % of GNP	Govt. Budget as % of GNP	BEI
	1.00	2.0	3=(1+2)
Bangladesh	16.25	12.2	1.33
Egypt	11.94	45.5	0.26
Indonesia	8.00	24.0	0.33
Malaysia	1.24	31.9	0.04
Morocco	12.20	35.0	0.35
Pakistan	17.26	21.4	0.81
Turkey	**14.55**	22.8	0.64

The above estimates show that in order to bridge the 1987 BN gap, in Bangladesh we need an increase of 133% in her budget for that year. Pakistan ranks second in terms of additional budget requirement of 81% while Turkey, needing a budgetary increase of 64%, ranks third in the group. Malaysia, on the other hand, needs the least additional budget (0.04%) to bridge the BN Gap. It is interesting to note that there is a high positive correlation ($r = + 0.8$) between BNG expressed as a ratio of GNP, and the BEI. This clearly shows that the higher the basic needs gap relative to income, the greater will be the effort required to mobilize resources for the improvement of the condition of the poor in a `roll up' scheme.

4. CONCLUSION

In recent years the thinking on the poverty question in economics has matured in so far as the focus has shifted from mere per capita GNP growth to the fulfillment of the Basic Needs. This is a healthy development indeed, but from the policy point of view economists still remain undecided on the issue of absolute vs relative poverty. Apparently the `absolute' version sounds very appealing, and that is why most of the contemporary Islamic economists tend to take that route, but such an approach raises some very serious conceptual and operational issues as discussed in the present paper.

Furthermore, the approach raises serious problems in the case of extremely poor countries like Bangladesh. Clearly, if we begin in such cases by attempting to provide an internationally standardized basic needs package, the cost will be so high (in terms of the resource requirement) that it will become virtually impossible for that country to make any meaningful dent on poverty without risking a political upheaval. Even the international donor agencies would not be able to make a serious commitment to the required extent. It is this inherent difficulty of the lack of a realistic understanding of the problem which has resulted in the failure to develop a suitable technique for measuring resource requirement to solve it. The `roll-up' approach to BNF as outlined in this study enables one to have a realistic frame of analysis. For every country's poverty is evaluated in its own context and the cure is prescribed within its own resource capacity. The technique of estimation presented in this study is neither claimed to be perfect nor final. Rather, it marks the beginning of a serious discussion on the estimation of resource requirement and the relevant strategies to reduce significantly the poverty in the Muslim world (or elsewhere). Here the BEI estimates the resource requirement to bridge the entire BN gap in just one year. Obviously, this gap cannot be bridged in such a short period, and the resource requirement will have to be estimated on an annual basis with reference to the desired time frame. At the same time there will be need to discuss the strategies for resource mobilization for the purpose. Hopefully, further research in the area will explore relevant issues involved in the process.

APPENDIX I

BASIC DATA AND DERIVATIONS : 1987

	Population (Miln)	Per capita GNP in U.S.$	GNP in US$ Miln	Aggregate Consumption in U.S.$ Miln (Govt + Prix)	BN Exp as % of Private Consumn. Expenditure	Total BN Exp. in U.S.$ Miln	Per Capita BN Availability	40% of the population (Miln)	% share of bolton 40% population in GNP	Share of bolton 40% in GNP US$ Miln	Per Capita GNP of bolton 40% population US$	Per Capita BN Gap for the bolton of 40% of pop US$	Total BN Gap for the bolton 40% of pop in US$ Miln	BN Gap Index or BNGI	BN Gap as % of GNP	Govt. Efforts as % of GNP	Budget Effort Index to Meet Basic Needs
	1	2	3=(1x2)	4	5	6=(4x5)	7=(6+1)	8=(1)x4	9	10=(3x9)	11=(10-8)	12=(10-8)	13=(12x8)	14=(12x8)	15=(13/3)x100	9	17=(15+16)
Bangladesh	106.1	160	16976	16636	87	14473	136	42.44	17.82	3025	71	65	2759	0.478	16.25	12.2	1.33
Egypt	50.1	680	34068	31002	70	21701	433	20.04	13.54	4613	230	203	4068	0.469	11.94	45.5	0.26
Indonesia	171.4	450	77130	54762	74	40524	236	68.56	12.95	9988	146	90	6170	0.181	8.00	24.0	0.33
Malaysia	16.5	1810	29865	18815	57	10725	650	6.60	13.13	3921	594	56	370	0.086	1.24	31.9	0.04
Morocco	23.3	510	14213	12223	71	8678	372	9.32	12.20	1734	186	186	1734	0.500	12.20	35.0	0.35
Pakistan	102.5	350	35875	32288	84	27122	265	41.00	13.09	4696	114	151	6191	0.570	17.26	21.4	0.81
Turkey	56.6	1210	63645	50280	73	16704	698	22.64	10.29	6549	289	409	9160	0.586	14.55	22.8	0.64
Total	525.5		271772	216006		159927		210.60		34526			30552				
Average		516.19			73.1		398.57		13.29		232.86	165.71					

Source: World Development Report, 1989 (and appendices II $ III)

Appendix II

STRUCTURE OF DEMAND : 1987
Distribution of GDP (%)

Country	General Government Consumption	Private Consumption	Gross Domestic Savings	Gross Domestic Investment	Resource Balance	
					1987	1965
	1	2	3	**4**	5=(3-4)	6
Bangladesh	8	90	2	11	-9	-4
Egypt	14	77	8	19	-11	-4
Indonesia	10	61	29	26	3	0
Malaysia	16	47	37	23	14	4
Morocco	18	68	14	19	-5	1
Pakistan	13	77	11	17	-6	-8
Turkey	12	67	23	26	-3	-1

Source: World Development Report, 1989, Table No. 9, Structure of Demand, pp. 180-81

Appendix III

EXPENDITURE ON FIVE BASIC NEEDS:
(Range of Years, 1980-85)
(As % Share of Total Household Consumption)

Country	**Food**	**Clothing** & **Footwear**	**Shelter, Fuel** & **Power**	**Medicare**	**Education**	**Total** % **on Basic Needs**
	1	2	3	4	5	6=(1+2+3 +4+5)
Bangladesh	59	8	17	2	1	87
Egypt	36	4	5	14	11	70
Indonesia	48	7	13	2	4	74
Malaysia	30	5	9	5	8	57
Morocco	44	9	6	7	5	71
Pakistan	54	9	15	3	3	84
Turkey	40	15	13	4	1	73

Source: World Development Report, 1989. Table No. 10, pp. 182-83

ENDNOTES

1. The literature on basic needs is now vast and penetrating, thoroughly covering the various issues in the area. Most notable is Paul Streeten et al First Things First which contains an extensive bibliography of just under one hundred entries up to 1980. No less important is the contribution of A.K. Sen. Some selected references are provided here mainly covering the. period since 1981. Some useful material has appeared periodically in the World Development reports.

   For a critical appraisal of the basic needs approach to development, T.N. Srinivasan, and Sidney Dell are important. Dell argues that there are difficulties of concept, measurement, and interpretation in using 'basic needs' as an operational tool of planning.

   Discussion on various aspects of basic needs has so far been very scanty in the nascent Islamic economics. Cursory references are found in many writings, but a comprehensive discussion is taken up only by Siddiqui and Ahmad more recently and that too primarily at the juridical level.

2. The GNP per capital of the developing countries grew at an average rate of 3.4% per annum during 1950-75 or 3.0% if China is excluded. This was faster than either the developed or the developing nations had grown in any comparable period prior to 1950, and exceeded both the official goals and private expectations (Meier p. 45).

3. Basic Needs Approach (BNA) emphasizes "poverty minimizing growth". Its strategy of direct attach on poverty has better potential for LDCs' development and fulfillment of their populations' basic needs than the trickle down mechanism of the Growth Approach. (Farooq, Abs). Nevertheless, while the benefits derived from the operation of BNF policies are not to be discounted in the longer term the success of the approach may

inevitably require an improvement in the rate of economic growth (Kumar, Abs.).

4. For a detailed discussion of these requirements see Paul Streeten Ch. 2 and also pp. 110-112.

5. Srinivasan has emphasized that the same political and institutional constraints that prevent the operation of the trickle down theory denying the benefits of growth from reaching the poor in an effective measure also apply to attempts to provide basic needs. He cites the Indian experience of planning for 'minimum needs' to prove his point. (Streeten pp. 55-58).

6. Usually a basic needs approach to development is cast in a limited time frame. Within a short period say one generation, it seeks to put the basic needs - food, clothing, shelter, medicare, and education - of a specified amount and quality within the reach of targeted groups. We attempt in this short paper to measure the financial dimension of the required program in the selected economies from only this angle. We are, for example, not concerned with the mobilization of resources or with their ways of utilization.

7. Not only Islam but all other major religions of the world insist on the fulfillment of basic human needs. An interesting elaboration available in recent times is that of the Talmud, a codification of the Jewish religious law spanning almost eight centuries. "The Talmud attempted to raise the poor to well-defined objective minimum living standards, while considering individual subjective needs." For details see Shapiro pp. 54-59.

8. For this restricted view see Streeten pp. 109-110 and also H.W. Singer.

9. The issue of material and spiritual poverty as an integral part of overall poverty is mentioned both by Mannan and Ahmad. While the former deals only with material poverty, the latter also includes

the spiritual poverty but fails to suggest its specific objective dimensions or concrete policy measures to reduce it, save for a vague, general remark.

10. A tradition says: "Sometimes poverty turns into disbelief' (al-Sayuti, Jami al-Saghir). The Prophet (peace be upon him) is reported to have sought God's protection from poverty (Abu Daud). Again, an Islamically regulated economy must create the environment where believers really heed to the Qur'anic advice: "But seek with the wealth which God has bestowed on thee, the home of the He and forget not thy portion of the present world" (28:77). Thus Islam seeks to convert the material ambition of man into the means for attaining spiritual heights i.e. his ultimate goal (Hasan pp. 41).

11. See Hifz-ur-Rehman pp. 40-48 supported by the Holy Qur'an e.g. 15:20; 41:10.

12. Indeed, the point had been conceded both in Libya and Iran, for example, much earlier than Siddiqui made it in 1983.

13. The paper gives the impression of a hurried effort. The argument is at places repetitive and shifty and marked with digressions. The verses quoted do not always bear out the points they are meant to support.

14. This formulation can be defended as an ultimate goal of the *shari'ah* in a 'pure' Islamic model. Indeed, such a broad eventual range of basic needs is also visualized in secular writings though for immediate purposes they stick to its narrower interpretation (Streeten for example makes such a distinction pp. 109-110).

    Furthermore, comfortable or decent living may be interpreted as relative to the level of economic development the country has reached. For example, the national average, which is used in this paper as the bench mark, may be regarded as decent for purposes of measurement. We owe this suggestion to Mr. Zakariya Man, presently Deputy Dean, Kulliyyah of Economics and Management, International Islamic University, Malaysia.

15. One finds a comprehensive and modern categorization of the poor in Erfan Shafey "To the traditional poor-the landless, the old aged, sick, orphans, divorcees, widows, and migrants - one ought to perhaps add contemporary types -victims of unemployment, run-away inflation, relative geographical isolation, and of random calamities such as fire, floods etc". (pp. 69).

    An important addition to the list is made by Streeten "Indeed, the very poor are not unemployed but work very hard and long hours in unremunerative, unproductive forms of activity in the towns: the street traders, garbage collectors, and casual workers, as well as many in small production such as blacksmiths, carpenters, sandal makers, builders and lamp makers. These people often work extremely hard, are self-employed, or employed by their family and are very poor. The "working poor" (pp. 13).

16. These institutions and agencies have been well-defined in Islamic economics. Siddiqui, Manna, Ahmad, Rehman and Hasan all refer to them and explain their respective roles. These are: the individual himself, the relatives, the neighborhood, the community, institutions, and the state in that order.

17. "The problem of development must be defined as a' selective attach on the worst forms of poverty. Developmental goals must be defined in terms of progressive reduction and eventual elimination of malnutrition, disease, illiteracy, squalor, unemployment and inequalities. We were taught to take care of our GNP because it would take care of poverty. Let us reverse this, and take care of poverty because it will take care of the GNP. In other words, let us worry about the content of GNP even more than its rate of increase". (Mehboobul Haque, pp. 6)

18. For a detailed discussion of these reasons see M.P. Todaro Ch. 1. See also Srinivasan.

19. Such a concept was adopted in some Indian studies in the late sixties. See, for example, Dandekar V.M. and Nilakantha Rath: Poverty in India, New Delhi, Ford Foundation, 1970. For the basic needs related concept of the absolute poverty line see Meier G. (p.43) and for the standardization of the line to facilitate international comparisons see Todaro, M.P. (pp.32).

20. For this (pp. 20) and other arguments against a 'relative' concept of poverty see Streeten pp. 17-21.

21. Interestingly, Mannan not only believes that a perception of relative poverty is unwelcome in the *shari'ah*, he also observes that "the *shari'ah* demands that we must attack absolute poverty rather than relative poverty as a matter of priority". (pp. 308). To this Naqvi's rider is no less interesting. "Consistency demands that one should deny any consideration to relative poverty, if it is not justified. The language employed by the author gives the impression that higher priority is to be given to the removal of absolute poverty, and thus by implication relative poverty also deserves attention, though entitled to a relatively lower priority".

    The inconsistency in Mannan's argument is further highlighted when he observes at a later stage that the "guarantee of a minimum level of living is both conditional and relative at the same time". In support of the relative nature of the guarantee he quotes two traditions (from Bukhari) but fails to see that the reference base for his 'relative' concept of the minimum living is not the same in both cases; in the first tradition it is measured by the "prevalent custom", in the second, by the consumption level of the employer.

    Also, one may presumably ask: Why should a perception of relative poverty only prompt the better off to exploit the "less fortunate people"? Why may it not lead the latter to rise in revolt against the rich or compel the state to take corrective measures? Will *shari'ah* bar this second course of action? The flow in Mannan is obvious.

22. "It is not all certain just how many people in the world are malnourished. In the late 1960s and early 1970s (for example) the FAO estimated that approximately 1.5 billion people were undernourished - but in 1974 the FAO estimated that around 1970 less than half a billion people were suffering from inadequate diets ... Unfortunately, the greatly reduced estimate of the number does not reflect improved diets - merely changed definitions. In 1977, the FAO once again estimated the number of undernourished in the LDCs at[*] somewhere over 400. million people... The calculations were based on a more conservative estimate of nutritional requirements than in 1974 (Murdoch, pp. 95-96 see footnotes also on p. 96).

23. U.S. National Academy of Sciences quoted in Murdoch, p. 97. Paul Streeten observes: "...a nutritionally adequate diet is difficult to define since caloric needs vary widely with climate, body weight, activity, height, age and other factors, and even for the same conditions between persons and for the same person in the same conditions from day to day" (p. 74).

24. In case of their earlier estimates of the malnourished the FAO maintained that the protein deficiency was a distinct problem affecting hundreds of millions who had sufficient calories. In 1974, however, the FAO concluded that protein deficiency is not a separate additional problem, except in regions where the main staple is cassava or some starchy crop (Murdoch, p. 95).

25. The 1977 estimate of FAO quoted above in no. 22 is based on a caloric requirement that takes no account of the energy needed for activities such as farming, and Serimshaw and Young have the evidence that even when allowance is made for such activities the FAO requirements may still be understated. (Murdoch, p. 96-97).

26. Such an estimate can be made by examining medical surveys in the developing countries. These surveys estimate directly the number of people showing clinical symptoms of malnutrition. The WHO has based some of its estimates on these surveys (Murdoch, pp. 97-98).
27. See Streeten p. 125, also Murdoch pp. 98-99.

28. Still, in developed countries the average person consumes 50% more calories and 70% more proteins than the average person in poor countries, and directly and indirectly uses three times as much grain. The extra food needed to provide adequate diets of the malnourished of the world is equivalent to about 37 million tons of grains. This was fifth of world grain production and is less than 10 per cent of the amount of grain fed to livestock in rich countries (Murdoch p. 98).

29. "By necessities I understand not only the commodities which are indispensably necessary for the support of life, but whatever the custom of the country renders it indecent for creditable people, even of the lowest order, to be without" (Adam Smith, The Wealth of Nations bk. 5 ch. 2 p. 2, quoted in Streeten p. 19). .

30. It is not K.A: Naqvi alone who raised this objection, as quoted in the text, to a relative concept of poverty, see also the discussion on the point in Streeten pp. 18-21.

31. Maintaining this link is important because it is "an empirical fact that only societies that have been successful in meeting the basic needs are those that have also reduced inequalities". (Streeten, pp. 20-21).

32. In the case of a notion of relative poverty the reference base may be a matter of one's predilections. It may be the mean national income, the bottom of the top 80 percent of population on the scale, the mean of the top 40 percent or any thing else for any given percentage of people at the bottom.

33. Even in secular economics it is now well recognized that the BHN (Basic Human Needs) strategy must be implemented in a flexible way and must go beyond health, nutrition, education, sanitation, water, and housing to include infrastructure and indigenous, small enterprise products that will make it easier for domestic production to meet basic human needs as and when the growing economy so permits (For details see Curry).

34. The 'Roll Up' approach would insist that as Xbt expands with growth in the GNP, the ratio of Xpt to Xbt is at least maintained at the old level and the effort is made to raise it with the passage time. This would require more pro-poor measures to raise their productivity, disposable income and availability at reasonable prices of goods and services included in the expanding basic needs basket. The process should eventually tend to raise the ratio of Xpt and Xyt making for a more equitable distribution of incomes (and wealth) in accordance with the Islamic norms.

35. The calculations here are based on the data given in Todaro (pp. 152-53, 1985).

36. M.S. Ahluwalia, N. Carter and H. Chenery, "Growth and Poverty in Developing Countries", Journal of Development Economics, 6 (1979), p. 306. And remember that nutrition is just one element of the BN basket.

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8
LONG TERM FINANCE IN ISLAMIC COUNTRIES : CASE STUDY OF PAKISTAN

MOHAMMAD AKRAM KHAN*

INTRODUCTION

The main objective of this paper is to review the progress made by Pakistan in Islamizing its financial system, more particularly in relation to sources and application of long term finance. I have chosen Pakistan for a detailed study because, of all the Muslim countries, it has shown the greatest enthusiasm at the official level to eliminate interest from the economy and this experience has attracted a lot of attention from all quarters. Although the paper concentrates on Pakistan, the lessons learnt from this experience and suggestions made in this paper are of a fairly general nature. I hope the proposals contained in this paper will be of interest to other countries as well if they genuinely wish to eliminate interest from their economies.

The paper consists of five parts besides the Introduction. The first part of the paper briefly surveys the existing financial instruments and points out the extent to which these instruments adhere to the Islamic framework. The second part suggests possible changes in these practices to bring the financial instruments nearer to Islamic standards. The third part proposes such institutional arrangements as would be necessary to support the changes suggested in part two of the paper. Although the main thrust of the paper is on long term finance, the structural changes proposed in the paper will give rise to some related questions about short term finance and overall economic management of the economy. Therefore, part four discusses the related questions of the proposals made in part two of the paper. The last part consists of concluding remarks.

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The main conclusions of the paper are as follows. First, the Islamization of banking in Pakistan has not met with a success. Most of the finance is being provided by the savers and the bankers on interest although different terms are being used to camouflage this. Second, the early days of Islamization in Pakistan did see some genuine but inadequate efforts to eliminate interest from the economy but in a period of less than five years most of these efforts have either been reversed or, at least, further progress on them has been halted. Third, a genuine attempt to eliminate interest from the economy would require the restriction of all opportunities for interest-bearing finance. So long as avenues for interest-bearing investment are open, the possibility of a successful transition to an Islamic system of finance is well-nigh impossible. Four, a true Islamic system of finance would require the savers desirous of earning a return on their savings to assume risk as well. The *shari'ah* principle of no risk-no-return would have to be strictly enforced. This would mean a structural change in the role of financial institutions. Five, the macro-economic management of the economy would also have to be in conformity with the Islamic principles to make Islamic financing a successful experiment.

PART ONE : EXISTING PRACTICE OF LONG TERM FINANCE IN PAKISTAN

Sources of Long Term Finance

The main sources of long term finance in Pakistan are as follows:

(1) Long term deposits with commercial banks and development finance institutions (DFIs)
(2) Saving schemes of the government
(3) Long term bonds floated by the government or public enterprises (like National Bonds, WAPDA bonds etc.)
(4) Foreign loans from such institutions as Asian Development Bank (ADB), World Bank, IMF, and Islamic Development Bank, etc.
(5) National Investment (Unit) Trust (NIT)
(6) Mutual funds floated by the Investment Corporation of Pakistan (ICP)

(7) Profit-Loss Sharing Investment scheme of ICP

The first sources are purely interest-bearing. Any proposal to reform long term finance must suggest measures to transform these sources of finance. The next one is to a large extent, interest-free because NIT invests most of its funds on an equity basis. However, NIT also channels part of its funds to interest-earning avenues. Therefore, some reform is needed in this institution as well. It is only. the last two schemes which are completely free of interest. The mutual funds are invested in shares of joint stock companies. The profit-loss sharing scheme provides for investment in equity of joint stock companies with a maximum limit of Rs. 30000 for an individual's funds with the maximum of one self and one joint account of the individual. The ICP provides counterpart funds to the extent of 150% of the saver's funds. The profit is distributed in the proportion of 60:40 between the saver and the ICP. However, loss is distributed in proportion to respective capitals. But the ICP has closed the scheme for future domestic savers. Only Pakistanis living abroad and willing to invest in foreign exchange can avail of it now. It is pertinent to mention that part of ICP operations are also based on interest. It invests its own funds on a mark-up basis as well.

Application of Long Term Finance

The main applications of long term finance are as follows:

- Equity investment in business, industry or agriculture
- Participatory Term Certificates (PTCs) as Islamic substitute for debentures
- Term Finance Certificates (TFCs), a form of financing on mark-up
- Leasing and Lease-purchase
- *Mudharabah* Certificates (MCs)
- Housing Finance

There are no two opinions about the legality of the equity investment in the Islamic framework. Therefore, we shall not discuss it any further.

Participatory Term Certificates

The Participatory Term Certificates (PTCs) were designed to replace interest-bearing redeemable finance. The PTCs were an innovation of the Islamic finance movement. It introduced the concept of redeemable long-term finance on the basis of profit-loss sharing. The concept operated in the following manner. An enterprise which desired to get long-term finance was required to float redeemable PTCs. The financiers (mostly banks and DFIs) would accept the PTCs for the finance provided by them. The enterprise would share profit or loss with the PTCs-holders on the basis of a pre-determined rate. The profit of loss was determined on a pro-rated basis for the equity capital and long-term finance obtained through PTCs. The mechanism of obtaining finance through PTCs has recently been discontinued as the financial institutions have not found it profitable. Moreover, they involved some risk for the financial institutions which the latter were unwilling to assume.

The PTCs were an attempt towards interest-free finance, although a number of their conditions were un-Islamic. For example, they provided a fixed return of 12% during the gestation period of the enterprise availing of the finance. Similarly, in case of loss they provided for allotment of equity shares of the enterprise to the bank equal to the loss instead of reducing the claim of the PTCs-holders. Another clause provided that the bank would refund or forgo the profit" to the client if it exceeded 17% of the principal sum, thus keeping the market rate of interest as a point of reference. Instead of reforming the- instrument on the Islamic pattern, the financial institutions have altogether abandoned it. They have, as we shall show below, moved towards the interest-bearing mode. of finance by adopting TFCs.

Term Finance Certificates (TFCs)

The TFCs are, financial instruments which have replaced the PTCs. The" TFCs. are issued by the client enterprises to obtain. finance from DFIs and banks on a mark up of 22% which is calculated by using the compound interest formula. However, the client gets a rebate of 6%-7% if it pays back the principal sum with the mark-up on the due date. Introduction of FCs in lieu of PTCs is a step in the reverse direction, so far as Islamic financing is concerned. There is no difference between this type of finance and debenture-finance on interest, except that it does not involve compounding of interest beyond the due date. In that sense, however, it is a less "efficient" mode of finance than debentures.

Leasing and *Mudharabah*

Leasing has recently become very popular in Pakistan. At the time of writing this paper there are *22 mudharabah* which are mainly engaged in the leasing business. Similarly, some companies have been registered as leasing companies. The leasing companies deal in providing finance for, equipment, plant, building, land and transport. Most of the leases are finance leases in which case the leasing companies provide finance to the client and receive it back with a mark-up known as rental. The asset in question remains the property of the lessor as a mortgage. The lessee assumes all the risks and costs of depreciation, disaster, obsolescence, idle capacity, decline in value, etc. When requesting for finance the lessee enters into an agreement with the lessor to accept the asset specified by the former.

The lessee does not have the option to refuse the article or to return it before the lease term. In this way, the lessor does not assume the "business risk" which a lessor of operating leases (such as houses etc) would assume. The lessor in the case of finance-lease extends finance for a specified period and takes it back with a pre-determined increment without assuming business or trade risk. In brief, the finance-lease it nothing but another form of financing on interest. However, some companies are also in the operating-lease business. In this case the lessor assumes all the risks which an owner of an asset has to bear in the normal course of leasing business. This type of lease is not very popular, however. Data are not available on the exact proportion of the types of leasing business but interviews with the executives of some of these companies revealed that they are doing mostly finance-leasing.

Housing Finance

Housing finance in Pakistan. is mainly provided by the House Building Finance Corporation (HBFC). The HBFC started providing finance on rent-sharing basis from July 1979. HBFC shared the notional rent of the house with the owner in proportion to its investment in the total cost of the house. The rents are assessed every three years in respect of all types of localities. Since more than 80% of the users of the funds built houses in localities where rents were comparatively low, the rent share of the HBFC has also been low. It was assessed that in 1987 the average rate of return' of the HBFC. was 4.8% while there was an arrears of Rs 10 billions. The rate of recovery was also very low. The HBFC got most of its funds from the government through State Bank of Pakistan at a 9% rate of mark-up. After studying the causes of the huge government deficits, foreign lenders started pressing the government to raise the cost of housing capital for the users so that the rate of return of the HBFC finance was in conformity with the market rate of interest. Yielding to international pressure the HBFC has, from 1988, revised its rent-sharing scheme, which was nearer to the Islamic framework. The revised scheme has divided the HBFC clients into four categories. Finance is now made available on a predetermined rate of return which has been calculated by taking into account the principal, the period, and expected inflation during the net ten years. There does not now remain any difference between interest-bearing finance and the present scheme of the HBFC. Its previous scheme had some shortcomings from the Islamic point of view. For example, the HBFC did not assume and responsibility if the house met a natural disaster. Similarly, its system of fines and penalties also needed some reform. Instead of reforming the scheme towards an Islamic pattern, it has chosen to adopt a purely interest-bearing system.

Reasons for Going Back to Interest-Bearing System

The above discussion shows that the financial institutions in Pakistan did make some moves towards Islamic finance during the first few years. But in a short period of five years they have regressed to the old practice of interest-bearing finance. What could be the reasons for it? I interviewed about a dozen very senior bankers to explore the reasons for this phenomenon. A summary of their replies is given below:

- The bankers are extremely worried about the safety of the depositors funds. They feel that at the prevailing standards of ethics and honesty, it is highly risky to extend finance on profit-sharing basis. They are afraid that their clients will depict losses or at least will suppress true profits in their accounts and as bankers they will not be able to effectively check this tendency. The confidence in the banks will erode and the whole financial structure will collapse. Therefore, they have adopted the safer course of providing finance on the basis of mark-up which is a disguised form of interest.
- The banks do not have any experience of operating in the public sector which requires different types of skills. They do not want to risk the depositors' funds by operating in a field they do not know. They are conscious that they are in the position of financial intermediary and they want to remain restricted to that without assuming additional risk.
- The cost of finance for the financial institutions is higher than the return they can get from the investors or if they have to arrange finance on interest they cannot give it on a profit-sharing basis. For example, HBFC gets finance on a flat mark-up of 9% from the State Bank of Pakistan. It could not afford to provide it to individuals on rent-sharing bases, when the average rate of return was less than 5%. Similarly, Pakistan Industrial Credit and Investment Corporation (PICIC) obtained funds from ADB, IBRD etc. on fixed interest. It could not risk its deployment on profit-sharing basis where the return was uncertain.

The above account of the reasons for a reversal towards interest-bearing finance points toward the direction of the proposal we are going to make in part two of the paper. In brief, there are two compulsions: first, the banks are financial intermediaries. They cannot get into real sector. This, by itself is not objectionable from the Islamic point of view. The Islamic position is that, in this case, the banks should also not expect a return of the finance provided by them. They should remain restricted to getting a fee for being financial intermediaries, which is a service. From the Islamic point of view, if the banks want to earn a profit they should have to assume the business risk, also. Since at that present moment of history they are unwilling to assume the risk of loss, for whatever reason, they, should limit their role to being agents of investors and savers for a fee or service charge and quit the role of lenders on interest. In fact, this is going to be one of our major proposals.

Second, the sources of finance carry a burden of interest which does not allow the bankers to re-lend that finance on a profit-loss sharing basis. It only suggests that all schemes of domestic investment which collect household savings for a fixed return must also be discontinued. This would require opening up alternate channels for household savings. We shall take up this question below in part two of the paper.

So far as foreign finance is concerned, for the future the government should accept funding on a profit-loss sharing basis only. This would mean a lot of hardship in the beginning. But there is no alternative to bold initiatives. Fortunately, the international financial climate is quite favorable to risk capital at this point in history. The debt crisis of Latin American countries has more than ever before, taught the international creditors to look for such solutions for the heavily-indebted countries that would reduce their debt servicing liabilities. The move towards debt-equity swaps is a clear indication of the fact that the world is willing to consider non-interest-bearing alternatives for international finance.

PART TWO : ISLAMIC INSTRUMENTS OF LONG TERM FINANCE

In this section we shall present our main proposal to reform the Islamic banking system in Pakistan. The section describes a set of new instruments which would have to be introduced and promoted to move further on the party of Islamization.

1. Common Stock (CS)

The common stock of joint stock companies is a perfectly Islamic instrument of finance. It does not need any discussion. We have mentioned it here to make the discussion comprehensive.

2. Participatory Term Certificates (PTCs)

The PTCs, a substitute for interest-bearing debentures were introduced in Pakistan to attract redeemable long-term finance on a profit-loss sharing basis. They have only recently been abandoned. They need to be revived with following modifications:

- There should not be any predetermined return on them during or after the gestation period. In fact, profit of an investment accrues after some period of time. Since the clients will not be paying any return during the gestation period the profit expected from them after commercial production starts will be higher because of the present investment and therefore the financial institutions will also get a higher return. In other words, the profit from the client, after the production starts, will incorporate the effect of this investment.
- The clients should not be allowed to redeem the PTCs before the due date. This is necessary to forestall the tendency to have free finance during the gestation period.
- The financial institution should not be expected to forego or refund any part of the profit which flows to it according to the terms of the PTCs. This will have the effect of increasing the income of the financial institutions. This proposal effectively discards the concept of using interest as a point of reference for return on PTCs.

- The PTCs should be made tradeable on the stock exchange. The idea is to develop a secondary market for these instruments. This will obviate the need for discounting and re-discounting of the PTCs.

3. *Mudharabah* Certificates (MC)

They are already being issued by *mudharabah* companies. They should continue in the following manner:

- The *mudharabah* companies should not concentrate on leasing business only. Instead, they should enter into all fields - trade, industry and agriculture.
- Those household savers and corporate entities, which have surplus funds should invest in these certificates.
- These certificates, as now, should be traded on the stock exchange.
- The *mudharabah* certificates should provide a major channel to attract household saving once the interest-bearing schemes are banned altogether. These certificates will get a return based on the actual business operations.

4. **Leasing Certificates (LC)**

This is a proposed instrument. It will have the following features:

- These certificates will be issued by those companies which want to acquire assets on lease. The banks or specialist financial institutions will institute a Leasing Mutual Fund where savers, with the clear understanding that their savings will be invested in leasing operations, will place their funds.
- These certificates will be traded on the stock exchange.
- The banks or specialist financial institutions will act as agents of the savers. As agents they will examine the potential ability of the lessees to pay the rentals. They will also manage the leased assets on behalf of the savers. When an asset is be returned by a lessee the banks will make arrangements to lease it to another lessee. Similarly, they will also arrange the purchase of leased assets for

leasing to the first lessee if it is so required by him. The banks will also arrange to dispose of the assets once they are returned by the lessees after their natural life. In brief, the banks will act as agents of the savers who will be the lessors.

- As lessors, the leasing certificate holders will assume all the risks which any lessor has to accept in this business.
- Since the banks will not be assuming any risk they will also not be entitled to any profit. All profit or loss will be passed on to the leasing certificate holders after the banks have deducted their agency commission. This commission will be a fixed sum to be paid once for each service. However, to keep the interest of the banks it can be stipulated that the banks will share in profit if it is over and above a certain threshold.

5. Instalment Sales Certificates (ISC)

The consumers need credit to purchase durable goods like motor cars, motor cycles, refrigerators, air-conditioners, and houses. Since the consumer items do not generate any profit or loss their financing poses a challenge. The following proposal is likely to present a solution to this problem.*

- The government should encourage investment of private capital in the production of durable assets, like houses, motor-cars, motor-cycles, refrigerators etc.
- Manufactures of durable or builders of houses should offer to sell their products on credit to consumers after satisfying themselves of the credit-worthiness of the consumer and after obtaining a suitable collateral. (To avoid a few people getting more than one facility on credit, a national-wide credit-rationing system will have to be instituted, more about which will be discussed in the next Part of the paper.)

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* For a short-comment on economic implication of this proposal, see part four of the paper (below).

- These products will be offered for sale on instalment at the same price as cash. This is essential to forestall the re-entry of interest in the economic system in a disguised form. At present, the difference in the cash price and the credit price of products sold on installments is mainly due to the interest charges on the capital involved.
- Most likely, it will have the effect of inducing everyone to try to obtain the asset on credit, if possible.
- The manufacturers will get a refinance facility from the central bank on profit-loss sharing basis. The customers will repay their installments to the sellers who will return the finance to the central bank along with profit or loss. Since it may be possible that the central bank cannot, possibly, deal directly with so many manufacturers, the banks can act as agents of the manufacturers. They will charge their agency commission for their services'.
- Since the refinance will be available on a profit-less sharing basis, it is possible that some saving societies(*) choose to provide finance to the manufacturers or developers of the housing estates on a profit-loss basis.
- Gradually, the manufacturers and developers of houses can resort to issuing of Instalment Sales Certificates which can be bought by the consumers' saving societies or commercial banks, if they have funds, or through a central bank.
- These certificates will be traded on the stock exchange. In the beginning, the central bank wall take the initiative to provide the re-finance.
- The Instalment Sales Certificates shall be redeemable by the manufacturers and developers of the houses after a stated period.

6. Mutual Funds Certificates

At present the Investment Corporation of Pakistan (TCP) is the only institution which issues mutual funds. There is a great need for encouraging the establishment of such investment banks which accept

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* Please see part three of the present paper (below).

deposits from the savers in the form of special or general purpose mutual funds. These funds can be instituted to provide finance to specialized sectors or for general purpose financing through PTCs, MCs, LCs or ISCs. Since the former saving schemes, saving bank accounts, fixed earning bonds and certificates will be banned, these mutual funds will be a great attraction for the savers. The money collected in these funds will be invested on the basis of equity or for leasing or for *mudharabah*. The mutual fund certificates will be traded on the stock exchange.

7. Investment Trusts

At present, the National Investment (Unit) Trust (NIT) is the only institution which accepts small savers' deposits and invests them on equity and interest-bearing business. The first proposal is that the investment on interest-bearing business should be stopped. But the other, and more important, proposal is that a large number of such investment trusts be established which collect saving from different sectors of society. At present the investment trusts may fix their selling and re-purchase price in the light of the value of their assets instead of leaving it to the stock exchange. We visualize that gradual specialization will take place in the area. There will be unit trusts which specialize in investment in certain specific sectors of the economy.

8. Profit-Loss Sharing Investment

Scheme Our proposal is as below:

- The ICP scheme of profit-loss sharing, which has been discontinued for domestic savers, should be revived. The scheme was discontinued by the ICP as it did not have enough counterpart funds. But once other saving schemes are banned, it is hoped that savers will have few other avenues to divest their savings and the ICP is then likely to have enough deposits to provide counterpart funds.

- The limit of Rs. 30,000 should be relaxed and people should be allowed to make investment to any limit. However, the profit-loss sharing can be made proportionate to respective capitals.
- Similarly, the counterpart funds can be made available in equal proportion.
- There is no reason why the profit loss sharing investment scheme funds should be restricted to the purchase of joint stock shares. These funds should also be made available for investment through other financial instruments.
- The ICP also accepts funds for investment in equity stock without providing counterpart funds. This arrangement can continue.

PART THREE : INSTITUTIONAL SUPPORT

The financial instruments proposed in part two of the paper cannot become operational until strong institutional support is provided to make them effective. Before we discuss the institutions, we should like to mention three prerequisites for the proposals made above.

PREREQUISITES

1. Political Will: There should be a strong political will to eliminate interest from the economy effectively. A lukewarm political attitude can do more harm than good.

2. Legal framework: A suitable legal framework will have to be devised to make various instruments operational. The legal framework will specify rights and obligations of all parties and prescribe penalties for violating the rules of the game. It will 'also provide for the setting up of special courts to adjudicate cases of disputes and defaults.

3. The benefits of profit-loss sharing and equity-based investments should be highlighted through the public media, educational institutions and mass contact by leaders. An environment conducive to a shift toward interest-free finance should be created to make the changeover a success. Training and education of personnel to those

working in financial institutions in the concept and practice of Islamic finance should be given a priority at the national level.

INSTITUTIONS

1. The Commercial Banks

The commercial banks will also have a changed role. They will accept deposits on current account for safe custody only. They may be allowed to charge a fee for providing this service. They will not accept savings for investment and lending except in those cases where the depositors agree to make them their agents or trustees for investing on their behalf.

The commercial banks will provide short term loans to their depositors on an interest-free basis. The limits of loans and the periods of loans can be regulated on the basis of average balances held by clients throughout the year. Moreover, the central bank can prescribe that a certain percentage of the demand deposits held by the banks will have to be set aside for giving loans on an interest-free short term basis. The commercial banks shall be allowed to invest their surplus funds in mutual funds, investment trust, *mudharabah* certificates, leasing certificates, and installment sales certificates if they feel confident of their liquidity. However, this activity of the commercial banks will be closely monitored by the central bank to safeguard the interest of the depositors. Since all this investment will be done by the banks of their own risk only they will be entitled to the entire profit and would be liable for the entire loss. In no case will the banks be allowed to invest these deposits in risky investments beyond the limit of their own equity capital.

The commercial banks will mainly provide agency services to various types of savers who want to invest their funds in real sector. They will supervise and monitor operations of various business on behalf of the savers. Besides, they will continue carrying out a number of other services in relation to remittance of funds, foreign exchange arbitrage, brokerage, etc which they are doing at present and which do not involve any interest related activities.

2. Investment Banks

The investment banks will replace the present day saving schemes, saving bank accounts, postal saving accounts, fixed return certificates and bonds issued by a large number of DFIs. The investment banks will collect household and corporate savings and act as agents or trustees to place those funds in the real sector. These banks, again, will be doing this business on behalf of the savers and would receive agency charges for various services they perform. At present the ICP and the NIT are examples of investment banks. A large number of such banks will have to be established in the public and private sector. Their number will have to be large because they will be mainly responsible for attracting household and corporate savings.

3. Mudharabah

The *mudharabah* law in Pakistan allows a company registered under the Companies Act to float *mudharabah* which could be special purpose as well as general purpose. Similarly, *mudharabah* can be terminal or perpetual. At present, most of the *mudharabah* are in the leasing business which is a very limited application of the concept of *mudharabah.*

Since our proposal visualizes abolition of all such channels where interest-bearing investment can be made, the demand for this type of business organizations will increase dramatically. *Mudharabah* will have to be encouraged in all sectors of the economy.

4. Stock Exchanges

Our proposal visualizes a number of new financial instruments which can be traded on stock exchange. At present there are only two stock exchanges in the country and the size of business is also very small. One reason is that the size of financing on interest-bearing basis is so overwhelmingly large and. the equity capital market is much smaller. As a result, the activity and the stock exchanges is also very limited. If necessary, more stock exchanges may have to be opened.

The regulation of stock exchanges and measures to forestall speculation are also necessary. We have discussed elsewhere an Islamic framework for the stock exchange [2].

5. Saving Societies

Another institution is the establishment of Saving Societies on a cooperative basis. A suitable legal framework and institutional support will be necessary from the government to encourage the organization of household Saving Societies. These societies will collect savings from individuals and small business firms and invest them in joint stock company shares, unit trusts, instalment sales certificates, *mudharabah* certificates and leasing certificates. These societies will not pay any interest on deposits. They would distribute the, profit or loss on the savings invested on behalf of the savers. Since the societies will be supervised by democratically elected savers and professional managers, their overheads will be lower. They will provide agency services on no-profit-no-loss basis to their members.

6. Corporate Law Authority (CLA)

There exists a Corporate Law Authority in the country. But our proposal visualizes the establishment and growth of the real sector companies on a large scale. This authority will have to be expanded with wider powers to inspect and order independent audits. The confidence of the people have to be won before going in for such major changes as visualized in this paper.

7. Islamic Audit Foundation (IAF)

Since the entire economy will now be governed on the general principle of profit-loss sharing, the possibility of accounting frauds, misrepresentations, non-disclosures etc. will also increase greatly.

There will be an urgent need to establish an independent Islamic Audit Foundation (IAF) responsible for issuing accounting and auditing standards which are in conformity with the Islamic law. The IAF should also appoint auditors on behalf of the savers and investors to carry on audits independently. The IAF will pay the audit fees for these audits which it will recover from the companies registered with it. The incentive for getting a registration of the IAF would be entitlement to finance from various specified sources. We have discussed this question in more detail elsewhere[3].

8. Al-Hisbah

Perhaps the need to revive the institution of al-Hisbah will never be greater than the time the present proposal is put into practice. The office of the *muhtasib* will undertake his traditional functions of supervision of markets, and forestalling of malpractices in various agencies suggested in this paper. It will be a supreme regulatory body to ensure that interest is effectively abolished from the economy and that it does not yet back through some back door. It will also be the last appellate authority for any malpractices carried out by an individual or an agency[4].

9. Independent Credit Rating Agency (ICRA)

An Independent Credit Rating Agency (ICRA) will have to be created to assess credit-worthiness of individuals, especially for consumer durables. This is essential to reduce the political influence of the financial sector. The ICRA would also issue credit ration cards for specified finance such as housing or the purchase of motor vehicles so that an individual does not avail of more than one facility within a specified period of time.

PART FOUR : SOME RELATED ISSUES

In this part we shall discuss some broader issues which have a deep impact on the success of the proposal made above.

1. Economic Implication of Consumer Durable Finance Proposal

At this stage, it seems pertinent to make a short comment on the economic implications of this proposal, although it deserves a full-scale analytical treatment, which is not within the scope of the present paper.

Once a durable assets market emerges which sells assets on installments at the same price as cash, in all likelihood, the incentives for buying in cash would decline considerably. Everyone would prefer to buy these assets on installments. One immediate consequence would be an abnormal increase in demand for these assets. This would open the door to all sorts of pressures and political influence. How to regulate this demand? In neoclassical theory, the rate of interest acts as a regulating device. At market rate of interest, the supply of and demand for loanable funds stabilizes. But in practice, this is hardly so. Firstly, there is no one unique market rate of interest. Secondly, even at the rate of interest on which banks lend money the demand for funds is always higher than the supply of funds, which is evident from the going rate of unemployment in the economy. At any rate of interest, there are always resources (human and physical) available which can be made productive but for the availability of funds. Therefore, the theoretical postulate that interest rates regulate the supply of and demand for loanable funds and creates economic equilibrium is not borne out by facts. But the question remains, how to regulate the increased demand for durable assets? The answer is that the State Bank of Pakistan can regulate it by using any or all of the following devices:

• Size of down payment.
• Number of installments.
• Frequency of installments.
• Size of collateral.
• Requirement for counter-part funds (esp. in case of houses) •
Fixing personal quotas for each individual.

It can be argued that the scheme can be misused. The answer is that the legal framework, monitoring and auditing controls will have to be strengthened to forestall its misuse. The possibility of misuse is not specific to the proposal. It is general to all arrangements.

Another implication of the scheme is that in all probability even those who have cash available for the purchase of assets would also be going in for instalment purchases. The question is: what will they do with their surplus cash? One possibility is that they would spend it on current consumption, especially the small savers, who always have a pent up demand for consumption to the extent that aggregate demand in the economy shall be pushed up, giving an impetus to greater investment and thus higher income levels. The other possibility is that these savers will put this money into a Unit Trusts or Leasing Certificates, or *mudharabah* Certificates etc. through Saving Societies or banks. To that extent this will ease the supply of funds for re-finance to the manufacturers of durables. What the actual pattern of behavior will be depends on the performance of the economy as a whole. It is possible that as things get settled down and the profitability to manufacturers of consumer durables is established, the initial spurt of consumerism will get channeled into various investment areas from where individual savers will get a return on their savings.

Another question is: since the cash price and credit price will be the same, it will stabilize at a level, where the manufacturers of consumer durables are able to earn a profit and give a share of this profit to the financial institutions providing finance. This level would, in all probability be higher than the cash price level. As a result, there may be a general price-hike in the economy. This fear is not realistic. The cash price in a system where finance is available on interest contains an element of interest which bids up the sale price. In a situation, where the price does not have an element of interest, the increase in price due to the manufacturers' expectation for a higher profit would compensate for the reduction in price due to absence of interest as an element of cost of production. In practice, the price in the proposed arrangement could be more or less than the effect of interest on price.

But then, we cannot make a firm comment at this stage of our knowledge.

The proposal is likely to attract another criticism: it will lead to a very high level of consumer indebtedness, which is not very desirable from an Islamic point of view. The answer is that we will have to educate people in Islamic consumer ethics to restrain this tendency. But the overall benefits of the proposal will have salutary effect on distribution of income. The consumer debt will be interest-free. It will lead to a better standard of living without the burden of interest, which channels wealth from the poor to the rich.

2. Public Debt

By end of 1989-90 Pakistan had accumulated a domestic debt of Rs. 328 billion and foreign debt of over $ 15 billion. The debt servicing consisted of Rs 59.5 billion which was 26% of the export receipts during 1988-89. It included about Rs. 40 billion as interest'.

Domestic Debt

We should like to make the following proposal. To effectively abolish interest from the economy the government must revoke all interest on domestic as well as foreign debt.* Such an action would be in strict conformity with the injunctions of the Qur'an. It would also be in line with the Sunnah of the Prophet (SAW) who abolished all outstanding interest on the day of the Last Pilgrimage. For the domestic debt taken by the government, it should own all principal sums and announce their conversion to the already invested government equity in public enterprises(6). For any left-over amounts the government should issue any of the financial instruments suggested in part two of the paper giving the' holders an entitlement to the profit-loss of various government businesses in the real sector. These

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* This is his personal opinion and does not necessarily reflect the views of IRTI/IDB.

instruments can be issued in installments according to the paying capacity of the government.

A related question is the inflation that has eroded the value of the money originally lent by a person to the government. It is highly injudicious, it can be argued, to return the principal sum after so many years. But this objection could have some validity if the loan had been an interest-free loan. The lenders had been receiving interest on their loans which, more or less, was equal or more than the inflation rate. In fact, such lenders are not losing anything.

The domestic outstanding debt which has been taken by big industrialists and politicians from nationalized banks be converted into equity. Where possible, suitable legal enactment should be made giving the debtor an option, either to return the debt in a lump sum or to issue common stocks or PTCs in favor of the banks, giving the banks an entitlement to share in profit or loss. In cases where the banks feel that the conversion of debt into equity would be risky as the borrowers' business may not have prospects of profit, the collateral with the bank should be encashed. Anyway, a case-to-case assessment will have to made for a suitable action. The objective should be to ensure that abolition of interest does not become a windfall gain for the already wealthy sector.

Foreign Debt

For foreign debt, a dialogue will have to be established with foreign lenders. The government should persuade the foreign lenders to convert the interest-bearing loans into equity, in cases the loans were taken to finance business or commercial ventures. However, the foreign loans taken for defence purposes or for such public sector projects which do not generate business profit will have to honored according to the contracts.

The question of development without foreign finance will also have to be raised. The subject requires a full scale treatment which this paper cannot afford. Suffice to say at this time that so long the domestic rate of savings is low, the need for foreign capital may remain. Moreover, it may not be possible to change the course of the economy in a sudden manner. Therefore the first effort should be to try to get venture capital on a profit-loss sharing basis.

The question whether foreign funding will be available on a profit-loss sharing basis in sufficient quantities to meet the demand for sustained economic growth, needs to be considered in the wider macro-economic perspective. The foreign capital will become available if the financiers are reasonably sure of its safety, proper use and profitability. This, in turn, depends on such exogenous factors as the "supply of entrepreneurship", managerial ability, political will, national commitment to growth, etc. Foreign capital on interest also does not become available if the financiers are not sure of the above factors. Therefore, if we want to attract foreign capital, major structural, cultural and macroeconomic changes would be necessary. The terms of finance, whether on an interest or a profit-sharing basis, would assume a secondary position, in that event. It is pertinent to mention here that once the government decides to contract future financing on a profit-loss sharing basis, it will have to introduce a major change in its economic management. For example, those public sector projects where user charges can be levied (like roads, bridges, canals etc.), foreign firms can be invited to participate on a build-own-operate-transfer (BOOT) basis. (In fact, the Government of Pakistan has already started inviting international firms to undertake projects on this basis). In case, the social objectives are required a limited level of subsidies can be introduced in user-charges. However, defence purchase, is perhaps, one such area where finance cannot become available on a profit-loss sharing basis. In this case, efforts will have to be made to avail of finance from other Muslim countries in return for certain other services that we may be able to offer such as training of their personnel in defence, science, nuclear technology and medicine. All these areas need to be explored further. This is not to argue that there are easy solutions to these problems. Efforts would be necessary on a number of fronts: economic political, diplomatic and social.

3. Public Financial Management

The public financial management in all developing countries including Pakistan is highly inefficient, bureaucratic, wasteful and ineffective. Corruption is rampant. Idle capacity and multiplication of resources in the public sector, empire-building at the cost of tax payer and unproductive conspicuous spending are the order of the day. All these practices need overhauling in the light of the Islamic norm of public spending. Some of the concrete suggestions are as below:

- Deficit financing should be phased out, at whatever cost.
- All public departments and agencies should frame their budgets which specify physical targets.
- All government departments should institute internal evaluation programs.
- The Auditor-General should be made responsible for reporting on the performance of the executive departments. . .
- Every department should publish an annual report specifying the savings in wasteful expenses.
- All domestic or foreign borrowing should be gradually stopped.

4. Macroeconomic Management

The macroeconomic management of the economy should focus on the following areas:

- All development plans should aim at developing the human beings of the country. Expenditure on health and education should be substantially increased.
- The tax structure should promote trade and industry.
- Monopolies should be controlled. An economic environment conducive to healthy competition should be increased.
- Development should take into account environmental and ecological needs of the society.

5. Credit Rationing

To avoid favoritism in credit, especially in consumer durables, the government should issue National credit cards to anyone who wants to avail of this facility. It should have a personalized number. Simultaneously, a computerized data base should be created which has an on-line reference facility with all those agencies which deal in consumers durable credit. At the time those who want to avail of such credit, tax payment records should be consulted before an interest-free loan is provided. The Independent Credit Rating Agency should be consulted before allowing interest-free credit to any one.

6. Accountability Mechanism

An effective system of accountability of all public servants needs to be instituted. A lot of lip service is being paid to this concept but hardly anything has been done to strengthen it. Some of the suggestions are as below:

- The citizens should be granted the right to examine those papers on which a certain decision affecting their entitlements has been made.
- The citizens should be granted the right to receive information on any changes in the laws, rules, and procedures. It should be the responsibility of the executive departments and agencies to inform their clients about the law.
- The office of the *muhtasib* which exists at the federal level for redress against administrative excesses should be opened at provincial as well as local levels.
- Public enquiries should be held against all those people who obviously live beyond their means and all ill-gotten wealth should be confiscated besides other penal measures.

There are some of the examples of the policies which will be necessary to abolish interest from the economy. Mere passing of laws will not help. Interest is an economic phenomenon and needs an economic solution.

PART FIVE : CONCLUDING REMARKS

The paper has briefly discussed the existing pattern of long term finance in Pakistan. It has been argued that by and large long term finance is still being made available on an interest basis. Conceptually, long term finance is one area where the concept of profit-loss sharing is most suitably applicable. But this has not happened in Pakistan despite all the lip service paid to Islamization. The reasons are, mainly, lack of political will, existence of an interest-bearing economy which had the effect of Gresham's law, nonavailability of interest-free finance from other countries, internal resistance from the banking community which is extremely skeptical of the whole concept of interest-free finance, and inadequate legal support. The proposal made in this paper seeks to establish the whole financial structure on a profit-loss sharing basis. It visualizes a new role for banks and financial institutions. They should restrict themselves to agency and other services for which they may get a fixed fee. The savers in the economy, who like to earn a return on their savings, should assume the risk as well. To facilitate this concept a number of financial instruments have been proposed. At the same time there is a need to establish such institutions which support the new system. Not only this, a host of policy measures and structural changes would be needed to effectively abolish interest within unIslamic community.

This is from me and Allah knows the best

ENDNOTES

1 In fact, this is being done even now. The State Bank of Pakistan provides re-finance @60% for Locally Manufactured Machinery credit. Our proposal only transforms the fixed interest into profit-loss sharing.

2 American Journal of Islamic Social Sciences, Herndon, (5:1), 1988, pp. 91-114.

3 Journal of Research in Islamic Economics, Jeddah (3:1), 1985, pp. 31-42.

4 For a detailed treatment, see the present writers' "al-Hisba and the Islamic Economy" in Ibn Taimiya, Public Duties in Islam, Leicester: The Islamic Foundation, 1982.

5 Annual Report of The State Bank of Pakistan, 1989-90, Karachi: SBP, 1990.

6 In fact, the ICP already has a State Enterprises Mutual Fund (SEMF). This fund can be enlarged to include all government investments in state enterprises. The holders of domestic debts may be issued SEMF certificates, where profit and loss from all state enterprises will be pooled. This will also allow a uniform rate of dividend to holders of these certificates. The certificates can be made tradeable on the stock exchange.

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9
FINANCING ECONOMIC DEVELOPMENT IN ISLAMIC ECONOMICS: ATTITUDE TOWARDS ISLAMIC FINANCE IN SMALL MANUFACTURING BUSINESSES IN SAUDI ARABIA

BANDAR AL HAJJAR*
AND
JOHN PRESLEY**

INTRODUCTION

There is a growing volume of literature in Islamic economics which argues that one of the major reasons for a failure to develop the economic potential of small firms in Islamic developing economies is the unwillingness to promote Islamic means of finance in the establishment and expansion of small firms.' This paper is an attempt to assess the attitude towards Islamic financial instruments in small manufacturing businesses in Saudi Arabia and therefore to ascertain whether their use would generate a greater demand for external funds for small business development.

In this study, attitudes to two major forms of Islamic finance were investigated - *musharakah* financing, or participation finance and *mudharabah* finance.[2] The former is a joint venture financial arrangement between two parties where both parties participate in the capital of the venture. Profits and losses from the venture are distributed according to a previously agreed proportion. In contrast *Mudharabah* finance is a contract between two parties where one party provides the capital for a joint venture and the second party provides

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managerial and entrepreneurial skills. Again profits are shared according to a proportion agreed in advance. Losses, if incurred, are the liability of the provider of capital; the *mudhareb* (entrepreneur) merely loses his expected share of profits and his efforts are foregone without remuneration.

Essentially the perceived advantage of such forms of finance for small businesses lies in the non-existence of high up-front borrowing costs which are said to reflect capital market imperfections in developing economies. High borrowing costs - in other words high interest charges which anticipate higher risks are not a feature of Islamic financial instruments; any return has to reflect the actual outcome of the projects and cannot be a guaranteed return on the capital provided.

THE MANUFACTURING SECTOR IN SAUDI ARABIA - THE BACKGROUND

The primary objective of industrial development in Saudi Arabia is to liberate the economy from its overwhelming dependence on crude oil as a main source of national income, in order for it to become a diversified industrial economy. The industrial strategy has two directions: first, to implement manufacturing projects in which the Kingdom has a comparative advantage, second, to develop industries which offer import substitution.

To achieve these objectives the Government has adopted two major strategies: first, it has established, -in collaboration with foreign companies, basic industries utilizing crude oil and natural gas and secondly, it has encouraged the private sector, through a wide range of incentives, to set up non-hydrocarbon related industries.

Accordingly, the structure of industry consists of oil-related industries which are owned by the Government and foreign companies and non-oil industries which comprise of factories regulated by the Ministry of Industry & Electricity, (entitled to obtain interest-free loans from the Saudi Industrial Development Fund (SIDF) in addition to other non-financial incentives) and factories and workshops regulated by the municipalities, having no access to financial and non-financial incentives.

The oil related industries tend to be large scale industries in which the Kingdom has comparative cost advantages resulting from reserves of crude oil and natural gas. - There is very little small business activity in this sector. In contrast most small manufacturing businesses are concentrated in the non-oil related industries.

Several measures were adopted by the Government during the 1950's and 1960's to encourage the domestic private sector and foreign investors to set up non-oil industries. These measures included, in particular, the issuing of the Regulation for the Protection and Encouragement of National Industries, the issuing of the Foreign Capital Investment Regulations in 1964, the issuing of Company Law in 1965 and the establishment of the Industrial Studies and Development Center in 1967.

Despite these measures obstacles existed which prevented the emergence of large scale non-oil industries until the mid-1970's. These included the absence of financial facilities necessary for the establishment of industrial projects, lack of raw materials, a skilled labor force and the necessary physical infrastructure and the preference of Saudi nationals to invest in property rather than in industrial projects; in addition, the domestic market, with a small population and low average income levels, worked against the expansion of non-oil industries. However, this gave small factories and workshops on opportunity to extend throughout the Kingdom, since their establishment required neither large amounts of capital nor highly skilled labor nor a large market place. Accordingly, businesses employing less than 10 persons accounted for 96.5 per cent of the total industrial concerns by 1971.[3]

The Government offered various financial and non-financial incentives in the mid-1970's to encourage the private sector to set up non-oil industrial projects producing import substitution goods directed mainly at the domestic market. These included food, beverages, dairy, chemical, metallic and non-metallic products. Government incentives included the provision of medium and long-term interest free loans of up to 50 per cent of the total cost of the project with a repayment holiday of between one and two years, exemption from custom duties on raw material and machinery used in production, preference of national products on government contracts, distribution of land in various industrial cities at nominal rent, subsidized prices for electricity and water and the imposition of tariffs on similar foreign products: the latter was possible given the ability of national factories to provide at least 70 per cent of the market demand.'

However, these incentives were confined to factories whose invested capital exceeded one million riyals and had an industrial license from the MIE. This increased the profitability of these factories and hence the contribution of internal funds as a source of finance.

The response of the private sector to these incentives is- shown in the number of factories and the contribution of the manufacturing sector to total GDP and to non-oil GDP. Table 1 indicates that the number of factories operating -in the Kingdom up to 1987, reached 2,016, covering all economic activities. Of these 31 per cent were small according to the definition adopted in this study (employing between 10 and 30 persons and their invested capital ranged between one and five million riyals).

Despite the industrial development which has taken place since the mid-1970's, small factories and workshops continue to play a dominant role in some industries. The census of private establishments conducted in 1976 and again in 1981 indicated that 92.8 per cent and 91.2 per cent respectively of industrial concerns employed less than 10 people.

TABLE 1

NUMBER OF FACTORIES BY ECONOMIC ACTIVITIES, EMPLOYMENT AND CAPITAL SIZE'

Economic Activity	Small Factories'		Total	Medium and' Large Factories	Total Factories	% of Small Factories in Total
	Saudi	Joint'				
Foodstuff Industry	88	11	99	280	397	26.0
Textiles and Ready Made Garment Industry	12	2	14	27	41	34.0
Leather Products Industry	-	-	-	4	4	
Wood Products Industry	15	5	20	46	66	30.3
Paper, Printing & Publishing Industry	45	2	47	74	121	38.8
Chemical Industry	50	13	63	237	300	21.0
Pottery, Chinaware, Glass & Ceramic	2	-	2	27	29	7.0
Building Materials Industry	164	3	167	263	430	38.8
Metal Industry	109	32	141	271	412	34.0
Other Industries	48	21	69	165	234	228
	533	89	622	1,394	2,016	30.9

Source: Ministry of Industry and Electricity, The List of National Factories Licensed Under the Statute of Protection and Encouragement of National Industries and Foreign Investment Code up to 1987.

1.. These factories are licensed under the Statute of Protection and Encouragement of National Industries and the Foreign Capital Investment Code.
2. Small factories are those whose invested capital ranges between one and five million riyal, and employ between 10 and 30 persons.
3 Medium and large-scale factories are those whose invested capital is more than five million and employ more than 30 persons.
4. With Saudi and foreign capital invested in company.

TABLE 2

NUMBER OF ESTABLISHMENTS BY ECONOMIC ACTIVITY AND EMPLOYMENT SIZE 1976-1981

	1.	2-4	5-9	10-19	20-49	50-99	100	Overall Total	Total 1-9 only	% of establishments employing less than 10 persons
Food, beverages & tobacco:										
1976	342	994	250	77	25	6	9	1,703	1,586	93.0
1981	445	1,121	339	149	69	22	26	2,171	1,905	87.7
Textile, Clothing & leather:										
1976	1,733	1,867	124	17	10	1	-	3,752	3,752	99.3
1981	2,142	4,846	923	93	12	3	2	8,021	7,911	98.6
Wood, wood products & furniture:										
1976	629	677	179	74	27	3	2	1,591	1,485	93.3
1981	372	831	507	214	48	9	4	1,985	1,710	86.1
Paper products & printing:										
1976	34	40	28	27	23	9	6	169	104	61.5
1981	143	174	116	100	47	13	15	608	433	72.2
Chemical, petroleum & plastic										
1976	578	376	63	21	19	5	8	1,070	1,070	95.0
1981	26	28	32	33	43	15	18	195	86	44.0
Bricks, blocks, cement & glass:										
1976	234	700	680	233	82	11	10	1,950	1,614	82.8
1981	146	942	817	371	371	130	47	2,500	1,905	76.2
Basic metal industries:										
1976	19	59	14	2	3	1	-	98	92	93.9
1981	19	95	46	19	12	2	4	197	160	81.2
Metal products, machinery:										
1976	664	917	342	136	59	13	6	2,137	1,923	90.0
1981	1,476	3,078	1,205	491	200	69	60	6,579	5,759	87.5
Other manufacturing industries:										
1976	298	239	44	11	5	-	-	597	581	97.3
1981	172	121	9	7	5	2	1	317	302	95.3
Total:										
1976	4,533	5,869	1,724	598	253	49	41	13,067	12,126	92.8
1981	4,941	11,236	3,994	1,477	566	182	177	22,573	20,171	89.4

Source: Kingdom of Saudi Arabia, Ministry of Finance and National Economy, Central Department of Statistics, Census of Private Establishment, 1401 AH (1981 AD), p. 109.

Many factors support and facilitate the continued existence of small factories and workshops. These include the market size, high transportation costs and frequent changes in the nature of products. The cost of transportation and the availability of raw materials throughout the Kingdom have defined the market size for products like blocks, bricks, tiles, marble and ready-mixed concrete. Table 2 shows that 76 per cent of factories producing building materials are small (employing less than 10 persons and their invested capital is less than one million riyals).

The products of some industries are subject to frequent changes due to the development in consumer tastes and preferences; small concerns are often more flexible in adjusting to these changes. Industries which exhibit this tendency are furniture, clothes and certain types of building materials.

During 1973-80, Saudi society was more exposed to a Western way of life especially with the inflow of expatriate labor. This, coupled with high purchasing power, brought about rapid change in taste and fashion. 34 per cent respectively of small factories and 98.6 per cent of workshops are engaged in manufacturing clothes, leather and textiles.

After 1982, the growth rate of the value added of the manufacturing sector started to decline. Indeed, until recent years its growth rate has been negative. This was due partly to the decline in government spending, completion of most infrastructure projects and the departure from Saudi Arabia of many foreigners, especially construction sector workers.

METHODOLOGY

Unfortunately there is no universally accepted definition of what constitutes a small business. The social and economic structure of each country differs and accordingly the definition of a small business in each country embraces different criteria, which best suit its structure. The relevant statistical data is not necessarily available in all countries and therefore definitions are often adopted within the constraints set by data availability. (Burn & Dewhurst 1986; Neck & Nelson 1977).

Consequently two approaches can be adopted in defining small businesses.' The first one stresses the distinctive differential features of small and large businesses in terms of such factors as management, ownership employment and market share. The second approach emphasizes the role of statistical criteria in forming the definition, and the range of each selected criteria determines the size of the business. These criteria include such variables as the number of employees, the annual turnover, profits, output and capital invested. Whether the definition is on a qualitative or quantitative basis, it must be applicable, unambiguous and appropriate for the purpose of any investigation. (Davies & Kelly 1972).

.In the case of the manufacturing sector in Saudi Arabia identification of small businesses by number of employees and level of invested capital is possible via official data.' For the purpose of this study, therefore, a small manufacturing business is defined as having less than. 30 employees and an invested capital of less than SR5M; this definition embraces manufacturing firms which are registered with the municipalities and with the Ministry of Industry & Electricity.

The investigation outlined in this paper was part of a much broader investigation of most small businesses in Saudi Arabia and with a much wider coverage of factors influencing small business development than managerial inefficiency. The methodology adopted, having identified small businesses in the manufacturing sector, was to produce an unbiased sample of small businesses and to conduct a pilot study based upon interviews; the results of these, in turn determined the nature of a more comprehensive questionnaire and interview study.

The main objectives of the pilot study were to 'establish a better understanding of the problems involved with small businesses in Saudi Arabia and to identify new, relevant factors judged to have a great bearing on small business development; to test the response of firms to certain questions developed with considerations as to the best approach to the conduct of interviews and also the most suitable ways of distributing and collecting questionnaires. As far as the authors are aware, this is the first survey undertaken of small businesses in Saudi Arabia.

Four major conclusions emerged from the pilot study:

i) It was apparent that lack of finance was only one factor limiting the development of small businesses.

ii) The lack of management sophistication appeared to limit not only the ability firstly to approach sources of institutional finance and secondly to secure that finance, but the general development of the business. It therefore gained much more importance than was originally intended in our broader study of small businesses in Saudi Arabia.

iii) The pilot survey revealed that accounts were not readily available in small businesses in Saudi Arabia. It was therefore impossible to conduct the kind of case study approach adopted in other developing countries, based upon accounting ratios. (Osaze 1981; Ahmed 1987). A more general approach was adopted based upon distributing a large number of questionnaires, accompanied by follow-up interviews.

iv) The nature of interview techniques was also determined by the pilot study. It was found that structured interviews were not suitable for the case of small businesses in Saudi Arabia. This is mainly due to the lack of, or limited, educational background of the majority of small business managers. As a result, an unstructured approach was used in interviewing managers which allowed for more flexibility and as little use of accounting and economic terminology as possible. Clearly the apparent ignorance of entrepreneurs in small businesses limited the sophistication of the questionnaire and interview approach in this study.

The major investigation of the questionnaire which followed the pilot study consisted of a questionnaire survey of 412 small firms within the manufacturing sector: of these 222, or 53.9 per cent were completed, collected and analyzed. The breakdown of these by product group is contained in Table 3.

THE SURVEY RESULTS

The attitudes towards *musharakah* finance appear in Table 4. Of the 211 respondents, 176 (83.4 per cent) rejected the possibility of shared ownership with the provider of finance, with only 35 (16.6 per cent) prepared to do so. Of the six manufacturing sectors considered rejection of *musharakah* never fell below 80 per cent in any sector, nor rose above 87.5 per cent so there was little sectoral variation in attitudes. Follow up interviews were able to ascertain why respondents were both positive and negative about *musharakah* financing. Those prepared to accept it did so on the grounds that the financier may also be able to offer much needed managerial or technical skills required in the business: others admitted to being under such financial pressure that they were prepared to take finance in whatever form it came whilst others saw *musharakah* finance as a means of assisting product diversification.

TABLE 3

THE MANUFACTURING SECTOR SAMPLE

Value	No. of Questionnaires Distributed	No. of Questionnaires Returned	% of T/D*	% of **R/S**** Sample
1	143	64	44.8	28.8
2	57	27	47.4	12.2
3	62	33	53.2	14.8
4	30	17	56.7	7.7
5	79	52	65.8	23.4
6	41	29	70.7	13.1
	412	222	53.9	100.0

Where:

1 = Building materials
2 = Aluminum products
3 = Wooden products
4 = Chemical products
5 = Iron products
6 = Others

$$*R/D = \frac{\text{Total questionnaires returned from each industrial class}}{\text{Total questionnaires distributed to each industrial class}}$$

$$**R/S = \frac{\text{Total questionnaires returned from each industrial class}}{\text{Total questionnaires collected and analyzed for all industrial classes}}$$

Of those rejecting *musharakah* finance the overwhelming majority (133 or 89 per cent) did so in order to remain sole owner(s) of the business and to be in a position to hand over the business at a later date to their heir(s). 10 per cent felt that new part owners would want too much authority in the management of the business. A significant number failed to provide a reason for rejection, but certainly one strong notion in the context of Saudi Arabia, is the need for the true owner of the business to remain anonymous. All businesses should operate under Saudi ownership, but the questionnaire revealed that in many cases must be collected a "kafil" arrangement exists where a Saudi national has the appearance of being the owner in order to disguise the true identity of the real owner who is non-Saudi. Any *musharakah* arrangement would bring with it the fear of exposing the illegality of the business. Interviews also revealed that were aware of the need to supply financial and non-financial information in order to gain Islamic financing. Most indicated that they were not in a position to be able to do this.

A further aspect of Islamic finance tested was the attitude towards different types of financiers.

TABLE 4.

CROSSTABULATION RESPONDENTS' OPINION ABOUT *MUSHARAKAH* BY TYPE OF INDUSTRY

COUNT ROW PCT COL PCT TOT PCT	**Building Materials** 1	**Aluminum Products** 2	**Wooden Products** 3	**Chemical Products** 4	**Iron Products** 5	**Others** 6	**Row Total**
Prepared to accept *Musharakah* arrangement	9.0 25.7 15.0 4.3	5.0 14.3 19.2 24	4.0 11.4 12.5 1.9	20 5.7 10.0 0.9	10.0 28.6 20.0 4.7	5.0 14.3 17.2 24	35.0 16.6
Not prepared to accept *Musharakah* arrangement	51.0 29.0 85.0 24.2	21.0 11.9 80.8 10.0	28.0 15.9 87.5 13.3	120 6.8 85.7 5.7	40.0 227 80.0 19.0	24.0 13.6 82.8 11.4	176.0 83.4
Column Total	60.0 28.4	26.0 123	320 15.3	14.0 6.6	50.0 23.7	29.0 13.7	211.0 100.0

Number of missing **observations** = 11

TABLE 5

POTENTIAL INVESTORS PREFERRED BY THE RESPONDENTS

Type of Respondent	Frequency	Percent	Valid Percent	Cum Percent
1	29	13.1	22.7	22.7
2	17	7-7	13.3	36.0
3	17	7.7	13-3	49.3
4	39	17.6	30-4	79.7
5	26	11-6	20-3	100.0
0	94	42-3	Missing	
	222	100-0	100.0	

Where:

1. Friends 2. Relatives 3. Commercial banks 4. Islamic banks 5. National company 0. No. Answer

TABLE 6

CROSSTABULATION RESPONDENTS' OPINION ABOUT *MUDHARABAH* BY TYPE OF INDUSTRY

COUNT ROW PCT COL PCT T0T PCT	Building Materials 1	Aluminum Products 2	**Wooden Products** 3	Chemical Products 4	**Iron Products** 5	Others 6	Row Total
Acceptance of *Mudharabah*	7.0 19.4 15.2 4.3	8.0 222 24.2 4.9	9.0 25.0 45.0 5.5	2.0 5.6 15.4 1.2	7.0 19.4 20.6 4.3	3.0 8.3 17.6 1.8	36.0 22.1
Rejection of *Mudharabah*	39.0 30.7 **84.8** 23.9	25.0 19.7 75.8 15.3	11.0 8.7 55.0 6.7	11.0 8.7 **84.6** 6.7	27.0 21.3 **79.4** **16.6**	14.0 11.0 **824** **8.6**	127.0 77.9
Column Total	46.0 28.2	33.0 20.2	20.0 123	13.0 8.0	34.0 20.9	17.0 10.4	163.0 100.00

Number of missing observations = 59

Of the respondents (128), 36 per cent more preferred to share business ownership with a friend or relative than with a financial institution or national company. Interviews confirmed that this was due to the simplicity and informality which might attach to such a financier compared to the requirements, for example, of bank borrowing where financial records and/or business plans might be required before share capital is provided. In contrasts only 13 per cent would prefer to share ownership with a commercial bank. Interviews concluded that this was primarily because such banks were seen to be charging interest on other accounts and therefore for religious reasons should be avoided. Despite this response however it is noticeable that Islamic banks were not overwhelmingly popular 'as financial sources, only 26 per cent preferred than as first choice financiers.

The traditional formula for *mudharabah* lies in the willingness of one party to provide capital whilst the other provides labor and experience. Profits generated from the partnership are divided between these two parties according to a predetermined percentage. If losses occur, the provider of the capital alone incurs them, whilst the provider of labor and experience loses his efforts only.

As Table 6 indicates, 78 per cent of respondents would not be prepared to enter into *a mudharabah* financing arrangement. Of these approximately two-thirds argued that their rejection stemmed from a fear that the financier would eventually take over the business. The partnership could be dissolved and the investor could replace the "manager" under the *mudharabah* arrangement: as a consequence *musharakah* was more popular than *mudharabah* financing. 30. per cent of respondents also indicated that their reluctance to accept *mudharabah* was due in large part to the possibility of management interference that it might entail. Many examples of potential interference were identified in interviews with owners objecting to interference in the manner in which final products would be sold, in how raw materials could be bought, where business could be located, who could be employed and how products could be marketed.

CONCLUSION

In relation to the finance of small, manufacturing businesses in Saudi Arabia, the evidence here indicates that the two Islamic financial instruments tested here, *musharakah* and *mudharabah,* could not be relied upon entirely to finance business development in its various forms. They may, given current attitudes towards Islamic Finance in Saudi Arabia, offer another source of funds alongside other financial sources, and in this sense would complement the availability of finance and speed small business development. If they are to make a more significant contribution to small business finance there must be a major educational process undertaken to generate a change in attitude towards Islamic Finance of the type tested here; otherwise Islamic financiers must seek out alternative financial instruments to more strongly complement *musharakah* and *mudharabah* in Saudi Arabia.

Equally significant is the need for improving the provision of both financial and non-financial information in small businesses through education and training. This is essential both for the success, of small businesses and Islamic financial institutions; without it the efficiency of decision making is greatly undermined and unproductive investment may well result.

FOOTNOTES

See, for example, J.R. Presley (e) Directory of Islamic Financial Institutions, Croom Helm, 1988.

2. This is part of a much larger study of "Small Business Development in Saudi Arabia".

3. Central Dept of Statistics, Statistical Year Book, 1390 A.H. Ministry of Finance, Saudi Arabia.

4. Saudi Consultancy House, A Guide of Industrial Development, 7th Ed., Riyadh.

5. For more details about the inconsistency in international statistics about small firms, see Burns P & Dewhurst J. (eds.) Small Business in Europe (1986). Macmillan Educational Ltd: Also see Enterprise Development: Policies and Programs, International Labor Organization (1977). For more details about the economic and statistical definition of small businesses, also see Bolton Report: Report of the Committee of Inquiry on Small Firms, Cmnd 4811, London HMSO 1971. For more details about the statistical definition of small businesses in some developing countries, see Stalev E & Morse R. Moders Small Industry for Developing Countries, McGraw-Hill, New York, 1965.

6. For a more detailed explanation of how random samples were obtained, please contact either of the authors and also see Appendix 1.

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Appendix I

SAMPLE METHOD: MANUFACTURING SECTOR

Having determined what constitute small businesses, the next step is to identify the names and addresses of workshops and factories which fall within our definition. In other words, to seek statistical data from government departments which would classify the size of concerns according to the measures mentioned in the previous section.

The Related Government Departments

1. The Ministry of Industry and Electricity issues a list of licensed factories in production under the National Protection and Encouragement Law and Foreign Capital Investment Law up to 1987.

   The list contains the following information:

   - Names and addresses of firms
   - Type of manufactured products
   - Annual production capacity
   - Total invested capital
   - Number of employees
   - Date of license approval
   - Foreign capital share and nationality

   The information included in the list only partially serves the purpose of this study since the list does not contain data on financial measures such as annual turnover, sales and profits and, secondly, it only covers those factories whose invested capital exceeded one million Saudi riyal.

2. The Commercial Registration Department at the Ministry of Commerce should keep a list of small factories and workshops capitalised below one million riyals, since they are obliged to be recorded under Commercial Registration Law. Unfortunately,

despite their fully . computerized system, the Commercial Registration Department have, to date, not produced such a list or directory. The Department considers that the task of organizing and classifying this information is the responsibility of the Ministry of Industry and Local Municipalities since these concerns are involved in industrial rather than commercial activities.

3. Local municipalities are the only official department responsible for issuing licenses/permits for workshops, handicraft and small factories which are not subject to the industrial license system. They record, in the form of raw data, the name, address and type of manufacturing activity of all concerns which have been granted a license. However, the records are not yet organized in a manner which would assist this study.

4. The Central Department of Statistics (CDS) has conducted four surveys of private establishments operating in different economic sectors. The first census was in 1967 and covered 25 cities; the second and third censuses were in 1971 and 1976 and both covered 61 cities; the second and third census were in 1971 and 1976 and both covered 61 cities. The fourth census, in 1981, was the most comprehensive and covered 111 cities and towns.

   The CDS published a summary of the results of the 1971, 1976 and 1981 censuses. However, information, including names and addresses of concerns which participated in these surveys are considered to be confidential by the CDS and are not available to this study.

5. The Chambers of Commerce are well equipped with qualified staff and technology. They produce a computerized list which contains names and addresses of industrial establishments classified according to the number of employees and the size of capital invested. This list is useful, though it is confined to Chambers of Commerce and Industry members.

6. The Domestic Economy Department at the Ministry of Finance and National Economy has produced a very valuable list which is part of a survey study of the national factories in production up to 1985. The list contains the following information:

- Names, addresses and telephone number of industrial establishments.
- Types of products produced by each factory.
- The year production commenced.
- License number and its source.
- Total capital invested and the share of the foreign partner. - Number of employees and their nationalities.
- Value and classification of raw materials used in producing the intermediate or final products.

The list covers 10 manufacturing sectors including chemicals, engineering, iron and steel, building materials, wooden products, paper textile, leather and other industries.

Moreover, the list contains 165 concerns capitalised below one million riyals, 416 concerns with invested capital ranging between one million and five million riyals, and 393 factories with invested capital of more than five million riyal (see Table 7.8).

It is useful for the purpose of this investigation to consider two samples. The first sample represents factories and workshops whose total invested capital is less than one million riyals and employ less than 10 people; the second sample represents factories whose total invested capital ranges between one and five million riyals, and employ between 10 and 30 employees.

The main reasons for adopting two samples is to stress the extent to which the smaller concern has access to external sources of finance in contrast to the slightly larger business. Members of the second sample are entitled to obtain an industrial license from the Ministry of Industry and Electricity, which enables them to obtain long and medium interest free loans up to 50 per cent of the total cost of the project from the Saudi Industrial Development Fund (SIDF). This, in turn, paves the way for them to obtain financial facilities from commercial banks and other external sources of finance. Members of the first sample are not subject to industrial license regulations and this deprives them of access to the financial facilities provided by SIDF. Hence it is more difficult for them to secure loans or other financial facilities from commercial banks.

The first sample was drawn from the lists prepared by the Ministry of Finance and National Economy, and that. of the Chambers of Commerce. The second sample was drawn mainly from the list of licensed factories in production issued under the National Protection and Encouragement Law and Foreign Capital Investment Law up to 1987 and the list prepared by the Ministry of Finance.

10

SOME CONSIDERATION ON THE SIZE OF THE PUBLIC SECTOR IN THE ISLAMIC REPUBLIC OF IRAN

IRAJ TOUTOUNCHIAN*

INTRODUCTION

It has always been instructive, on efficiency and equity grounds, to ask about the size of the public sector. So much so when the growth in size is unavoidable i.e. when a country goes through drastic changes such as revolution and war. The new Iranian constitution, with regard to the economic activities of government, has somehow, changed in comparison with the old one. In the new constitution additional responsibilities has been assumed for the government but none of the previously assigned responsibilities have been eliminated.

The paper addresses itself to the above question and seeks answer to see whether this past trend will persistently show up in the future or if there are reasons to believe that past growth was temporary and transitory?

Less than two years after the Islamic revolution in Iran, the country engaged in an unwanted war with Iraq. Quite expectedly the government in response to the expectation of the general public for protection against resulting shortages and rising prices, intervened in some areas of economic activity. This intervention went beyond the scope outlined in the constitution.

On the basis of statistics provided in this paper, as the war continued, the government increased its intervention in the economy. However, after the end of the war, the government tried, in response

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to escalating economic problems such as unemployment and inflation to limit its involvement in economic affairs.

This paper is composed of three parts and an introduction. In the introduction, different measures, conventionally used to evaluate the size of the public sector will be discussed. In the first part, the Iranian government, by using different measures introduced in introduction, will be measured. The period of analysis basically includes (six years after the revolution) one year before the revolution and bearing in mind that an Islamic state assumes greater social responsibilities than a capitalistic state, the year before the war has been chosen as the base year. In the second part, reasons for government interventions in an environment distant from perfect competition will be analytically discussed. Finally, in the last part of the paper, the Islamic duties of the Iranian government will be viewed in the light of the new constitution, in an effort to find a measure for the "optimum" size of the government.

SIZE OF GOVERNMENT

Although it is a common practice to measure the size of government by the size of the public expenditure and taxation, what needs to be answered is what set of transactions is to be considered as being that of the public sector. Government might intervene and as a result limit the activities of the private sector by providing goods and services directly or by redistributing incomes. Both of these activities will be reflected in the budget as increases in government expenditure,but each may have different impacts on economic behavior.

. Public expenditure and taxation do not exhaust ways that government intervenes in economic activities; private sector activities can also be regulated with almost every law passed. In such cases, if government expenditure is used as the measure of the size of the public sector, the degree of government intervention would be underestimated since regulatory activities do not drastically increase public expenditure except for expenditure on bureaucratic activity. Hence, there exist the difficulty of measuring government activity.

Economists, in general, have come to the conclusion that any measure of the size of the government is arbitrary.

. Size of government, measured by the public expenditure, is not an absolute concept but rather a relative concept. It has to be set alongside the size of the whole economy. When population, total output, personal incomes and prices increase so will, in response to the increasing needs of the people, the public expenditure. The interest lies in the relative rates of increase rather than their absolute increase. Such relativity is usually measured by comparing public expenditure with national aggregates.

There are a number of national aggregates that public expenditure can be compared with. In Table 1 below you will find four such measures:

TABLE 1

ALTERNATIVE MEASURES'

1.	The ratio of public expenditure to GDP (at factor costs)
2.	The ratio of public expenditure to GDP (at market prices)
3.	The ratio of public expenditure to GNP (at factor costs)
4.	The ratio of public expenditure to national income, i.e. net national product (at factor costs)

Each one of the above-mentioned measures has its own merits and demerits. Not all measures have the same sensitivity with regard to the factor. chosen. For example, the errors in estimating capital consumption, in using "national income" measures are likely to be greater than .the errors in -the measurement of "gross product' so that variations in the ratio will be sensitive to the- precise method used to calculate capital consumption. The same argument applies to the choice between market price and factor cost measures. Variations'in the ratio will be sensitive to- variations in the mix of direct taxes, indirect taxes and subsidies. This means that if ratio (2) is to be used to show changes in the relative size of the public sector over time to compare the sizes of the' public sectors in different countries, the conclusions that can be drawn are clouded because the ratio will. not only be an indicator of the relative size of the public sector, it will also reflect. variations in the structure of public sector revenues. The following example illustrates the point:

For example; Two countries A and B each spend 100 units on public expenditure. Each of these two countries have gross domestic products, measured at factor cost, equal to 200 units. Country A finances its public expenditure from the following mix of taxes: 10 units from direct taxes and 90 units from indirect taxes. Country B finances its public expenditure from the following mix of taxes:, 90 units from direct taxes and 10 units from indirect taxes. Subsides in country A=20 units and in country 13=30 units.For country A, GDP (market price) = GDP (factor cost) + indirect taxes - subsidies = 200+90 - 20 = 270, for country B; GDP (market prices) = 200 + 10 - 30 = 180.

In Table 2 the alternative measures of the public sector in the two countries are shown. While the absolute sizes of the public sector in this example are identical, and while their relative sizes are identical when using the factor cost measure of GDP, their relative sizes differ when suing the market price measure. The difference lies, in the instance, in variations in the tax structure and not because of variations on the public expenditure side.

TABLE 2

ALTERNATIVE MEASURES OF THE PUBLIC EXPENDITURE

Ratio of Tax Revenues to	Country A	Country B
1. GDP (factor cost)	50	50
2. GDP (market prices)	37	56

One should note that the conclusion derived from this example depends on the degree of shifting the tax incidence. In other words, the underlying assumption here is that both indirect taxes and subsidies will be 100% shifted upward, which is of course a strong assumption.

It would seem that GDP measured at factor cost,however arbitrary, is the most appropriate measure; Although the factor cost measures of GDP will be biased and the measures of the relative size of the public sector will be subjected to error. The lessons that should be drawn are that the appropriate use of any measure requires an understanding of the conceptual basis of the data as well as its sources and that there is no such thing as a "true" measure of the size of government. One of the reasons might be that the size of the public sector varies from one country to another because some include , public corporations, nationalized industries and other quasi-government organizations while other countries do not. That is why some organizations such as OECD use a standard set of national income definitions when making international comparisons.

In a survey of a selection of OECD countries, taxes as a proportion of GNP, of the years 1965-75, reveal useful facts.[2] In 1975, the percentage ranged from a high of 50 per cent in Sweden to a low of 20.4 per cent in Turkey, with the U.K., some where in the middle at 38..2 percent.[3]

Capitalism has a long and diversified history, therefore, having properly defined and established one single measure, however arbitrary, for one capitalistic state, it can be properly used for another capitalist state.But in the case of an Islamic state the problem is that no such measure has ever been introduced. This paper does not claim to have established a unique measure (or measures) to be suitably used by all Islamic states. It is the task of all Muslim economists on the basis of the additional functions and responsibilities of an Islamic state in comparison with a Capitalistic state, establish appropriate measure(s).

PART ONE : THE SIZE OF THE IRANIAN GOVERNMENT BEFORE AND AFTER REVOLUTION

In this section different measures as outlined above have been used to measure the size of the Iranian government at two different time periods, i.e. before and after the revolution; each of which resembling its own ideology.

In Table 3 below, you will find alternative criterion used to measure the size of the government of the Islamic Republic of Iran (for brevity, hereafter, IRI will be sued wherever appropriate).

TABLE 3

ALTERNATIVE MEASURES OF THE SIZE OF THE GOVERNMENT OF THE IRI

Year / Ratio of Government Expenditure to	1977	1981	1982	1983	1984	1985	1986
1. GDP (factor cost)	26	32	29	26	23	21	20
2. GDP (market prices)	25	31	29	25	22	20	20
3. GNP (factor cost)	24	32	29	26	23	21	20
4. NNP (factor cost)	28	34	31	29	25	22	22

Source: Calculated ont he basis of the data provided by Department of National Income Accounting; Central Bank of Iran and Ministry of Economic Affairs and Finance-

With respect to the years selected and the time period chosen in this paper some caveats are in order: 1) The year 1977 (corresponding to 1356 of the Iranian calendar) has been used as the base year with which other ratios for the corresponding year can be compared. The reason 1977 has been selected as the base year is that during that year three major economic activities (namely, Agriculture Ministries and Mines, and Services) had been operating at almost full capacity.4 2) Although the revolution happened on 11th February 1979 the data for the two preceding years have not been, due to the turbulent state of affairs in the economy, reliable. 3) Unavailability of a uniform data to make comparisons easy did not allow me to present them here.

The numbers in the table 3 reveal the following results:

(1) The range of numbers starts from 20 per cent and goes to the highest value of 32 in all years covered, which is a mild increase in the size of Government. However, the highest ratio was observed in 1981 which not only does not keep its time trend in the following years but also declines to its minimum value in the last year of coverage, i.e. 1986.

(2) The maximum and the minimum values of all four ratios occur, without exception, in 1981 and 1986, respectively. Emphatically, all four ratios in 1986 are below the corresponding ratios in the base year. Having accepted the four measures as being appropriate and sound measures, this result might be used as an evidence of a relative decline in the size of the government of the IRI during the ten years under consideration.

Granted that government expenditures,by and large, increase the welfare, of, the community, the decline in the ratios means decline in welfare due to the war. Obviously, those who suffer the most will be the low income receivers. The picture gets worse especially when one notes that 35 million inhabitants in the IRI increased to almost 50 (actually, 49.5) millions. In other words, per capita government expenditures, at current prices,had, during the said, period, drastically declined. The picture would look even worse if per capita real expenditure is used as standard.

(3) Heavy dependency of the economy of the IRI on oil revenues shows itself in 1983 and 1986. Full fluctuations in oil revenues are reflected in the size of government expenditure in these tow years. In 1983 the economy enjoyed the highest oil revenue ever since the revolution. In that year, the first two values remain constant, relative to those in the base year. But the last two measures show slight increases in comparison with the corresponding figures in 1977. In 1986, a sharp decline in oil revenues, caused a corresponding decline in government expenditure to such an extent that almost all figures reach their minimum values in this year.

During 1980-85 inclusive, oil revenues account for over 50 per cent of the total revenues (see Table 4). This fact has made the country quite vulnerable and as the result severe action had to be taken to reduce the degree of dependency. The degree of dependency will increase if government should decide to devalue the local currency. More will be said in this regard in the following sections.

(4) None of the four measures show any significant difference in one specific year. The range of values of the table for seven years of coverage can be summarized, respectively, as follows: (24, 28); (31, 34); (29,31); (25,29); (22,25); (20,22); and (20,22).

The narrow range of these values show as if an organization had been responsible to have close eye on these numbers not to allow them to go beyond a narrow limit. Comparing the second and the last ratios' in one specific year shows that the highest increase took place in 1986, i.e. an increase of 10 per cent.[6] The corresponding values for a country like England in 1980, are, 50 and 62 per cent respectively, i.e. an increase of 25 per cent. More will be said on this point when the procedure for budgeting is briefly mentioned.

TABLE 4

GOVERNMENT REVENUES

Unit: Billion Riyals

Year / Source of Revenue	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990•
1- Export of oil and gas	889	1056	1690	1779	1373	1189	417	766	668	763	1090
2. Other than oil and gas	543	868	1012	1217	1620	1780	1159	1748	1832	2619	3427
3- Taxes	340	554	614	797	899	1034	1025	1030	986	1031	1930
4- Non-taxes	202	314	398	420	721	846	575	718	846	1588	1797
Total	1431	1924	2701	2996	2993	2969	2016	2514	2500	3382	4517

* Figures are forecasts not actual-
Source: Calculated from the data provided by the Ministry of Economics Affairs and Finance; **Deputy** Ministries of **Expenditure and Tax Revenue**

COMPOSITION OF PUBLIC REVENUES AND EXPENDITURES

A) Public Revenues

. In this section four other tables have been provided. The first two tables show the sources of government revenues and the remaining two tables show the government expenditures. Table 4 shows four different sources of revenues from 1980 to 1990. Although a mild decline in total revenues was observed in 1984 and 1985 relative to those in the preceding years, the decline in 1986 was quite sharp, i.e. over 30 per cent.

Revenues from the export of oil and gas show a relatively small decline in 1984 and 1985 compared to those in the preceding years.But a drastic decline of 65 per cent occurred in 1986. As noted earlier, the evidence of heavy dependency on one revenue source is shown in the first six years where, oil and gas revenues accounted for 54 per cent of the total revenues. It should be noted that the formal exchange rate is $1=Riyals 70 i.e., all revenues earned from the export of oil and gas are multiplied by 70. But inflation has ceased to allow the formal exchange rate to play its role. If government should decide to devalue the local currency, the degree of reliance on one revenue source will increase. For example, in. 1987, oil and gas revenues amounted to over 10 billion U.S. dollars. If effective exchange rate should be $ 1= Riyals 500 (in the current year the black market rate has been over Riyals 1300) then, ceteris paribus, total revenues would increase to 2719 billion riyals. Consequently, the ratio-of oil and gas revenues calculated at the new exchange rate (which would amount to 5471 Billion Riyals) to total revenue of 7219 billion, Riyals -would go up to 75 per cent compared to the actual rate of 30 per cent.

Tax revenues exhibit an increase in all years covered except for two years of 1986 and 1988. Tax collections has almost doubled in size compared to 1981. There are. three reasons for such an increase. Firstly, considerable ware expenditures forced the government to put strict controls over the foreign exchange revenues and hence investment expenditures declined drastically. Therefore, capital stocks were allowed to depreciate to their minimum level. The book values of the already existing stocks had been quite low, consequently depreciation expenses were minimal. However, due to high inflation rates, the replacement costs of capital stocks compared to their book values was quite high. Secondly, inflation caused revenues to increase. Granted that, during inflation, the rate of increase in other expenses such as wages and salaries, customarily, lag behind the rate of inflation, the two factors were partially responsible for the rise in profits and hence an increase in tax revenues collected from corporate profits. Thirdly, on equity grounds, government tried to collect more taxes from occupational incomes on the belief that they had enjoyed windfall profits during the inflationary period.

Table 4 shows that tax revenues did not exceed more than 50 per cent of the government's revenues during the period of coverage. The highest ratio occurred in 1986 which accounted for 50 per cent of total revenue and the lowest ratio is identified in 1982. Although, since the revolution, the greatest fall in oil and gas revenues bills in 1986, tax revenues partially compensated the fall. Again, during the period under consideration the IRI had the highest revenues, from the export of oil and gas, in 1983. It reached the highest ratio of 59 per cent relative to the total government revenues. But, in this year the ratio of income taxes to total government revenues was the lowest at 27 per cent relative to total revenues. Putting these facts together we can conclude that tax revenues are the most reliable source of the revenue to the IRI. Revenues received from the export of oil and gas are liable to external shocks and drastic fluctuations in price and hence represent an unreliable source of revenue.

TABLE 5

DIRECT AND INDIRECT TAX REVENUES

Unit Billion Riyal

Year Source and Ratio	1977	1988	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Direct Taxes	231	270	229	129	327	296	331	405	528	579	612	646
Indirect Taxes*	213	197	140	211	227	318	464	503	505	446	418	340
Total Taxes	444	467	369	340	554	614	795	908	1033	1025	1030	989
Ratio of Direct to Total Taxes	52	58	62	58	58	48	42	45	51	56	59	65
Ratio of Indirect to Total Taxes	48	42	38	62	42	52	58	55	49	44	41	35

Source: High Council of Taxation; Ministry of Economic Affairs and Finance (1989)

* Close to 100 per cent of indirect taxes is composed of import taxes- Other indirect taxes are negligible.

To embark on the policy implication of the point made above, we need further information. Table 5 is provided to furnish us with the necessary information about direct and indirect taxes for the period 1977-88 inclusive. The growth of indirect taxes, quite expectedly, parallels oil and gas revenues because of higher incentive led to increased imports. As a result one can see the maximum value of oil and gas revenues in 1983 (Table 4) which coincides with the highest ratio of indirect taxes to total tax revenues of 58 per cent.

Speaking of reliable source of government income, after a peak in oil and gas revenues in 1983, (see Table 5), the government of the IRI put more emphasis on collecting (direct) taxes to finance development expenditures. This amounts to saying that after 1983 the revenue from oil and gas lost its importance. This tendency is still in full force. In other words, the lesson from past experience, namely unpredictable oil revenues, has changed the attitudes of government authorities towards heavy reliance on this sole and, relatively important external source. However, the economy has been operating on the basis of natural wealth, namely oil and gas, for quite a long time. naturally it takes time to move the economy towards diversified external revenues.

B) GOVERNMENT EXPENDITURES

The ratio of government expenditure to some national aggregate show one thing but absolute levels of government expenditure show something else. Table 6 shows the composition of government expenditures for a period of 11 years. The four ratios measuring the size of government, discussed earlier did not show any significant increase in the size of the government of the IRI. However, using absolute figures of total government expenditures is unrealistic but instructive as represented in table 6 below. This shows the relatively important role played by the government during the period of analysis. But the catch lies in the population explosion during the war. The rising trend of government expenditure is due to both-increasing war expenditures and a steady rise in the population. A population growth rate of close to 4 per cent, forces the government to increase its expenditure on naturally greater needs such as health, education and if possible, welfare. As mentioned earlier the overall welfare of an average Iranian- citizen has considerably declined.

Furthermore, the importance of public expenditures, relative to current expenditures, has slightly increased during 1980-38 inclusive; but the trend completely changes until 1988. In 1988 the relative importance of this item declines to its minimum of 17 per cent.

The real picture in table 6 has been clouded by using figures at current prices.But if one chooses constant prices, the clouds would be removed and the true picture show itself; i.e., all capital stocks had been forced to depreciate. This was turn of only for the public sector but also for the private sector as well. If we go little further into the argument, the outcome becomes obvious. That is, allowing capital stocks to depreciate, due to foreign exchange controls, would result in negligible depreciation expenses which account for the high percentage relative to total expenses. During inflationary periods, revenues will increase and so will profits,. taxes and corporate profits. Having purchased capital goods at a cheap rate before the revolution at $1=Riyals 75, the profit rate (the ratio of total profits to the registered capital) give unreal high rates. One solution to this problem is to allow: (1) Replacement costs, instead of historical costs ax used by corporations and a corresponding figure to be added to the registered capital; and (2) Newly appreciated capital stocks to depreciate again, despite the fact that their book values have declined close to zero. This would make it attractive to offer the stocks of corporations on the stock exchange market. Some steps are being taken in this regards.

To complete the picture, we need to briefly discuss negative income taxes (subsidy) indirectly paid by government. In order to protect the poor and the fixed income earners against shortages and inflation during war period, the government of the IRI has paid the following amounts:

TABLE 6

COMPOSITION OF GOVERNMENT EXPENDITURES

Unit: Billion Riyal

Year / Expenditures	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990*
Total Expenditures	2404	2861	3367	3895	3632	3616	3466	3983	4625	4528	1602
1. Current Expenditures	1730	2032	2253	2524	2476	2548	2410	2911	3394	3203	3965
2 Capital Expenditures	568 (24)	675 (23)	915 (27)	1149 (29)	878 (24)	765 (21)	746 (21)	729 (18)	816 (17)	900 (20)	1631 (26)
3. Other Expenditure	105	154	199	223	278	303	309	342	415	725	507

Sources: National Income Accounting Department: Central Bank of Iran - and Ministry of Economic Affairs and Finance - various publications-

* All figures are forecasts not actual.

Note: All figures are at current prices- Figures in parentheses are ratios of the respective figures to total- For further information: budget deficits have traditionally been financed through borrowing from the Central Bank-

TABLE 7

AMOUNT OF SUBSIDIES

Unit Billion Riyals

1977	1981	1982	1983	1984	1985	1986	1987	1988*	1989*
65.8	81.3	109.7	106-1	120-2	207.1	127-3	104-6	155-0	206.0

Source: The Organization for Protection of Consumer and Producers (various pamphlets)-

* Receipts not payments.

Subsidies being mainly financed through overcharges on imported goods, it is seen from the table that in 1986 during which we experienced the highest decline in oil and gas revenues, we witnessed a somewhat corresponding decline of 60 per cent in subsidies. However, when the country had the highest oil and gas revenues in 1983 the amount of subsides not only failed to rise but decreased slightly relative to 1982.

Q THE PROCESS OF BUDGETING

The economy is an organic phenomena whose affairs cannot be stopped; therefore, decisions, either good or bad, have to be made. These decisions are made by bureaucrats and politicians who may neither be economists nor even know about economics. In fact, they do not need be economists to make economic decisions. As long as they are properly advised by experienced and professional economists one can be confident that their decisions will increase the efficiency and equity of the economy. However, not all decisions are necessarily based upon the principles of economics. Hence, the question in this: in the context of budgeting, is there an appropriate model to explain the, behavior of bureaucrats and politicians?

A behavioral analysis of the process of budgeting has been advanced by Aaron Wildavsky, a political scientist.* According to Wildavsky, the largest determining factor of the size and content of this year's budget is last year's budget. (see his book written 1964; p. 13).

To be brief, the model of decision making that Wildavsky has in mind is one made up of sequential or iterative procedures. The result of a sequential decision-making model depends upon the order in which events are decided upon. The outcome of earlier decisions may enter as binding constraints on current decisions. Applying this model in the context of budget decision making implies that a decision made about this year's budget must take into account the decisions made

*Adopted from C.V. Brown and P.M. Jackson (1982), pp.157-160. 262

about last year's budget and the one the year before that and so on. A decision to build a highway or a public health care centre is not a commitment to allocate resources to these activities for the next year only. Instead, these resources are committed until a decision is taken to change the level of quality of service provision. thus, last year's budget determines this year's budget because of the large commitment of resources that is carried forward into the present from the past.

The second feature of Wildavsky's model of budget decision making is that the amount of resources upon which current decisions are made is a relatively small percentage of the total. The reason for this is that the decision - maker does not start from a clear sheet but instead carries forward a commitment of resources from previous decisions. Wildavsky refers to this as "incrementalism", therefore, current decisions are subjected to accepting previous decisions.

The third feature of Wildavsky's model is that incrementalism also described the way in which decision-makers deal with the complexities and the cost of decision-making in practice. Decision-makers have a limited amount of time to prepare their budgets, although it is repeated every year. To start each budget cycle and consider a balance of resources between sub-programs and the interrelationships between different parts of the implicit production function and study the spill-over effects of each program would be an immense task requiring large volume of computational resources. Not only would such practices expensive but also decision makers have limited personal computational facilities. According to Wildavsky, incrementalism is cheaper on decision making resources. Moreover, if the demander of a new program did not proceed via a piece meal incrementalist approach, there is always a possibility that the program would run the risk of being completely rejected.

The process of request and appropriation in the context of incrementalism can be modelled by the following simple statistical decision rules:

(1) Agency's decision rule:

$$X_{it}=b_iY_{it-1}+e_{it}$$

where: X_{it}= the requested budget by Agency i in period t.

Y_{it-1}= The actual budget granted to agency i in the previous year.

b_i= a parameter> 1

e_{it}= a randomly distributed variable with mean equal to zero.

An agency current year budget equals the previous year budget plus certain mark-up. If, for example, b=i=1.12 then this year's budget is 12 per cent greater than the previous year.

(2) Committee's decision rule:

$$Yit= aiXit+Eit$$

where: a = a parameter <1

Eit= a randomly distributed variable with mean equal to zero.

This rule shows that the actual budget granted by the committee is equal to some proportion (less than one) of the actual amount requested. (The model needs some refinement. That is, after this process has been continuously in use, then both the agency and the committee know the rules of the game. Then each side can predict the game that the other will play. Thus, the applying agency will always overstate the amount requested with the belief that the committee will try to reduce it. Consequently, as the committee has learned from past experience that the agency often overestimates the needed budget it has the rationale to cut it. In other words, overstatement of budgets and slashing them become an established rule. My experience as a deputy minster, in the past, and as an adviser, at present, allows me to claim that this has been the rule practiced for long time in the IRI).

Substituting the Agency's decision rule into that of Committee's, we .get the following simple rule:

$$Yi_t = aibiYit\text{-}1 +(E_{it}+e_{it})$$

It means that this year's budget is a function of last year's budget; which is, the decision rule of incrementalism. The error terms in each decision rule reminds us that these are statistical decision rules. In other words, the actual outcome is dependent upon the actual amount granted plus random events that occur during the year such as unforeseen floods, earthquakes and other natural calamities.

The actual process of budgeting in the country is a proof that incrementalism is a reasonable description of the decision-making process. In other words, in the IRI, presumably like any other countries, all three features of Wildavsky's model operate effectively. The narrow range of the four ratios calculated to measure the size of the government of the IRI, in Table 3, gives an overall average of 25.5 per cent. This ratio shows that both the numerator of the measure (i.e. government expenditures) and the denominator (i.e. GDP or GNP either at market prices or factor costs) were controlled to change almost at the same rate.

The Plan and Budget Organization is responsible for annual budget making and planning the five-year economic development programs, it, along with the legislative branch of government have performed their tasks according to the prediction of the model developed by Wildavsky as the controlling agents in the IRI. Furthermore, since the share of the private sector accounts for almost three times as such that of the public sector in GDP or GNP, it has also performed its own task in harmony with the public sector. Hence, it can be concluded that the private sector is a reliable one that the government of the IRI can depend upon. However, it has to be under the direct control and supervision of respective public agents.

PART TWO : REASONS FOR GOVERNMENT INTERVENTION

Real world markets are far away from being perfectly competitive. There are some impediments that may prevent free markets from generating allocative efficiency. Hence, government finds it to the benefit of the pubic to intervene. The number of impediments to perfect competition is practically infinite.Where possible, however, these can be classified into three categories that include most of the cases in the real world. They are namely: imperfect competition, externalities, and public goods. In order to be able to carry forward the results of this part of the paper to the next I will try to discuss each on of these categories very briefly.

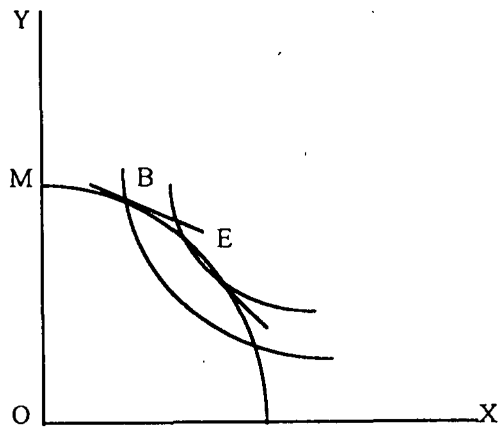
A) Imperfect Competition

Imperfect competition includes all those situation, in which economic agents exert some market power in determining price. In such cases, a profit-maximizing firm will not produce where price is equal to marginal cost. As an example consider the following case. If good X is produced in a monopoly market the profit-maximizing firm will choose that output combination which the rate of product

transformation $\frac{MCx}{MCy}$ is equal to $\frac{MRx}{Py}$. This level of output corresponds

to point B where the rate of product transformation is less than individuals' rate of substitution. This is obviously less than the rate of

these goods' market prices $\frac{Px}{Py}$. Hence, too little X will be produced as a result of monopolization of its market an optimal allocation of resources cannot be achieved. This may give a reason for government to intervene into the market and regulate the monopoly. However, the regulated monopolist may be forced to produce where demand cuts average cost curve. Average costs, in such cases, shall include some mark-up. In this case, the price will be lower and output higher than that exhibited by point B in the above figure.



B) Externality

A perfectly competitive model is a world of an absolute absence of externalities. This market structure is a spaceless and timeless economy; i.e., market distances shrink to zero and information is costlessly obtained. Furthermore, individual utilities are independent of each other. In brief, there are assumed to be neither positive nor negative externalities. But realities are too complex to allow us to use such a sample hypothesis, however useful a model in practice. Societies, by and large, provide ample evidences on the presence of externalities, both positive and negative via interactions among individuals and firms.

Probably the best institutional expression used to show the reason of externality is that of Professor G. Becker who says "externality results from improper ownership of property". We need further elaboration on this view point. Costs imposed by firms and utilities derived from consumption are hardly internal; rather they go beyond the original producer and the consumer (so much so with respect to utility externalities in an Islamic economy). Therefore, there is always divergence between private and social cost (utility). In cases where production of a commodity entails pollution the social rate of product transformation will exceed the private rate of product transformation of the same commodity with no pollution. Since the price system reflects only the private costs therefore, the social and private rates of transformation differ. The result would be that the private market will tend to produce too much of the commodity when production entails pollution, relative to other commodity.

In Islamic jurisprudence there is the principle of which allows an Islamic government, to intervene in production and in consumption activities. To make sure, when negative consumption externalities occur, individual muslims are responsible as well.

In an Islamic economy, according to my views reflected in my book entitled: Towards a Theory of Muslim Consumer Behavior (forthcoming), due to the presence of positive utility externalities (via interdependent utility functions) among Muslims the consumption bundle as well as the pattern is somewhat different from that advocated by Western economists. The price system, again because it reflects only private utilities will not adequately register real behavior. Therefore, it is the responsibility of Muslim economists to furnish the world with a new set of rules of Islamic welfare economics.

C) Public Goods

A third possible failure of the market system to yield an optimal allocation of resources stems from the existence of public goods for which non-exclusion principle applies.This principle makes it possible for all individuals to make use of the benefits derived from public goods. The pervasive nature of this incentive will ensure that resources are under-allocated for such goods. To avoid this under allocation, people may decide to have the government produce non-exclusive goods.

I believe that the scope of public goods goes beyond the examples conventionally given such as national defence, inoculations against infectious diseases, criminal justice, pest control and the like. Another important public good, whose importance cannot be exaggerated, is "money" with all externalities attached to it. In my paper entitled:, "Money in an Islamic Economy" I have prescribed that, due to the peculiar characteristics of money such as not being allowed to hoard, speculate or used on interest - based contracts, the government, not the private sector, shall manage it.

An important caveat is in order at this point. Due to the mere existence of externalities both in consumption and production, a freely operating price system will be incapable of generating a true Pareto optimal allocation. (According to Professor S.K. Nath: a Paretian optimum is not necessarily superior to any non optimum.: See p.22 of his book). Therefore, it is tempting treason that a competitive price system could still be advocated for those sectors of the economy in which these impediments are important: hence the Petro rules of efficiency would be satisfied there. Unfortunately, this intuitive answer to the problem of finding a 'second-best' solution is not correct. According to R.G.Lipsey and K. Lancaster (See their paper pp. 11-32). It is not true that having more (but not all) of the optimum conditions necessarily superior to having fewer hold. As the result, one must analyze each individual situation rather than attempt to draw such broad all-inclusive policy recommendations. This, it seems to me, will allow the government to exert more control and close supervision, if not absolute intervention, on the activities of an Islamic economy.

PART THREE : THE GOVERNMENT OF THE IRI IN THE LIGHT OF THE CONSTITUTION

A) Economic Duties of the Public Sector in the Constitution

The constitution, adopted by referendum on December 2-3, 1979, contains twelve chapters with the general principles covered in Chapter 1. Article 4 of this chapter declares that "all civil, penal, financial, economic, administrative, cultural, military, political, and other laws and regulations must be based on Islamic criteria, "As another general principle, Clause 1 of Article 3 of Chapter 1 state that "the planning of a correct and just economic system in accordance with Islamic criteria is to be one of the "goals" of the Government of the Islamic Republic".

Chapter IV of the Constitution deals exclusively with "Economy and Financial Affairs". This chapter specifies the general form and objectives of the economic system to be adopted by the Islamic Republic of Iran. The economics system is to consist of the three sectors: public, cooperative and private. The first sector " is to include all large scale and major industries, foreign trade, major mineral resources, banking, insurance, energy, dams and large scale irrigation networks, radio and television, post, telegraphic and telephone services, aviation, shipping, roads, railroads, and the like; all these will be publicly owned and administered by the State." The second sector "is to include cooperative companies and institutions concerned with production and distribution, established in both cities and the countryside; in accordance with Islamic criteria". The private sector is to consist of "those activities concerned with agriculture, animal husbandry, industry, trade and services that supplement the economic activities of the State and cooperative sectors." The precise activities of each sector is to be specified by the Consultative Assembly (the parliament).

At first glance, it seems that the private sector has been assigned a residual and relatively minor role in the economy. However, the above description of the cooperative sector does not assume, implicitly or explicitly, that this sector is to be totally within the public sector domain. Rather, the provision for the establishment of the cooperative sector indicates an attempt to implement and foster the spirit of the principle of cooperation in economic activities observed by the Qur'an and *Sunnah*. This sector can be wholly within the private sector domain, that is, the firms and units comprising this sector can be private, but "cooperatively", owned just like a corporation whose shares are owned by a large number of stockholders, as opposed to single proprietorships or (small) partnerships. This idea is reinforced by Clause (b) of Article 43 which designates cooperatives as means by which" conditions and possibilities of employment" can be "assured for everyone, with a view towards attaining full employment "by" placing the means of production at the disposal of anyone who is able to work but lacks the means. "The same clause specifies the granting of interest free loans as a vehicle for securing the "means of production" for those who are able to engage in productive activities but lack the financial resources to do so. Clearly, the constitutional intent is to prevent concentration of economic power in the hands of the few.

The remaining provisions of Article 43 endorse the right of everyone to choose their own line of work, prohibit the formation of monopolies, hoarding, usury, "extravagance and wastefulness in all matters related to the economy, including consumption, investment, production, distribution, and services, "and concentration of wealth; call for planning of the national economy at each stage of its growth;" and most important of all, require the "provision of basic necessities to all citizens". Basic necessities are defined to include "accommodation, food, clothing, health care, medicine, education, and the necessary facilities for the establishment of a family.

Articles 22, 44, 46, and 47 of the Constitution affirm private property rights by declaring that everyone "is the owner of the fruits of his legitimate business and labor" (Article 46), and that private property" legitimately obtained is to be respected "(Article 47), held "protected by the laws of the Islamic Republic" (Article 44). The private property that is to be "protected" must meet three conditions: (1) the ownership of such property must "not go beyond the bounds of Islamic law," (2) the property itself "contributes to the economic growth and progress;" and (3) that the property "does not harm society" (Article 44).

Article 49 makes it a responsibility of the Government to "confiscate all wealth resulting from usury, usurpation, bribery, embezzlement, theft, gambling, misuse of endowments, misuse of government contracts and transactions, the sale of uncultivated lands and other categories of land inherently subject to public ownership, the operation of houses of ill-repute, and other illicit sources". Before confiscation can take place, however, the government is required to carry out" due investigation and verification in accordance with the law of Islam". The confiscated property is to "be restored to its legitimate owner, and if no such owner can be identified, it must be placed in the public treasure". Economic activities declared as illegitimate sources of property rights are precisely those listed in traditional Islamic sources. However, Article 50 of the Constitution expands the traditional list to include those economic activities" that tend consistently to pollute the environment or inflict irreparable damage on it".

The right to work is endorsed for everyone, and the Government has been made responsible for providing "every citizen with the opportunity to work," as well as with the duty of creating "equal conditions for obtaining it" (Article 28). In carrying out these duties, however, the Government itself must not become "a major or dominant employer" (Article 43).

Regarding distributive justice, in addition to the provisions concerning the basic necessities, the Constitution gives recognition to the right of everyone "to benefit from social security with respect to retirement, unemployment, old age, disability, and destitution benefits, as well as benefits relating to emergencies, health services, medicine and medical care, provided through insurance and other means. "These rights are to be "assured" by drawing down on the national income, in accordance with the law, and income derived from the participation of the people" (Article 29). Moreover, the Constitution declares that "owing a dwelling commensurate with one's needs is the right of every individual and family in Iran". The Government is asked "to pave the way for implementation of this principe" (Article 31). The Government is further required to "provide all citizens with free education to the end of the middle school, and must expand higher education to the level required by the country for self-sufficiency" (Article 30).

To provide financial resources for the Government, the Constitution (article 45), places at the disposal of the Islamic Government all public wealth and property, such as uncultivated or abandoned land, minerals, seas,. lakes, rivers and other public bodies of water, mountains, valleys, forests marshlands, natural forests, unenclosed pasture land, legacies without heirs, property of undetermined ownership and public property recovered from usurpers". Additionally, the National Consultative Assembly (the parliament) is empowered to imposed taxes, "in accordance with the law" (Article 51). The Government is to prepare annual budges, "in a manner specified by law" and submit them "to the national consultative assembly for discussion and approval" (Article 52). Government revenues are to be placed" in accounts at the central treasury, and all disbursements shall be within the allocations approved in accordance with law" (Article 54). An auditing agency, under the supervision of the parliament, is provided for in the Constitution as a check on fiscal operations of the Government, its agencies, and its contractors (Article 54 and 55).

To ensure that all laws passed by the parliament are compatible with the *shari'ah,* the Constitution stipulates for a Council of Guardians composed of twelve members-six Islamic scholars and "six jurists, specializing in different areas of law". A majority vote of the Council membership is required to declare legislation passed by the National Consultative Assembly as compatible with the *shari'ah,* as well as the Constitution.

B) Institutional Changes after the Revolution*

The fundamental changes that took place in the IRI after the revolution led to the creation of many organizations and foundations. The most important of these organizations are: (1) the Foundation for the Oppressed; (2) the Reconstruction Crusade; (3) the Islamic Revolution Housing Foundation; (4) the Foundation for the Affairs of the Refugees of the Imposed War; (5) the Foundation for the Martyr of the Islamic Revolution (the Martyr Foundation); and (6) National Iranian Industrial Organization.

* Bank Markazi Jomhouri Islami Iran, Post-Revolution Economic changes, 1983/84, pp. 165-69, and 268-78.

1. The Foundation for the Oppressed

This foundation was created on March 5, 1979 in order to consolidate and manage "the wealth of the Pahlavi family as well as the wealth of those who through their connections to the Pahlavi family, have obtained illegitimate wealth. "The foundation is also authorized -to receive private contributions. The resources of the foundation are to be used to improve "the living conditions, particularly the housing needs, of the oppressed." The foundation is a non-profit organization whose resources are chiefly revenues from its holdings and whose financial operations are exempted from the laws and regulations of the General Accounting law to which every public organization is subjected. The holdings of the foundation by March 1982 included 786 parcels of land, 412 orchards, 238 trading firms, 146 industries, 101 buildings, and 64 mines.

2. The Reconstruction Crusade

This organization was founded on June 16, 1976 with the aim of improving living conditions for the rural population residing in much neglected 60,000 or more villages and tribal centers in the country. Its responsibilities include: (a) activities related to improvement in production of farming and animal husbandry, (b) construction and maintenance of public buildings, serving villages and tribal centers; (c) construction and maintenance of roads in rural and tribal areas; (d) provision and maintenance of water resources in rural areas; (e) health service assistance, and (f) provision of cultural services and activities in ural areas. The Reconstruction Crusade has been very effective in providing the above services to rural and tribal areas and was formally brought into the governmental structure as a full-fledged ministry in 1986. Before that time its financial resources were supplied through: (a) special line-item in the government budget; (b) surplus budgets of provincial governments; (c) revenues from its own projects; and (d) financial contributions from urban and rural areas.

3. The Housing Foundation

The Housing Foundation began its operations on June 26, 1979 as a non-profit organization to assist in provision of housing for the poor, especially in the rural areas. It is headquartered in Tehran and has more than 200 branches in other provinces. Its duties include: (a) construction and repair of low-income housing units; (b) provision of *Qard ul-Hasanah* loans to the poor for the purpose of construction and repair of housing units; (c) direct investment for the purpose of establishing production units, specialized in producing raw materials for construction of housing, particularly in the economically deprived and depressed areas of the country; (d) help distribute construction materials provided by government agencies as well as loans provided by the Housing Bank for construction of low-income housing in rural and tribal areas; (e) construction of government housing in rural areas; (f) planning and implementation of projects aimed at improving the living environment of the rural people; and (g) cooperation and coordination with the Government and revolutionary and legal organizations in affairs relating to planning, research, and studies in housing (particularly rural housing), construction materials, and housing education. Financial resources needed to carry out these functions are provided through: (a) a special account set aside for this purpose called "the Imam's Account 100" established in the Bank Melli which contains private contributions designated for the Housing Foundation (b) cash and in - kind contributions from the Foundation for the Oppressed; (c) cash and in-kind contributions from the development budget set aside for "rural housing"; (e) use of credit allocated by the banking system for housing; and (f) income from production and distribution of construction materials.

4. Foundation for the Affairs of the Refugees of the Imposed War

This organization was established by a special provision of an act of the Majlis on June 4, 1981 as an agency of the Ministry of Interior in order to: (a) centralize the affairs of war-damaged areas; (b) assist refugees in problems related to resettlement; (c) deal with economic, social, political, cultural and , health problems of the war-torn areas and its people; and (d) help for reconstruction of the war-spoiled areas after the war and the return of the refugees to their homes. Financial resources for the foundation are provided by: (a) government budgets; (b) gifts and other cash and in-kind contributions from the people as well as agencies; and (c) income received from the foundation's investments in various projects.

5. The Martyr Foundation

The Martyr Foundation was organized on March 25, 1980 in order to manage the affairs and provide for the needs of the family of the martyrs as well as the disabled veterans. The financial. needs of this foundation are provided through: (a) special allocation provided through the budget of the executive branch; (b) private and public contributions; and (c) sale and utilization of expropriated wealth designated for the specific use of this foundation. The Martyr Foundation has more than 180 offices in provinces throughout the country managing a vast organization that deals with all aspects of the lives of the families of the martyrs and disabled war veterans.

6. National Iranian Industrial Organization

This organization was established in July 1979 when the Provisional Revolutionary Government announced a set of regulations called "The Law for the Protection and Development of Iranian Industries." The aim of this organization is to promote the industrial sector which was most severely impacted at the time of the revolution due to many factors including the flight of entrepreneurs and owners of many factories, labor problems, uncertainties regarding ownership rights, and lack of clear mandates on the rights and responsibilities of the private sector. According to this law, the existing industries were divided into four categories based on the conditions of ownership and financial status of each:

(i) . In addition to oil, gas, railroads, utilities, and fisheries which had already been nationalized, certain other industries such as automobile manufacturing, metals, production, shipbuilding, and airplane industries were also declared nationalized. The private shareholders and owners of these industries were compensated the net worth of their shares.

(ii) Large industries and mines, the owners of which had accumulated great fortunes via their illegal relationships with the previous regime, and many of whom had already abandoned their shares, came under the possession of the government. The claims of these owners were to be settled through legal channels.

(iii). The government also took possession of industrial units for which the liabilities to the Government and to the banking system exceeded their assets.

(iv) All other industries which did not fall into categories (ii) and (iii) remained in the private sector.

By the end of March 1983 some 580 industrial units were nationalized in accordance with provisions of the above-mentioned law of which about 130 were turned over to the three ministries namely: Industry, Mines and Metals, and Heavy Industries. About 450 industrial units employing more than 170,000 workers were placed under the control of the newly organized "National Iranian Industrial Organization". These units had total assets of Rls.774 billion and total liabilities of Rls.890 billion of which Rls.404 billion (or 45 percent) were owed to the banking system.

In order to evaluate the degree of burden on the Iranian annual budget of the above mentioned Organization, attention has yet to be drawn to some facts as follows:

The Foundation for the Oppressed has its own revenues and budgets independent of the annual budget. The budget and the annual report is, in fact, approved by the Muslim Leader. The Foundation's budget is not only a burden to the Government budget but also due to its surplus generating feature it does indirectly constitute to the well-being of some economic classes of the country.

The Reconstruction Crusade of the early years after the revolution has been. transformed, as noted earlier, to a full-fledged ministry. Therefore, its expenditures show up in the annual budget which due to common low efficiency of the public sector is a great burden. However, it has been quite successful in some aspects of its responsibilities.

The Housing Foundation generally has deficits with regard to its heavy duties in the depressed areas. The Foundation for the Affairs of the Refugees of the Imposed War and also the Martyr Foundation have become great burdens on the Annual budget, however useful and necessary to the country.

The National Iranian Industrial Organization, was once said to control on the basis of registered capital, almost 70 percent of the country's industrial units. In order to avoid any further unrest during the war, the government appointed its own managers to these some 580 industrial units. From the one side, the managers were not qualified and from the other side, the government, due to then existing rules for governing the public sector, did not indirectly allow them to manage the unit-in the same way a manager in the private sector would have done. Furthermore, shortages of foreign exchange, due to severe government controls forced them to operate the unit at some 50 percent of normal capacity. Putting all these factors together explains the great losses in many units, a burden naturally passed to the budget. The burden was even greater through the creation of three ministries namely, Industry, Mines and Metals, and Heavy Industries. There duties had previously been assumed by one ministry called "Industries and Mines". On efficiency grounds, there was no legitimate reason for a country whose highest earnings from non-oil and gas exports amounted to less than one billion dollars to have three different industries each of having its own budget and bureaucracy.

Last but not the least the factor contributing to the growth of the size of the government, was that the Majlis decided, for several years, to treat the foreign exchange budget, in the same way as the regular (Rial) budget. In order to properly use the controlled foreign exchange revenues, it was claimed that the benefit to the public could best be served through the establishment of centers to supply and distribute commodities. To this end 10 different large centers were created by the Ministry of Commerce in order to import and distribute various types of commodities. Not only did these centers control the importation of many items but also other items intended for import to the country required the appropriate center's approval. Obviously, each center has its own personnel and budget included in the said ministry's budget.

C) Recent Developments and Outlook

In the last 12 years, the Iranian economy has experienced a Revolution, leading to a protracted and costly war with Iraq, various trade and financial sanctions, and the turbulence of the world of the world oil market. These developments have brought profound institutional and structural changes to the economy.

With the emigration of many owners of businesses and property as well as skilled workers, combined with a decision to bring strategic industries and activities under the State control, the government took over the bulk of the countries manufacturing and service sectors. The exigencies of war prompted the government to extend its regulation of the economy into such areas as prices, distribution, and external trade. As a result the scope and activities of the private sector were circumscribed. The war also entailed the diversion of human and material resources to military purposes as well as marked changes in the composition of government expenditures in the composition and direction of foreign trade.

The end of the war and the removal of the internal as well as external pressures from the economy has given a chance to the authorities to give some thought to the problems created during the war period. In order to understand the current state of the economy, studies have been undertaken in various areas, all of which are in the process of compilation; therefore specific decisions have rarely been announced. However, information released through newspapers and magazines and also official interviews are evidences of some new developments. The most important of them crudely put include the following, irrespective of priorities:

(a) To bring about one single rate for foreign exchange in order to eliminate a great many distortions in different markets. Presently, there ' are four major rates for foreign exchange, namely: official, preferential, competitive, and black market rate. To give an indication of the scale of distortion introduced by having multiple rate of exchange it should be mentioned that the black market rate is over 20 times higher than the official rate.

(b) Deregulation of the private sector: There has been considerable movement to make it easier for the private sector to perform its duties especially with regard to paper work, import regulations, foreign exchange demands and the like.

(c) Limiting the subsidy Bases: Some subsidies generated distortions in different markets. Government has already decided to largely eliminated the subsidy on some items like milk. Probably the most important subsidy has been the under-valued foreign currencies given to nationalized industries. Recent elimination of such subsidies has already developed new problems. For example, one of the locally built automobiles called "Paykan" now costs more than 36 months of a recently-adjusted university professor's monthly salary. More thought has to be given to such problems.

    Subsidy on bread is still in force. This subsidy has a two-fold charter: one is about over-valued local currency, and the next is on the supply of bread at a cost lower than that dictated by the official exchange rate. These two factors combined together mean that the purchasing power of an American dollar priced at a black market rate is enough to buy over 100 loaves of bread. Bread, being an Iranian staple food, can no longer be a substitute for expensive rice, therefore it does not seem necessary to have this subsidy eliminated in a near future. Other subsidies on necessities have also been kept in tact.

(d) Reappraisal of the Assets of Publicly Owned Corporations: Government has come to the conclusion that it is no longer necessary, on efficiency grounds, to keep ownership of these industrial units any further. Many researchers have been undertaken to study the financial state of such units which are under the control of National Iranian Industrial Organization, as discussed earlier. '

Evidence show that if assets of these industrial units are duly reappraised, the current value of such assets makes it quite profitable to have the share sold on the stock exchange market.

Before a conclusive results have been reached from these studies, it is said that the government has already decided to turn over about one third of the shares to the respective laborers and the rest to the general public.

In summary, a lot has to be done by the government in order to be able to disentangle itself from the economy from the situation that has developed, intentionally or unintentionally, over the past 12 years. By and large, the economic outlook seems rather clear, but years may have pass to see how much the government has succeeded in performing in accordance with the Constitution of the Islamic Republic of Iran.

ENDNOTES

1. The table and the following example has been adopted form pp. 130-131 of C.V., Brown & P.M. Jackson (1982).

2. On the criteria of tax as a proportion of GNP the U.K. is not therefore, a relatively heavily - taxed country.

3. Op.cit.pp.145-6.

4. Following dates might be of some assistance if there should arise confusion: Revolution happened on 11th February 1979; War began on 21st Sept. 1980; the Iranian fiscal year starts on March 21.

5. Fourth measure will be that chosen by those who wish to argue that the public sector is too large.

6. See C.V. Brown and P.M. Jackson (1982), p. 130.

7. Bank Markazi Jomhouri Islami Iran, Post-Revolution Economic Changes, 1983/84, pp.165-169, and pp 268-278.

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11
EFFICIENCY OF THE ISLAMIC APPROACH TO EXTERNAL DEBT MANAGEMENT IN NORTH AFRICA AND THE MIDDLE EAST

I. O. TAIWO*

INTRODUCTION

Most less developed countries (LDCs) have been battling with the debt crisis which emerged in 1982 following an announcement by Mexico, a major debtor country, that she would not be able to service her external debts. This crisis cuts across ideological leanings, various religions and geographic groups. Table 1 shows the magnitude of the external debt problem facing LDCs in general and North Africa and the Middle East in particular. As at 1982, when the debt crisis erupted, all LDCs were indebted to the tune of about $752.00 billion; their debt-export ratio was 160.3 per cent; and their debt service ratio was 15.4 per cent. As for North Africa and the Middle East, the external debt stock was about $68.00 billion, while the debt-export ratio and the debt service ratio were 140.6 per cent and 18.3 per cent respectively.

The debt crisis has become worse since 1982. As at 1988, the latest year for which reliable information is available, LDC external debt stock amounted to about $1,121.00 billion; and their debt-export ratio and debt service ratio had risen to 201.2 per cent and 26.7 per cent respectively. A similar fate befell North Africa and the Middle East, as their external debt stock had increased to about $119.00 billion, and their debt-export ratio and debt service ratio had risen to 296.0 per cent and 38.4 per cent respectively.

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North Africa and the Middle East is not the most indebted geographic group,' but from Table 1 it is clear that this group's debt-export and debt service ratios are above average, implying that the debt crisis faced by North Africa and the Middle East is sufficiently serious. However, this is not a sufficient reason for focusing on this geographic group. Our focus on the group is based mainly on the fact that this paper is about an evaluation of the Islamic approach to the debt crisis; and North Africa and the Middle East is comprised of a great number, and in fact the largest concentration of Islamic countries, where policy measures based on the Islamic doctrine can be more readily put into practice.

The current approach to the debt problem is dominated by initiatives from creditor countries. The measures that have been adopted or proposed include debt rescheduling, debt forgiveness, debt swaps, coupled with a program of structural adjustment. These measures have been described as "a muddling through policy"[2], i.e. short term measures which would enable debtor countries themselves to work out appropriate long term measures for combating the debt crisis facing them Given this view, the Islamic approach has the potential of contributing to the solution to the debt crisis, once it has been established that it is a viable option.

The main purpose of this paper is to assess the role and viability of the Islamic approach to the debt crisis. This is done by first tracing the causes of the debt crisis, with the aid of an econometric model; and then assessing the extent to which the Islamic approach, if adopted, can influence the major causes of the debt crisis, for the better.

TABLE 1

DEBT INDICATORS FOR ALL LDCS AND NORTH AFRICA AND THE MIDDLE EAST, 1982-88

	All LDCs			North Africa and the Middle East		
Year	Debt Stock ($ billion)	Debt export ratio (%)	Debt service ratio (%)	Debt stock ($ billion)	Debt export ratio (%)	Debt service ratio (%)
1982	**752**	**160.3**	**15.4**	**68**	**140.6**	**18.3**
1983	**816**	**176.2**	**15.6**	**71**	**145.4**	**18.7**
1984	**822**	**179.9**	**25.3**	**80**	**168.5**	**24.0**
1985	**915**	**204.0**	**28.9**	**92**	**195.2**	**24.5**
1986	**1,007**	**230.4**	**30.1**	**106**	**273.1**	**31.8**
1987	**1,137**	**229.8**	**27.1**	**120**	**285.2**	**29.5**
1988	**1,121**	**201.2**	**26.7**	**119**	**296.0**	**38.4**
Average		**197.4**	**24.2**		**214.9**	**26.5**

Source: The World Bank, World Debt Tables, 1988-89 Edition, various volumes; and 1989-90 Edition, First Supplement.

There are ten countries in North Africa and the Middle East which are listed by the World Bank as having a debt problem and which have reported data on their debt situation. In this paper, we consider all of these countries, except one, namely Lebanon. The reason for excluding Lebanon is that not all the data needed for the estimation of our model are available for this country. The remaining nine. countries that constitute our sample are Algeria, Egypt, Jordan , Morocco, Oman, Syria, Tunisia, Yemen Arab Republic, and Yemen Peoples Democratic Republic.

With this background, the rest of this paper is organized as follows: Section II specifies our estimating equation; Section III states the methodology of the study, Section IV presents and analyses the empirical results; Section V assesses the role which the Islamic approach can play in the debt crisis; while the last section, Section VI, draws the conclusions and makes appropriate recommendations.

2. THE MODEL

A) The Dependent Variable

Debt burden can be measured in various ways. The measures include total outstanding debt, total debt service, the debt-export ratio, and the debt-GNP ratio., Others are the debt service ratio, the ratio of total debt service to the GNP the ratio of external reserves to total debt, and the ratio of external reserves to imports. In this paper, we shall adopt the debt-export ratio as our measure of debt burden. This is because this ratio measures more accurately a country's ability to service her external debt.

B) The Explanatory Variables

(i) Level of Economic Development

Following Nau, Ekpo, and Ihonvbere, there is a structural dimension to the debt crisis, so that we should expect the level of economic development to account for a part of this crisis.' The argument has been that the level of a country's development determines whether it is at the center or periphery of the world economic system. At the periphery, a dependency culture would likely prevail, 'leading to reliance on imported consumer and capital goods, and technology.. On the export side, a LDC is a small country, facing a somewhat perfectly elastic supply, which indicates a low level of market power.

We adopt the relative concept of economic development, and measure it using the ratio of the real income per capita of a LDC to the average real income per capita of the industrial world.

The remaining issue to be settled is the expected direction of the relationship between economic development and the debt crisis: should it be positive or negative? The answer depends crucially on -the style of development-.' There are at least three cases. The-first case is when development proceeds through innovation and capital widening without much reliance on foreign assistance. In this case, the LDC would gradually proceed from the periphery to the center of the world economic system, and the relationship between economic development and debt crisis would be a negative one. Secondly, we have the case in which development is financed by debt and the system is riddled with leakages such that we end up with a positive association between debt and development. Lastly, we have the case in which development is intended to be financed by debt, but the receipts are diverted to non-developmental issues. In this case, we end up with a negative relationship between debt and development.

(ii) Terms of Trade

Some studies emphasize the role played by decline in primary commodity prices in the debt crisis facing LDCs.[4] Related to this are studies which emphasize the role of oil price shocks on this crisis.' We can capture the role played by these prices by a single term, namely the terms of trade, which is the ratio (in percentage) of the export price index to the import price index. It is common knowledge that many LDCs have witnessed a deterioration in their terms of trade, either because of a decline in their export prices, or because of an increase in their import prices, or both.

On the direction of the relationship between the terms of trade and the debt burden, the expected initial impact of a deterioration in this variable on debt burden is a negative one. However, we should expect a secondary impact, because the demand and supply of exports and imports are expected to be responsive to changes in import and export prices. This secondary impact may reinforce the initial impact, or it may offset it, partially or fully. Consequently, we should not expect a unique relationship between the terms of trade and the debt burden.

(iii) Relative Price Level

The domestic price level plays at least two important roles. First, the different between the domestic price level and export, prices serves as a measure of export competitiveness which affects the supply of exports.[6]. The, higher. this. differential the lower the supply of exports.

Secondly, the differential' between the domestic price level and the foreign price level affects the demand for imports and exports. The higher this differential the greater the demand for imports and the lower the demand for exports. Because export prices are already incorporated into the terms of trade dealt with in the preceding subsection, the latter differential is emphasized here.

We use as our measure of this differential, the ratio of the domestic price index suitably adjusted for the exchange rate, to the foreign price index. There then exists a composite relationship between the debt burden on the one hand, and the foreign price index, the domestic price index, and the exchange rate, on the other. Overall, however, we expect a positive relationship between the relative price, as defined above, and the debt burden.

(iv) Other Explanatory Variables

Another reason that has been proffered for the debt crisis facing LDCs is the increase in the cost of borrowing in the international debt market.7 Up to the mid 1970s, most of these countries borrowed at concessionary rates from official creditors, and interest rates were low. Thereafter, most LDCs were compelled to borrow largely from private creditors and at market rates. Consequently, the nominal interest rate increased, especially up to 1981. Between 1970 and 1981, the ratio of concessionary loans to total outstanding debt decreased from 55.8 per cent to 26.3 per cent, and nominal interest rate increased from 5.3 per cent to 11.1 per cent.[8] However, other considerations influencing market forces have tended to push down the nominal interest rate since 1981. In this paper, we shall focus on the real cost of borrowing which is the nominal rate minus the rate of inflation. We expect that an increase in interest rate will, ceteris paribus, reduce the demand for debt but increase the difficulty with which contracted debt can be managed, and vice versa. The overall effect can go either way.

There are also those who emphasize domestic policy lapses as a major cause of the debt crisis." These lapses are of different forms, including the level of corruption, defective project appraisal, grouping of debt maturities, and defective investment incentives leading to an industrial sector that is highly dependent on foreign inputs. Not all of these lapses are measurable, and we do not have adequate time series data for others. We then limit ourselves to two measures for which reliable information is available, namely the average debt maturity and the degree of openness of the economy, measured by the ratio of imports of the GNP.

We expect a shortening of the debt maturity to worsen the debt crisis. In the case of the degree of openness of the economy, a lot depends on how the exposure is handled. For countries that emphasize importation of capital goods and use them well, we expect exposure to, ceteris paribus, ameliorate the crisis,[10] while for those countries which emphasize the importation of consumer goods or do not use imported capital goods efficiently, we should expect exposure to worsen their debt crisis.

From the foregoing, we have the following equation:

$$\frac{EDT}{EGS} = f(LED, TOT, PR, INT, MAT, DOP, u) \qquad (1)$$

Where; EDT = total outstanding external debt; XGS

= export of goods and services;

LED = Level of economic development, measured by the ratio of the domestic real income per capita to the average real income per capita of the industrial world;

TOT = terms of trade, i.e $\frac{(100)P_x}{P_m}$ where Px is export price P_m index, and P_m is import price index;

PR = Relative price level, measured by the ratio of the domestic price index P_d, suitably adjusted to the exchange rate (e), to the foreign price index (P_f);

INT = real cost of borrowing, which is the nominal cost of borrowing minus the rate of inflation;

MAT = average debt maturity;

DOP = ¯degree ' of openness or exposure of the economy;

u = the error term.

One additional consideration is important to the construction of our model. This arises because equation (1) is static. We cater for dynamic adjustments by incorporating lags using the flexible autoregressive distributed lag (ADL) approach." Only a one-period lag of some of the variables, namely the terms of trade, the relative price level, and the real interest rate performed well, severally and, in a few cases, jointly.

3. METHODOLOGY A)

Estimation Method

In deciding on the estimation method, one basic issue is whether there are stochastic or endogenous regressors among the set of explanatory variables. Following Wallis,[12] a regressor is stochastic if it can be influenced by the dependent variable. Turning to equation(1), one can regard three of the explanatory variables, namely the level of economic development, relative prices and the degree of openness of the economy as stochastic or endogenous regressors. This is because the heavier the debt burden,. the more difficult it is for a country to embark upon growth-promoting policies; the more likely it is for domestic inflation to be fuelled by factors such as currency devaluation and low capacity utilization; and the more likely is import restriction. The other variables are not so influenced.

In view of the above, we adopted the two stage least squares (2SLS) method in preference to the ordinary least squares (OLS) method. In the first stage, we regressed the stochastic regressors on their lagged values as well as the exogenous variables of the model. The second stage is comprised of a regression of the dependent variable in equation (1) on the predicted values of the stochastic regressors as well as the exogenous variables of the equation. We corrected for autocorrelation, where present, using the Cochrane-Orcutt method.[13]

B) Evaluation Methods

Our estimated equations were tested for acceptability. We used four statistical measures, namely R^2 for goodness of fit, F for overall significance of the model, t for significance of individual coefficients and d for autocorrelation of the error term. The regressions were also evaluated for economic meaningfulness, using the expected signs stated in Section II.

C) The Data

We used time series data for the period 1970-87 to estimate the regression equations. 1970 is the earliest year, while 1987 is the most recent year, . for which a comprehensive debt and other data are available. Our data were obtained from two principal sources, namely (i) The World Bank; World Debt Tables, 1988-89 and 1989-90 Editions, various volumes; and (ii) IMF; International Financial Statistics,, various issues.

On the units of measurement, we expressed the GNP (or the GDP), exports, imports, debt, and debt service payments in million US dollars; and all per capita incomes in US dollars. All ratios, except the one measuring the level of economic development, were expressed in percentages. That measuring the level of economic development was expressed in decimals. All price indices have a base year of 1985 = 100, and average debt maturity is in years.

4. EMPIRICAL RESULTS

Our empirical results are presented in Table 2, comprising equations (2) - (10). Notice that our model has performed well, especially judging by the various values of R^2, d and F. Secondly, none of the reported regressions has a constant term. The equations are much better without them; so we restricted the constant terms to assume a value of zero.

We shall discuss our results by taking the explanatory variables in turn. The level of economic development has a positive impact on the debt crisis in six of the countries sampled, and a negative impact in the remaining three. However, only three of the positive impacts (those of Algeria, Morocco and Syria) and one of the negative impact (that of Oman) are significant. The overall impression given by the results is that economic development has some impact on the debt crisis, but the direction of the impact is not unique. Those countries that are experiencing a negative impact are not unique. Those countries that are experiencing a negative impact can have their debt burden reduced if they develop, while those with a positive impact have some fault in their style of development and should have their style changed.

The terms of trade also have a positive impact on the debt crisis in six of the countries sampled, and a negative impact in the others. Two of the positive impacts (those of Oman and Syria) and three of the negative impacts (those of Algeria, Morocco and Tunisia) are significant, so that the majority of the countries sampled are significantly affected by their terms of trade. Like the case of the level of economic development, however, the direction of the impact of the terms of trade on debt burden is not unique.

Both the relative price level (i.e. the ratio of the domestic price level vis-a-vis the foreign price level) and cost of borrowing exert a positive impact on the debt crisis, implying that both domestic inflation and high interest rate are bad from the viewpoint of the debt crisis. The relatives price level and the cost of borrowing have a significant impact in eight (the exception being Yemen P.D.R) and five (the exceptions being Jordan, Morocco, Tunisia and Yemen Arab Republic) of the countries sampled, respectively.

The average debt maturity has a positive impact in only two of the countries sampled. Consequently, for most of these countries, a longer debt maturity eases the debt burden, which conforms to our a priori expectation. However, only one of the positive impacts (that of Egypt) and one of the negative impacts (that of Morocco) are significant, implying that for most of the countries sampled, the maturity structure of the debts is not a major factor in the debt crisis.

Lastly, the degree of openness of the economy, measured by the import GNP ratio, has a positive impact in only four of the countries sampled; and, by inference, negative impact in the remaining five. Two of the positive impacts (those of Algeria and Tunisia) and three of the negative impact (those of Jordan, Oman and Yemen Arab Republic) are significant. One can then infer that the direction of the impact of import compression on the debt crisis is not unique:

TABLE 2

EMPIRICAL RESULTS

	Explanatory variables						
Country	**LED**	**TOT**	**PR**	**INT**	**MAT**	**DOP**	**R2 (in %)** d **and** F
Algeria	1176.57 (237)	-3.04 (-299)	40.95* (230)	9.77 (228)	-11.73 (-1.77)	577.38 (3.25)	R'=95.0 d =214 F=34-8
Egypt	-219228 (-1.57)	0.39* (0.62)	308.27 (4.71)	6.17 (222)	7.59 (4-1)	-121.39 (-1.28)	R'=98.7 d =1.89 F =143-1
Jordan	660.51 - (1.62)	0.48* (1.16)	416.92* (226)	223 (0.94)	0.65 (0.52),	-15224 (-275)	R2=97.3 d =1.92 F =66.4
Morocco	5087.22 (4.72)	-0.71 (-3.53)	25.57 (5.2)	1.27* (0.36)	-5.05 (-3-91)	23-9 (0.13)	R'=98.5 d =202 F =216.2
Oman	-11214 (4.98)	0.51* (3.79)	228.85 (7.85)	247* (5.24)	-1.40 (-207)	-50.48 (4.01)	R=98.5 d =1.91. F =348.9
Syria	54286 (236)	1.52* (3.02)	5.91 (277)	5-52* (246)	-3.73 (-1.47)	16231 (-1.03)	R'=95.4 d =21 F =37.6
Tunisia	260.01 (0.36)	-1.76 _ (-261)	199.23* (4.43)	1.42* (0.68)	-1.94 (-1.88)	383.04. (3.91)	R=98.9 d =2.12 F =163.4
Yemen Arab Rep.	584.26 (1.02)	0.43 (0.63)	21.36 (8.37)	1.20* (0.31)	-0.008 (-0.007)	-148.5 (-224)	R'=98.0 d =2.07 F =65.7
Yemen P.D.R.	-0334.81 (-1.06)	0.81 (0.43)	580.16* (1.26)	30.51* (239)	-1.91 (-0.43)	915.84 (1.79)	R=81.9 d =2.12 F =8.3

Source: Author's **computation.**

Notes: 1. Because of data constraint and the use of lags, the data used for Oman and Yemen are for the period 1974-87. For the other countries, we used the data for the period 1971-87. With six parameters, the degrees of freedom for Oman and Yemen P.D.R is 8, while that for others is 11.

2 At - = 0.05, the critical values of t are 2 306 and 2.201 for 8 and 11 d.f respectively.

3. At - = 0.05, the critical values of F are 3-69 and 3.2 for 8 and 11 d.f respectively.

4. For d, - = 0.01 is preferred to - = 0.05, because the inconclusive region arising from the latter is too wide. At - = 0.01, we do not have autoconelation problem. * denotes parameters for a one-year lag of relevant variable.

import compression would worsen the debt crisis to a significant extent in one-third of the countries sampled, and alleviate it significantly in about 22.0 per cent of these countries.

By and large in the majority of the countries sampled, domestic inflation vis-a-vis inflation abroad, and the high cost of borrowing are major causes of the debt crisis. In some, but not most, of these countries, the debt crisis has been fuelled by the level and/or style of economic development, a deterioration in the terms of trade, debt maturity structure and import liberalization.

5. ISLAMIC ECONOMICS AND THE DEBT CRISIS

A) A Survey of Islamic Economics on Relevant Issues

We shall start with interest on loans *(riba* al Duyun) which is a type of predetermined excess or surplus *(riba).*[14] Islam abhors all *riba,* the interest on loans included. In Islam, the legal rate of interest is zero, so that any interest rate above zero, no matter how low it is, is usury. Interest on loans is considered invalid for at least three reasons. First, it does not involve a quid pro quo: the creditor receives an increment without giving to the debtor an equivalent return, in which case, the interest received by the creditor is considered to be an unearned income. Secondly, the creditor and the debtor do not exchange on the basis of equality, because one party, the creditor, receives profit with certainty whereas there is no certainty of profit for the debtor. Last, but no least, unlike in trade where a shareholder or vendor demands profit from the purchaser only once, the interest on loans continues to accrue as long as there is some principal outstanding.

Islamic economics preaches an alternative to interest charging, namely partnership coupled with profit sharing. This arrangement presupposes that capital, loan capital *(aqridni)* included, is an instrument of enterprise so that it is needless to treat capital as a separate factor of production. There are two main types of partnership, namely *al sharikah and al mudaraba.* The former involves provision of joint capital or labor and profit sharing according to an agreed ratio. In joint partnership, losses are distributed in proportion to the shares of the partners in the joint capital. There are several types of joint partnership, but the one which is considered to be the best substitute for interest charging is *'inan* partnership. This is a form of partnership in which the rights of the partners, are not necessarily equal in terms of, e.g. share ownership and profit sharing. The institution of involves the provision of capital by one or more partners, and the work done by the other(s). Profit will be shared according to an agreed ratio, but in the event of a loss, partners lose in proportion of their capital share in the total investment. Islamic banking is then modelled in a tripartite relationship consisting of two tiers. The first tier involves depositors and the banks, while the second involves the bank and investors.

It is now easier for us to state the Islamic attitude to borrowing, both private and public.[15] The overall spirit of Islam is to discourage deficit financing and public borrowing; the partnership method of financing being a preferred alternative; an alternative that can be coupled by aids and other economic assistance from richer Muslim countries or even individuals. Islam also preaches spiritual discipline in expenditure policy so as to curb waste.

Islam treats economic development as an integral part of the overall human development. [16] This concept of economic development derives from certain philosophical ideals including *tazkiyah (i.e.* purification plus growth). The outcome of *tazkiyah is falah,* i.e. prosperity both in this world and the Hereafter. The Islamic approach to development preaches, among other things, the common good *(maslaha),* expansion of useful production, balanced development, equitable distribution of . wealth, reduction of national dependency on non-Muslim world through, for instance, evolution of indigenous technology; and the need for the Muslim world to play a more positive role in reforming international instabilities and exploitation. There is a general condemnation of both the capitalist and the socialist modes of development.

There are several routes by which prices are managed in an Islamic state. First, Islam abhors illegitimate excess on sales *(riba al Buyu'),* just as it abhors interest charging *(riba* al Duyun). It is then needless to say, trade practices such as hoarding, speculative deals and illegal adjustments of weights and measures are condemned by Islam.

Secondly, we have the *zakat* and other taxes which act as in-built mechanisms for redistributing income and wealth, and for controlling spending. Last, but no least, we have those measures which are aimed at combating cost-push inflation such as linking of wages with productivity, subsidies on certain inputs and direct control method.

Finally, we have the Islamic attitude to trade." Islam is not against trade. What Islam is against is trade which can lead to *riba* on sales. This attitude applies to both domestic trade and international trade. Consequently, Islam frowns at certain international trade practices such as forward exchange rates, commodity pricing which is generally in favor of the industrial countries of the world, and deceits relating to quality of products.

B) Appraisal of the Islamic Approach to the Debt Crisis

In Section IV, we identified certain variables as accounting for the debt crisis facing North Africa and the Middle East. The major ones are the level of economic development vis-a-vis that of the industrial world, the terms of trade, the domestic price level vis-a-vis the foreign price level, interest rate and the degree of openness of the economy, measured by the import-GNP ratio. Notice that these variables affect the various countries differently.

Our discussion in Sub-Section V(i) shows that Islamic economics has something to contribute to the debt crisis. Firstly, Islam tackles the debt problem at the roots by discouraging public borrowing and deficit financing; and favoring collaborative effort and the integration of loan capital with enterprise. Where borrowing occurs at all, no interest is charged. Turning to Table 2, we find that a reduction in interest rate, or the abolition of interest charging would alleviate the debt burden of all the countries sampled; and the relief is significant for Algeria, Egypt, Oman, Syria and Yemen P.D.R. For instance, a one percentage point reduction in interest rate would reduce Algeria's debt-export ratio by about 9.8 percentage point,, and that of Egypt by about 6.2 points.

Secondly, Islam abhors all *riba* on sales, whether at the domestic or international levels. This has a lot of implication on the relative price level turning to Table 2, we find that a reduction in the. domestic price level would alleviate the debt burden of all the countries sampled; and the relief is significant for all of these countries except Yemen P.D.R.

For instance, a one percentage point reduction in the relative price level would reduce Jordan's debt-export ratio by 4.2 percentage points, and that of Oman by 2.3 points.

The abolition of *riba* on sales can also affect the terms of trade depending on whether *riba* on imports departs from that on exports, or not. If *riba* on imports exceeds *riba* on exports, and -all *riba is* abolished, then the terms of trade would improve, which in turn affects the debt burden. Table 2 shows that an improvement in the terms of trade would significantly alleviate the debt burden of Algeria, Morocco and Tunisia; and it would worsen it in the remaining countries, the impact being significant in only Oman and Syria. For instance, a one percentage point improvement in the terms of trade would reduce Algeria's debt-export ratio by about 3.04 percentage points, and worsen Oman's by about 0.51 points. It can therefore be concluded that there are wide cross-country differences in the role which the Islamic approach can play to alleviate the debt crisis through the terms of trade.

On the degree of openness of the economy, Islam is, strictly speaking, not against trade, but its concept of economic development implies the need for self-sufficiency, which can be interpreted to mean less dependence on imported goods and technology. Table: 2 shows that import compression would significantly increase that of Jordan, Oman and Yemen Arab Republic; and it would have no significant impact on the debt burden of the remaining countries. For instance, a one percentage point increase in imports vis-a-vis the GNP would reduce Algeria's debt burden by about 5.8 percentage points, and increase Jordan's by about 1.5 points.

By and large, the Islamic approach can be used to check the debt crisis facing North Africa and the Middle East if the emphasis is on price and interest rate reduction. But if the emphasis shifts to other variables such as import control and the terms of trade, the evidence will be divided; some countries would be worse off, while others may gain. For example, import compression and an improvement in the terms of trade would alleviate Algeria's debt burden, but worsen Oman's. Even in countries where the Islamic approach is favorably disposed to work, we should not expect smooth sailing and we now turn to the constraints.

C) Constraints Facing the Islamic Approach to the Debt Crisis

We shall limit ourselves to two problems which are likely to militate against the efficacy of the Islamic approach to the debt crisis.

1. Economic dependence. Most countries are already heavily indebted to the industrial countries of the world, and this is coupled with dependence on foreign technology and capital. The question is: can Islamic economics be ideally practiced without a minimum level of economic in dependence?

2. The tendency towards a uniform international economic order. The development of multilateral institutions and regional groupings seem to be a pointer to a tendency towards a uniform international economic order. Behind this tendency is some form of competition between alternative systems. The point then is that Islamic economics must expand its area of influence, or be threatened by other systems.

6. CONCLUSIONS AND RECOMMENDATIONS

The debt crisis confronting North Africa and the Middle East is part of a global crisis faced by most LDCs. This crisis can be accounted for by several factors, especially the level of economic development, the terms of trade, the domestic price level vis-a-vis the foreign price level, cost of borrowing, and domestic policy lapses measured, for instance, by the average debt maturity and the degree of openness of the economy. The Islamic approach to economic issues has -a lot to say about each of these factors and can therefore be used to influence them all. Islam abhors all illegitimate excesses, including interest charging and extortionist trade policy; it also abhors wasteful spending; it discourages deficit financing; and it has an integrated approach to human development. It is then clear that the Islamic approach, if adopted, can ameliorate the debt crisis facing North Africa and the Middle East, and some other countries as well. However, there are problems which can stymie a full scale adoption of this approach. They include polarization within' the Muslim world, and economic dependence on the developed West. We recommend that:

a. Muslim countries should embark vigorously on a program of economic development. The policy measures should include development of indigenous technology. With self-sufficiency, it would be easier for Muslim countries to close their ranks; and with greater unity, a more conducive environment would be created for the practice of Islamic economics.

b. Muslim countries should cartelise, or strengthen existing ties, as debtors, importers and exporters, not necessarily to repudiate their debts, but to obtain more favorable terms on their trades and borrowing. A collaborative effort with non-Muslim LDCs can also be considered.

ENDNOTES AND SOURCES

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17. See El Gousi, op. cit, p. 150 and pp. 263-279.

18. See El Gousi, op.cit, pp. 41-47.

19. For some of these dissenting views see, e.g. El Gousi, op.cit, pp. 138 and 141.

12

THE SURVIVAL AND DEVELOPMENT STRATEGIES OF THE MINORITY OF NAIROBIAN MUSLIMS IN NAIROBI

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1. INTRODUCTION

Kenya, like other developing countries, is a predominantly agricultural economy. About 80 per cent of its population still resides in the rural agricultural sector, 30 per cent of its GDP is accounted for by agricultural products, and about 60 per cent of its exports are unprocessed foods and beverages.' Although the country has an abundant supply of unskilled and semi-skilled labor, the production technology employed in the industrial sector is excessively capital intensive. Moreover, the available capital endowment is limited, as a result of which productive, stable employment in the industrial sector is severely curtailed. On the other hand, the agricultural sector has a promising potential. However, the exploitation of the available potential will need abundant resources and reorganization. In order for this sector to play its strategic role in the transformation of the economy through the creation of demand, generation of foreign exchange, and the production of raw materials, food, and labor, the sector would need to overcome a number of constraints it is currently facing. Some of these constraints include insufficient marketing arrangements, low use of fertilizers, poor infrastructure, appropriate technology, and inadequate finance and delays in payments.

The economic scenario described above has serious welfare implications for the majority of rural and urban residents. In the first place, the majority of these people are mostly unskilled and have very little or no education at all. This means that their eligibility for

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employment in the formal and informal sectors is very low, as a result of which they are faced with low and uncertain incomes. This further implies that their access to the formal labor and formal capital markets as well as the formal social security system is seriously limited. The sum total of all these factors is that the welfare situation of this sub-set of the population is very precarious.

The Nubian Muslims in Nairobi, together with Nairobi urban migrants fall within this category of urban residents. One major difference between the two is that, whereas the Nubian Muslims are "permanent urban" residents, the urban migrant has his home in the. rural area and expects to return to the rural village to retire.[2] This expectation leads the urban migrant to maintain strong reciprocal ties with the rural village community through the transfer of incomes which is reciprocated mostly by the transfer of foodstuffs in the reverse direction.[3] In addition, the migrant undertakes several pertinent investments intended to facilitate his easy re-entry into the rural village at the time of retirement.' Through this system of reciprocation, these urban migrants and their rural counterparts are able to ameliorate their welfare status in times of economic hardships.

Although the survival and development strategy of. the Nubian Muslim community is also based on income "transfers", the dynamics of such transfers is different. Available empirical evidence suggests that this community is relatively poorer, less educated, and ill represented in formal wage employment than other communities in the country.[5] However, through "Muslim Brotherhood Support Network", this community has endeavored to sustain its economic well being through interhousehold income transfers' which is the theme of this paper.

The first part of this paper is introductory. The second part provides definitions, and thereafter, sections three and four present empirical evidence of interhousehold transfers and theoretical foundations. Section five discusses the econometric model which is used to generate the results presented in section six. The emerging conclusions are covered in section seven.

2. DEFINITIONS

Two important terms used in this study deserve to be defined: "Muslim Brotherhood Survival Network" (survival network) and "transfers". The term survival network refers to a system of relations between a group of individuals or households through which one or more units of transfer can flow. The phrase "Muslim Brotherhood" is used to denote the fact that this system or relations is mainly based on the bondage of Muslim Brotherhood existing among the participating individuals or households. The system is also referred to as "survival system" in so far as it plays, among other things, the role of transferring resources for social maintenance and economic. survival 'and development of its members. In other words, the survival system has three main functions to play: that of economic survival, by guaranteeing that all the participating members can secure income necessary for their subsistences by influencing the flow of transfer between those who are well off and the less fortunate ones; that of social maintenance, by facilitating regular social interaction of members in the various social/cultural activities in the community; and that of development through the implementation of diverse infrastructural investments within the community.

The survival network plays the important role of facilitating the flow of transfers among individuals, household and community based organizations. The term transfer is, in this context, used to refer to the receipt or giving of one or more units of transfer by an individual, a household, or a community organization. The units of transfer in question can either be money, goods, or services, and when such transfers flow among household or community organizations, they are respectively referred to as inter-household and inter-community transfers.

3. EVIDENCE OF INTERHOUSEHOLD TRANSFERS

Empirical evidence on Kenya, India and El-Salvador suggests a considerable amount of income flow among individuals and households through non-market mechanisms. Such evidence further suggests that such income transfers constitute an important survival and development strategy of poorer families.

Knowles and Anker7 found that income transfers in Kenya takes place not only between urban and rural households, but also between inter-rural and inter-urban households. They* further showed that income transfers form a significant proportion of the gross income of poorer families. Later works by Oucho and Mukras[8] provided the following conclusions: that the urban migrant remits an average of 27 per cent of his urban income earning to the rural area; that the rural area is the net transfer recipient of urban-rural transfer flows; and that transfers play the role of providing income for social maintenance, subsistence, and development.

TABLE 3.1

PATTERNS OF TRANSFERS IN KENYA

Description of Flows	Number of Transfers	Per cent of Total Amount Transferred
Urban to Rural	431	50.4
Urban to Urban	119	15.0
Rural to Urban	76	6.3
Rural to Rural	540	28.3
TOTAL	1,166	100.0

Source: Knowles, J-C- and Anker R-, 1981, "An Analysis of Income Transfers in a Developing Countries: The Case of Kenya", *Journal of Development Economics,* 8, p-210-

A survey conducted among the Nubian Muslims in Kibera in Nairobi in 1988 and 1989 further corroborate some of these findings.[9] Covering a total of 267 households, the survey revealed that a total of Kshs.

525,000/= were remitted as transfers in the year 1988. Table 3.2 gives the breakdown of these transfers into the three main functions: survival, development and social maintenance.[10]

TABLE 3.2

MAGNITUDE OF TRANSFERS AMONG NUBIAN MUSLIMS IN NAIROBI BY FUNCTIONS

Functions	Transfers Ksh	Per cent
Development	262,000	50
Survival	146,700	28
Survival Maintenance	115,300	22
Total	524,000	100

Allocations going into development included allocations for schools, mosques, maddrass, health centre, purchase of land, and establishment of small scale business enterprises. The social maintenance category embraces such activities like funeral ceremonies, wedding ceremonies, and other such social activities.

The same picture emerges from the works of Kaufman in El-Salvador," and Oberai and Singh in India. [12]

4. THEORETICAL FOUNDATIONS

The Nubian Muslim Community in Kenya is a minority community which is relatively poorer than the other 'communities in terms of education and their economic welfare. Their limited access to the formal capital and the formal labor markets gives the survival network existing among members of this community an overriding importance as a mechanism for their economics survival and social maintenance.

The survival network embraces' Muslim Brothers who are members of the nucleus family, the extended family as well as neighbors and friends. Common religion, spatial and social proximity, and a sufficient degree of trust are important factors that create an enabling environment necessary for reciprocal transactions within the survival network.

From the point of view of the economist, this survival network can be looked at as some form of an informal insurance institution catering for. the economic welfare of member households. The close ties existing among members, together with the degree of trust and the effective access to information about the overall conduct of the members gives this system of informal insurance a comparable advantage over a formal insurance scheme. The main reasons for this relates to the usual problems faced by the formal insurance schemes, such as moral hazards, adverse selection, and deception which are -in this case taken care of by the overall proximity of member households.

In order to explain the economic rationale for an average/typical household to participate in this survival network, we shall denote its income by Y. The household is assumed to allocate this income into two consumption expenditures: expenditure for basic subsistence (C_B), and expenditure for non-basic consumption (C_{NB}). These two components of consumption expenditure correspond to Y_B and Y_{NB}, which are, respectively, the income levels required to cover basic and non-basic consumption.

For the two components of income and consumption expenditure, the following relationships hold:

$$Y = Y B + Y_{NB} \qquad (4.1)$$

$$C = C_B + C_{NB} \qquad (4.2)$$

Three scenarios can be discerned in relation to the households basic-consumption income. The household can either balance its subsistence needs, experience an income surplus, or an income deficit in an attempt to satisfy its basic consumption needs. These three scenarios are given by (4.3), (4.4) and (4.5) respectively.

$$Y = Y^B \qquad (4.3)$$
$$Y > Y^B \qquad (4.4)$$
$$Y < Y_B \qquad (4.5)$$

Since the typical household faces uncertain employment and income, income stream will be characterized with fluctuations particularly during bad periods, when $Y < Y_B$ and therefore is faced with a deficit in his basic-consumption income, the household will need income transfer from within the survival network in order to make up the deficit. On the other hand, during the fortunate periods when $Y > Y_B$, the household experiences a surplus and, through reciprocation, it will remit transfers to the less fortunate members of the survival network.

It is therefore clear that through the mechanism of transfers, the household is able to protect itself against undesirable income fluctuations. The survival network therefore provides a form of informal insurance coverage against such undesirable income fluctuations. This informal insurance protection constitutes a very important economic incentive for the household to become members of the network. The transfer that it remits within the network can therefore be looked at as an "insurance premium".

It should be noted that within the survival network, member households will differ in their earning capacity. They will normally differ in their expected earnings and the nature and degree of income fluctuations they experience. However, irrespective of the economic background of the member household, provided it does not often experience disproportionately large deficits (shown in equation 4.6 below)

$$Y - Y_B > \hat{o} \qquad (4.6)$$

where $\hat{o}$ = threshold income "deficit against income deficits by supplementing its income during bad periods.

Such protection against the impacts of household income deficits is made possible through the re-distributive role of the network. Sufficient resources are extracted from the surplus household in order to meet the deficits experienced by the deficit households.

5. THE ECONOMETRIC MODEL

5.1 Identification. of the Relevant Variables

Discussion's in the foregoing section suggest that there exists strong linkage, or correlation between household income and inter-household transfers whose behavior is the focus of this model. For this reason, it is hypothesized that inter-household transfers depends on, among other things, household income. Other explanatory variables are: age and education of head of household; employment status; marital status; number of children in household; ownership of property; and degree of religiosity of head of household.

5.2 Functional Form of Model

It should be noted that although a number of scholars have modelled inter-household income transfers in an attempt to explain its behavior, no a priori theoretical model exists in this area. Notwithstanding this shortcoming, we have decided to proceed in an exploratory manner -at each step using statistical procedures to evaluate the performance of the model we have specified.

We have postulated a multivariate stochastic model of the general form given by (5.1).

$$T_H = f(x_i, E) \quad - \qquad (5.1)$$

where: T_H = Inter-household Transfer

$x_i = i^{th}$ explanatory variable

$i = 1, 2, ..., n$

E = stochastic term

Both the linear additive (5.2) and log-log (5.3) functional forms were estimated.

$$T_i = A + \alpha_i x_{ij} + \epsilon_i \qquad (5.2)$$

Where: T'.= Inter-household Transfer of the i^{th} household

A = constant term

xi_j= the P^h observation of the j'^h explanatory variable

ai = coefficient of the jt_h explanatory variable

Ei = stochastic term

$$T = A X_1^{\alpha_1} \ldots X_n^{\alpha_n} e^{\epsilon} \qquad (5.3)$$

where: a_1 = constant elasticities

X_1 = explanatory variables

e = stochastic term

i = 1,2,...,n

Since the performance of the log-log form was found to be better, our results here are based on this functional form. The performance of these two functional forms were compared on the basis of two statistical criteria: the statistical significance of individual parameter estimates; and the goodness of fit of the model. Overall, the log-log form was performed better.

5.3 A Priori Expectations

The a priori expected direction of the impact of explanatory variables on transfers are summarized below:

(i) Household Income Y

Impact is expected to be positive. The explanation is that the higher the household income, the greater the ability of such household to remit higher transfers.

(ii) Education of Head of Household (ED)

Impact is expected to be positive. The rationale is that the higher the educational status, the greater the access to labor market, capital market, and the greater the potential earning capacity.

(iii) Employment Status (EM)

The employed are expected to have greater capacity to remit income transfer than the unemployed.

(iv) Marital Status (M)

The married are expected to remit, on average, more than the unmarried. The rationale is that, having a family to look after, they have more to benefit transfer from reciprocation than the unmarried.

(v) Number of Children (CH)

The Number of children is expected to have an inverse relation with income transfers. The rationale lies in the costs attributed to larger families.

(vi) Ownership of Property (PR)

Impact is expected to be positive as this is an indicator of well being and hence the ability to remit transfers.

(vii) Degree of Religiosity (R)

It is assumed that the more pious and generous a person is, the more the person will feel obliged to remit transfers in an effort to improve the well being of members of the network.

6. DATA

Date used in our regression were cross-sectional data collected from among Nubian Muslims in Kibera in 1988/89. The sampling frame used was constructed from the community Sports Clubs. Our sampling units were the household, and, on the basis of the sampling frame, simple random sampling was used to draw a random sample of 267 households from which the required data were collected.

7. RESULTS

Cross-sectional data collected from the survey described in the foregoing section were used to estimate the multivariate regression model described in Section 5. The OLS method was used for estimation and the results obtained are presented on Table 6.1

TABLE 6.1 **REGRESSION RESULTS**

Dependent Variable	Independent Variables	Coefficients (t-statistics in brackets)
T	Y	+0.39 (3.03)
	ED	+0.42 (3.66)
	AG	+0.17 (4.88)
	EM	+0.27 (3.30)
	M	+0.33 (3.25)
	CH	+0.87 (2.77)
	PR	+2.79 (5.15)
	R	+ 1.68 (3.95)
		R^2 = 0.48 n = 267 Households

Results on the table suggest that the regression model was able to explain 48 per cent of the variations of the dependent variable. In addition, apart from the coefficient of the explanatory variable representing the "number. of children", the sign of all the other coefficients are in conformity with a priori expectations. The coefficients are all found to be statistically significant at a level of 5 per cent.

8. CONCLUSION

Our discussion in this paper suggest that, bonded together by muslim brotherhood, and constrained by their limited access to the formal labor market, the formal capital market, and the formal social security system, the Nubian Muslims in Nairobi have resorted to an informal "survival network" which can be loosely looked at as an informal insurance institution through which income-transfers flow from the deficit to the surplus household thereby sustaining the household's economic well being in times of hardship.

In order to get a clearer understanding of the determinants of transfers, a multivariate regression model has been estimated from data collected from 267 households. Results from this exercise lead us to the conclusion that, in order to strengthen the role of transfers in the improvement of the economic well being of this community, we would need to strengthen their commitment to the religion of Islam, improve their education, and improve their access to the labor and capital markets.

ENDNOTES

1. Republic of Kenya, Ministry of Planning and National Development, 1989, *Economic Survey.*

2. Oucho, J.O. and Mukras, M.S. 1984, *Migration, Transfers and Rural Development: A Case Study of Kenya. A* report based on primary research conducted in Kenya between 1981 and 1984 (Nairobi, University of Nairobi, pp. 76.77.

3. See Mukras, M.S., Oucho, J.O. and Bamberger M., 1985, "Resource Mobilization and the Household Economy in Kenya" in *Canadian Journal of African Studies, Vol.* 19:2 (pp. 409-421). Rampel, H and Lobdell, B.A., 1978, "The Role of Urban to Rural Remittances in Rural Development", *Journal of Development Studies, Vol.* 14:3 (pp. 324-341) and Weisner T.,

1976, "The Structure of Sociability; Urban Migration and Urban Ties in Kenya", *Urban Anthropology 5 (pp. 199-223).*

4. Mukras, M.S., 1983; *Recent Findings on Determinants of Urban-Rural' Income Transfers in Kenya,* Tekuza Research Institute (TRI), Research Paper Series No.2, (Nairobi), TRI), pp. 17-19.

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6. Ibid.

7. Knowles J. and Anker, R., 1981, "An Analysis of Income Transfers in a Developing Country: The case of Kenya", *Journal of Development Economics 8 (pp.* 205-226).
8. Oucho, J.O. and Mukras, 'M.S., 1984, op.cit.

9. This survey was conducted by the author and, due to budgetary constraints, analysis has not been completed.

10. For detailed discussions on the functions of transfers see Mukras, M.S., *1980, Income Tansfers as a Survival Strategy of the Minority Nubian Muslim Community in Kenya: An Econometric Model.* Paper presented at the World Assembly of Muslim Youth, in *1986* in Riyadh, Saudi *Arabia.*

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Section IV

FINANCING DEVELOPMENT IN HISTORICAL PERSPECTIVES

13

THE ROLE OF FINANCE IN DEVELOPMENT : THE OTTOMAN EXPERIENCE

AHMET TBAKOGLU*

1. INTRODUCTION

"Development" is an ideological concept contained in the capitalist paradigm. Since capitalism has dominated the world economy since the eighteenth century, (material) progress has been given top priority in all spheres of life. Beginning from the late seventeenth century many Ottoman and other Oriental observers began investigating the secret of the material progress realized in the West. The term in vogue was "civilization" during the nineteenth century; and it was, in a sense, replaced by "development" in the twentieth. Europeanization, Westernization, Modernization all are other appearances of the one and same phenomenon: material development, based on a secularized world-view. The more value-free term for this process may be "industrialization". Here I am not in a position to discuss the appropriateness of a term like "Islamic development". Rather, I shall try to outline an 800 year experience of the Anatolian Muslim peoples from the XI to XIX (H. VI to XIV) centuries, in economic terms, and make an attempt to derive certain implications for current theoretical and practical experience.

2. MAIN FEATURES OF THE OTTOMAN ECONOMIC STRUCTURE

. The Ottoman State inherited the intellectual and institutional legacies of the former Islamic states. Such economic institutions as *iqtatimar, futuwwa-uhuwwa,* crafts guilds, *muqataa, diwan* etc. were closely associated with the past Islamic experience. Besides, ancient near

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Eastern (especially, Persian) and Byzantium influences can be observed in certain aspects of the Ottoman institutions. Particularly in monetary and fiscal systems, we can say that the Ottomans were as flexible as the early Islamic societies faced with local traditions. In a sense, the Ottomans were traditionalist, not `progressive-developmental'. Change was mostly considered as a sign of decay, its remedy being a return to the Eternal Law.

The financing of wars in a coinage economy requires the enhancement of state revenues. An increase in production sometimes depends on this condition. Revenue collecting is a function of just treatment of the community. The state is financed through revenue (taxation), revenue is collected through justice. Therefore, the foundation of the state *(El-Mulk) is* justice. The principle of justice leads to the conception of social `welfare'. The goal of the economy, as indicated in countless documents, is social welfare. In other words, man is not for the economy, it is the other way round.

The Ottoman system is not demand-oriented, it is supply-oriented. Such is the case both from the individual and the social points of view. Individuals are more `givers' then being merely "receivers". That is, they are not utility or profit-maximizing egoists, but rather are devout altruists. The essentials of this supply-oriented society and economy are service and support (mainly for the poor *`infaq').* Any modern treatment of `Islamic economics' must emphasize these crucial points.

(In the Ottoman Archives, we have now more than 100 million documents, illuminating many aspects of lengthy history politically, socially as well as economically. My paper will be based on first-hand research of relevant documents in these archives).

. A supply-oriented economy reveals that economy is subject to man and his welfare. Another implication is the high production potential of the Ottoman economy. Again for this reason, with the exception of certain articles, imports were not prohibited. As to the exports, basic food articles, industrial raw materials and armaments were not allowed for export.1

Until mid-eighteenth century the Ottoman economy was one with high production and a favorable trade balance.[2] This high production supported a flow of agricultural as well as industrial exports to Europe.[3] After the mid-eighteenth century, however, when serious under-production began to emerge, Western capitalism established its dominance over the Ottoman economic structure. The financial structure of this system of high production and social welfare should be studied first.

3. FINANCING OF PUBLIC PRODUCTION

Public production and the share of State out of this production may be studied under three headings:

A. Central Finance (Treasury)

This is the section whose revenue and expenditure are reflected in the central budget. Since the system was based on coinage, the revenues were collected, and expenditures made, in cash money: thus the existence of a powerful central treasury.

The treasury was of two kinds: Internal and external. The former covered the sultans' private revenues and expenditures. But, it was also a source of credit for the external treasury. This second one was the responsibility of the *Sadr-i azam* (modern Prime Minister) and the *Defterdar* (modern Minister of Finance); thus it was the State Treasury. With the introduction of Reforms in the late eighteenth century (called *Nizam el Cedid),* there had been a shift to a multi-treasury system. But after *Tanzimat,* the one-treasury system was resumed.

Budgets, which were certain accounting lists generally prepared in year-ends, reflected the share of the central treasury in public production. Moreover, there were budgets prepared at the beginning of the year predicting the next period's revenue and expenditure. The first Ottoman budget dates back to the year 930-1 H/1524-5 G. For the period until Tanzimat (mid-nineteenth century) there were around 30 states budgets.

The main principle in Ottoman finance was to adjust expenditure according to revenue. As a corollary to this principle, a logic, of subtraction is observed in the Ottoman accounting (and budget) registers. That is, if revenue has come to exceed expenditure, the surplus is retained in the Treasury. In short, a surplus budget was the target of the Ottoman financial mind.

The central budgets, which, generally reflected the cash in-and-outflows, covered 51 per cent of all national revenue in the sixteenth century.4 This share must have been risen through time, because the economy was increasingly monetized afterwards.

1. Revenue Sources of The Budget

Major revenue sources in the budget are *muqataa*, *jizyah* and *avariz* revenues. The *muqataas,* whose original forms were seen during the Abbasid reign[5] can loosely be defined as state enterprises run by the private sector. They may assume monopolistic properties. Moreover, the collection of a revenue share pertaining to the state can be organized in *muqataa* form. Prominent examples are customs, mints, mines and alum factories. The share of *muqataa* revenues in the budgets oscillated between 24-40 per cent.

Muqataas were run by three main methods: *iltizam, emanet* and since late seventeenth century, *malikane.* With the *muqataa* method, without shouldering the burden of establishing a separate organization for tax collecting, the state could determine these revenue sources and transform them into *muqataas,* and then leave the task to private enterprise. We see the *muqataas* in the official registers for demography and taxation only in the cities. But, the lands belonging directly to the Treasury were also run as *muqataas.* The agricultural, commercial and industrial revenues consolidated under the title of *`muqataa* revenues' in the Ottoman budgets and their respective rates can be observed through the following table:

Year	Rates (%)
1103/1691-2	51.7
1110/1698-9	37.7
1113/1701-2	41.6
1114/1702-3	38.1
1122/1710-1	42
1147/1734-5	29.4
1159/1146-7	40.8
1161/1748	55.3

The variations in the *muqataa* revenues and in their respective shares in total revenues had close connections with the political situation and wars.

Iltizam (tax-farming) is the running of *muqataas* by the private sector in return for a fixed price. The period is generally three years. Allocation is made through auction. Sometimes an extraordinary rise might be seen in the revenues of a certain muqataa, giving way to an unexpected `profit'. In such cases, *muqataas* could be transferred to someone offering a higher price, even before the time period expired. In doing so, the state prevented the `unearned' accumulation of wealth in private hands. On one hand, the *iltizam* owners *(multezims)* with their advance as well as annual payments, contributed to the financing of public expenditures; on the other, produced public goods. Thus, the state was engaged 'in the control of the production, not in the production itself. All the properties of the *multezims* was mortgaged to the treasury; therefore, they could neither sell nor transfer their property to third parties.[6]

As shall be explained later, the lands included in the *timar* system were started to become *muqataa* from the sixteenth century onwards. Since the old system was not suitable for the new war technology, plus the increasing cash requirements due to the continued wars the new trend was strengthened. Also, the trend to *iltizam* added much to the private initiative and possession.

Because of warring conditions, great difficulties were experienced in the operation of the *muqataas* with *iltizam* method, leading to unstable ups and downs in *muqataa* revenues. When peace was reached, new measures were taken and revenues expanded.[7]

During unfavorable economic cycles, because of the possibility of loss, the *iltizam* method became difficult and the state was compelled to extend these revenue sources to certain powerful groups on the basis of *emanet* (trust). In such cases, most often a mixed enterprise combining government tasks with private enterprise was established. It would involve a salaried official with the title of *emin* and a person responsible for the profit and loss of the enterprise who undertook to pay the government a pre-determined sum of money. This transitional regime was called *emanet ber vech-i iltizam* (entrusted tax-farming).

Emanet is the running of *muqataas* by state officers called *emin.* The *muqataas* which low-yield were unattractive to the *multezim.* Certain crucial areas which could not be put outside state- operation (such as state. land, mines, customs), were subject to the emanet method.

The *emin (i.e.* the entrusted government official) would not undertake any responsibility concerning the amount of revenue and contested the indemnity allocated to him by the government. They were expected to protect both the farmer and the land.8 The method of *emanet* was preferred to *iltizam* in the-Ottoman fiscal tradition.

Malikane is the transformation of an *iltizam* into lifelong possession. The. main reason behind this change was the increasing cash requirements of the, State since the late seventeenth century.

In the *malikane* system, revenue were sold to private persons on the basis of part cash and. part annual installments.

The implementation was first started in the agricultural sector which was destroyed by this tax-farming method. The miltezim (tax-farmer) instead of investing in the land and taking a long-run view, were inclined to maximize profits in the very short-term. In addition; under the pressure of financial crisis, the shortening of the *iltizam* periods worsened the situation. The tax-farmer did not care to provide the peasants with seed, draught-animal, and other `inputs' of agriculture. With the *malikane* system, the social security element of the classical timar system was to be re-substituted. In case of success, the *reaya* (subjects) and the land would be protected. Agricultural productivity would increase and thus an additional financial opportunity for expenditures would be created. With this thinking, the new *malikane* system was put into practice, first in the regions of Syria and Southern Anatolia near to Egypt where life-long tax-farming had been a dominant form for a ling time. The system was effective as one of the most important financial and economic institutions of the Ottoman Empire until the so-called *Tanzimat* period (1840's).

The revenues extracted in advance form the *malikane* system did not reach a modest share of 3 per cent in the total budget revenues. Moreover, the system was' not efficient in protecting the people working in it.

The system had spread out to all the activities as well as the provinces where the State had a tax base. However, it neither revived the security provided by the *timar* system nor avoided the inconveniences inherent in the *iltizam.* The chief reason for this failure was that the *malikane* owners started to run their enterprises on the basis of tax-farming, doubling the burden of the land and the working people.[9]

Jizyah is the capital tax the Islamic state imposes on its non-Muslim subjects. It symbolizes the sovereignty of the Muslims, thus acquiring the character of an `ideological' tax. It is the price paid by the non-Muslim subjects for their security guaranteed by the Islamic state.[10] The exceptions to this capital tax are men of religion, children, those under state service and the disabled. Those under the *jizya* obligation were separated into three categories according to their wealth. The *Jizyah* of Egypt, Baghdad and Basra provinces were included in the revenue surpluses *(irsaliye)* sent to the central government. Moreover, the lump-sum *jizyah* of the provincial states of Eflak, Bogdan, Erdel, Dubrovnik (today partly contained in the lands of Hungary, Romania and Yugoslavia) were significant. The share of total *jizyah* in the budget revenues was around 23-48 per cent and began to show increases after a reform in 1691.[11]

Avariz are extraordinary taxes, used primarily in the financing of the wars, and transformed into normal taxes in late seventeenth century. Their share in total was around 10-20 per cent. People serving military, religious or financial institutions were exempt from *avariz.* [12]

The *avariz* taxes, a part of which were collected in kind, considered the tax-payers as a collectivity and made them responsible for a definite amount, while *muqataa, jizyah* and other taxes were imposed upon producers and single tax-payers. *Avariz* was imposed upon communities. The unit was an *avariz* household. These `special' households consisted mainly of three to five real households. For the tax-paying unit to pay the tax, they had to be utilizing a certain dwelling (land) at the place of taxation. Accordingly, those living in villages and those in the cities were registered if they were actually in possession of land and a full-time trade, respectively.[13]

Avariz taxes also included a list of those exempt who were either individuals or collective groups. Those under military, religious or financial services together with the disabled people, were exempted from *avariz* taxes individually.[14]

Total or partial collective exemptions included the villages comprising the so-called *derbend* organizations, which provided transport and trade security throughout the Empire. Employees servicing, protecting and repairing bridges and water canals as well as functionaries in the mines and salterns, military couriers, the rice-growing farmers were also exempted.[15] Also, war destruction migration, epidemics, and similar events were also considered as reasons for total exemption.[16]

Major avariz taxes included *avariz akcesi* and payment for *nuzul, sursat* and *istira.* The first is a fixed tax, the amount of which increased parallel to the devaluation of money through time, collected on the basis of *avariz* households (i.e. several real households).

Nuzul was the provision of various foodstuffs (flour, barley etc.) for the Imperial army when it was on the way to a war. *Sursat* is an obligation on the *reaya* (subjects) to provide for the military certain foodstuffs and fuels at a price determined by the government. In *istira,* we see the same obligation at market prices. All these were transformed into cash obligation as time passed.

2. Budget Expenditures

The most important expenditure article in the budget was military outlays, with an approximate share of 50 to 70 per cent of the total. Next came various equipment costs of the army as well as the court, certain bureaucratic expenditures, and finally current expenditures.

The Ottoman budget registers the monetary expenditures of the State. Part of these are accounted without actual in-and-outflows to the Treasury. The allocation principle, like that of expenditure, ranks among the fundamentals of the general economic policy of the State. As an essential aspect of a supply-oriented economy, the allocation policy aimed at sustained production, realization of effective demand, and, as a result, maintaining social welfare.

Expenditures of the Central Treasury had, like revenues, expanded. However, when economic stagnation started in the second half of the eighteenth century it affected the budgets as well. Especially during the periods of defeats in wars, expenditure were fueled, whereas revenues, despite new tax sources and tariff increases, stagnated, leading to crucial budget deficits."

Public investment expenditures, which consist the major part of any modern budget, are not contained in the Ottoman budgets. Because, such investments, together with education, health, and other social service expenditures were financed not through the Treasury, but through private persons and especially foundations *(waqfs)* which were mostly exempt from taxation and other financial responsibilities."

Infrastructural investments are among the tasks of the modern state. The Ottoman was different. Infrastructure was left, through pious foundations *(awqaf)* and tax exemptions, to private persons. Needless to say, this private sector'.. had a different approach than its modern counterparts. The functions which the State should perform sensitively were the provision of justice and unity *(`adalah* and *tawhid).* Thus, instead of being directly engaged in investment and production, the State hoped to establish an efficient regulation and control mechanism. In an effort to maintain the unity of the State, while the dominance of tribal `feudalism' was gradually worn down, the ascendancy of a possible landed aristocracy and a commercial/industrial bourgeoisie was also precluded. The. control and supervision of production were carried out with great care, so that, in addition to reaching the above targets, individual efforts were channeled to the realization of justice and welfare.

3. Domestic and Foreign Borrowing

Domestic borrowing was resorted to from the seventeenth century, especially as a contribution to war financing. The first borrowing were made into wealth tax (amounting to some 70 per cent of the period's revenues) and all wealthy people were subject to additional taxation. These taxes were transformed into regular ones during peacetime.[19]

During the second had of the eighteenth century (in 1775), with the implementation of a bond-policy, large *muqataa* revenues were sold to the public in an effort to generate fresh resources for the State. This bond policy' (the *esham* system) is one of the original examples of today's revenue partnerships (widely used in post-1980 Turkey). The first paper money was introduced in 1839, thus the Ottoman economy began formally to assume a capitalistic character. In this new era, public expenditures were financed also through the non-Muslim *Galata bankers,* the mushrooming moneylenders of Jewish and Greek origin.

The first foreign borrowing was realized in 1854, during the Crimean war with the Russians. The long resistance of the Ottoman State to foreign borrowing is well known. They knew that an Islamic economy was one based on self-financing. However such resistance was undermined in an era of `Westernization' which had a totally different concept of economy largely based on the utilization of credits. But, the irrational use of the credits (mostly for wars or domestic consumption) forced the Ottoman government into a state of bankruptcy in less than 25 years.[20]

B. The *Timar* System

This section is not included in the calculation of the central budgets. The most crucial production activity was agriculture and the Ottomans carried that task through the *timar* system. The essence of *timar* is the allocation of the State's share of the agricultural revenue to specified areas of expenditure, without the interference of the Treasury. These revenues accrued from the utilization of the lands under state ownership *(rakabe)* by farmers. These revenues are allocated to state officers *(sipahis)* who are expected to perform certain military roles during expeditions and national defence. Therefore, there are three elements in the lands covered by the timar system. The first one is the state, the possessor of the `abstract' property on land; the second farmers; and third, the officials (generally the *sipahis)* who are allocated the revenue (tax) of the land in return for military services. The State thereby collects its tax revenue from the peasants or certain functionaries. It is a flexible, three-element system. Since the state was the legal possessor of the land, the sale, renting, donation, or dedication (to a pious foundation, *waqf),* of the land by the peasant was considered as illegal. The peasants, having the right to utilize the land, was the sole possessors of its produce, provided that they paid the rent (tax) to the officials *(sipahis)* nominated by the government. The sipahi-peasant relations were organized by specific laws. They were equal before the law. The functions of the sipahis were two fold: militarily, they trained and fed a certain number of soldiers for the Imperial army; economically, they supervised agricultural production and helped the peasants with regard to the provision of certain `inputs'.

For example, they provided the farmers with seeds, agricultural animals etc. 'in order to increase production. For all land to be cultivated, they contributed financially to the farmers. This economic security and solidarity was the main factor behind high agricultural produce.[21]

The system was so organized that the *sipahis* (or *timar* owners) were not able to form a landed aristocracy. (This attitude was carried over to prevent the formation of an industrial aristocracy as well). During the sixteenth century, the share of timar in overall public finance was around 35 per cent. However, with the monetarization of the economy throughout the subsequent centuries, this share sharply declined.[22]

C. The Foundations *(Awqaf)*

The discouragement and prohibition of luxury and extravagance in Islam has limited the prospects for disposable income, thereby directing such extra income to the enhancement of the social welfare through foundations. Besides, the revenues appropriated by the producers of the capitalist system through price differentiation are directed (in the Islamic system) towards furthering social welfare by way of foundations. Today the `investments' which are contained in the central budget revenues, such as religious affairs, education, health, social aid and civil construction are financed generally by the foundations. Foundations are of two kinds: tangible (in the form. of buildings or real estate) and intangible. In both cases, the essential point is the foregoing of individual property for the benefit of mankind. Thereafter, that property belongs to Allah (s.w.t.). The main *waqf* (P. *awqaf) is* in the form of real estate, primarily agricultural land and commercial buildings.

The share of *waqf* revenues in total public revenues was around 12 per cent in the sixteenth century. With the surge in private property, and *iltizams* in the succeeding century, there was a considerable enlargement in number of the foundations as well probably reaching some 25 per cent in the eighteenth century.[23]

4. FINANCING OF PRIVATE PRODUCTION

There was no contemporary `public-private' sector distinction in the Ottoman economy. In principle, production was carried by the `private sector'; the public authority was the controlling agent. The distribution of food products into specified regions as well as the allocation of raw materials and semi-finished goods to specified producers were under the control of the State.

Being an Islamic economy in nature, the Ottoman economy was a self-financing, not a credit-based economy. The main principle was not to resort to external financing, and encourage production with available capital. The capital need is primarily met through partnership in the enterprise. This point is so prominent that especially in the early fourteenth century the term `partner' was used for 'merchant'.[24] Nevertheless, the increasing needs for further production necessitated certain financing sources.

A. Sources of Credit

Since the Islamic Ottoman economy was not a credit-based economy, it was also familiar with the concept of `saving'. The phenomenon of credit is a relation of money demand and money supply. This leads to a potential medium for interest *(riba)*. Thus, the economic decision-makers were, firstly, not willing to utilize money for purposes other than being a medium of exchange. Secondly, whereas credit supply was encouraged, credit demand was not. Moreover, foundations based on cash money were generally discouraged. But in practice, the last one was largely implemented.

Though not encouraged, savings were the main credit source. High army officers *(pashas)*, court officers, foundations and their security vaults were utilizing the money they had in certain forms. The merchants were collecting money capital through the *mudharabah* system and returning a certain share to the owners of that capital.[25]

There were persons and foundations who met the credit needs of bid businesses and the craftsmen. There is detailed information on this point in the Legal Registers. In this system, we see prominent international traders as well as able bankers use third parties for money payments and disbursements on their behalf.[26]

Credit phenomenon brings the interest phenomenon together. We know also that money-foundations resort to disguised interest transactions through *hiyal shari'ah.* The amounts accumulated through money foundations (which were established under the authority of *Imam el-Zufer)* were used for interest and the revenues were spent for social purposes.[27] Money foundations were so developed that they were called foundation banks.[28] We also know that certain aid funds organized for social security purposes were run this way.[29]

Usury and unlawful interest rates were forbidden. The payments made above the official rate were to be deducted from the original total of the debt.[30] Those who practiced usury were either punished (directly and sometimes violently), or they were forced to provide certain social services with their acquired wealth (The provision of the meat requirements for Istanbul was among such services). Despite this, they could not help avoiding bankruptcy in many cases.[31]

Interest in the legal sense should be differentiated from economic interest. Both in the *fiqh* and its application in the Ottoman experience, we have certain cases which are not legally designated *as riba,* but are economically so: *bai al `inah, bai `al wafa,* or *bai al Istiglal ...* The Ottomans were always bound up with *fatwa* and continued the applications which existed (and legitimated) the former *ijtihad.* The common solution to *riba* was the so-called *hiyal shari'ah* (legal avoidance). From the replies to the objections, it is understood that such applications were mainly in the form of exchange transactions rather than lending/borrowing relations. Whereas the second type was forbidden, the first was considered as legitimate, although both economically fall into the realm of *.riba.* Therefore, contemporary Muslim economists must consider these legal and historical precedents. A possible solution would consider our Islamic economy as one which uses its own capital, rather than credit, as the base for profit-earning activities.

B. Financing of Industry and Trade

One of the main reasons for maintaining a self-financing manufacturing system was to prevent cheap pricing through deficient quality. [32] The judges *(qadis)* were acting as notaries in commercial sales with term payments (the so-called `cost-plus financing' in modern times). The merchant who made the sale or provided financing normally registered these transactions with the court and received document of guarantee. For the sales on a credit basis, with different terms of payment, the `borrower' acknowledged his debt and the related terms, and. the `creditor' confirmed this. The names of the witnesses were also included in this document *(huccet).*[33]

Since the lending contract that created an additional value is considered as *riba* in Islam, the special circulating papers called *`suftece'* led to a heated discussion. In Islamic jurisprudence, *suftece is* selling a commodity or lending some amount of money to someone on the condition that the payment will be -made to a third person, and taken back in another city. This procedure eliminated the difficulties resulting from money (gold and silver) transfers and provided a benefit for the lender (or seller). The risk involved in the transfer was undertaken by the borrower. However, if such a benefit had not been put as a condition into the contract, the *suftece* was considered legitimate. This document was being prepared by the judge *(qadi).*[34] *Suftece* was also used in the financial transactions of the State.[35]

C. Financing of Agriculture

In the classical Ottoman *timar* system, the small-scale agricultural enterprise was made dominant; thus, a financing system meeting their financial requirements was designed. Besides, an irrigation system was developed in certain lands of the Ottoman State. The farmers who provided irrigation through their own effort were to pay the main tax *(`ushr)* in half, i.e., at 5 per cent. The method that existed in agricultural activities concerning the shares of the labor (tenant) and the proprietor was called *muzaraah* and based on the principle of the former giving a portion of his produce to the latter. [36]

The cultivation of certain `industrial' plants such as cotton, sesam, hemp and hempseed were given high importance and encouraged through certain tax incentives.[37]

Since the supply and demand elasticities of the agricultural produce were quite low, the State prohibited the export of basic food items and pursued warehousing policies.

The equilibrium provided by the *timar* system was shaken especially during the second part of the eighteenth century. The small agricultural producer was forced into borrowing (on interest) due to unfavorable weather conditions, famines and animal destruction. In the absence of a well running *timar* system, people had to resort to the private lending market. The *salam* method, which consisted of selling the produce before reaping, was utilized in an effort to provide the producer with his cash requirement. However, whereas Islamically the factors of *jahl* and *gharar* (unknownness and indeterminacy) were avoided, in practice the buyer would not undertake the seasonal risks. Thus, in case of credit non-performance, the lands were converted into large firms *(chiftlik)*, with the previous owners being reduced to the ranks of either landless workers or share croppers.

As the system deteriorated under the influence of the Western capitalism the financial needs of the small agricultural producers were met through National Fund *(Emniyet Sandigi)* and the modern Agricultural Bank (in late nineteenth century). Their success being limited, the small producer became dependent on the private/commercial credit market.[38]

D. Financing of Social Security,

In the Ottoman State, state officials as well as certain sections of the general public formed specific funds to meet emergency needs during old-age, sickness, or disabilities. There were certain state payments for retirement or body injuries during official work. The professional army members *(Janissaries)* had their own social security fund *(orta sandigi)* which was operated as a credit mechanism, likewise, the guild members had their own funds *(esnaf sandigi),* the urban and rural dwellers had their *avariz sandigi,* all being operated on a credit basis. These latter had the status of foundations *(waqf).* [39]

In short, the social security funds organized under the patronage of foundations formed a considerable part of the credit supply for the economy.

CONCLUSION

To sum up, the Ottoman economy was fundamentally a self-financing economy which discouraged credit demand. Instead, certain partnerships provided a particular financing method. The credit supply was mainly formed through foundations. A high credit supply with low demand discouraged an interest-bound exchange medium. But, together with the influence of the West and the ensuring Westernization drive, interest rates began increasing. The Ottoman economy revealed that interest was a function of credit supply and demand; thereby, the governments kept the former high and the latter low to avoid an interest economy.

The fundamental characteristics of the classical Ottoman economy were a high level of supply (production plus importation) and the just distribution of this supply and the revenue created thereof. The aim was social welfare. The high supply structure in the classical period (until the latter part of the eighteenth century) permitted the restricted exports to exceed imports as well.

This paper intends to understand this structure and attempts to explain the way it was financed.

ENDNOTES

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3. Tabakoglu, 1986, pp.377-378.
4. Barkan, 1953, pp. 272A.
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6. Sahillioglu, 1963.
7. Rasid,. V, pp. 126-7.
8. Maliyeden Mudevver, 139; 23 11 1110/23 V 1699.
9. For further information see. Tabakoglu, 1985, pp. 120-135 and pp. 165-171.
10. Al-Qur'an, 9/29.
11. See Tabakoglu, 1985, pp. 136-152.
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13. Muhimme,. 96, s: 64: B 5 1089/VI 1678.
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21. A. Vefik, H. 1329, pp. 247-248.

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27. A. Refik, 1935, pp. 87.

28. Barkan-Ayverdi, 1970.

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30. Muhimme, 12, pp. 595/1137.

31. Muhimme, 7, pp. 79/162, pp.82-172.

32. Muhimme, 6, pp. 728/1994.

33. Sahillioglu, 1975, pp. 106.

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14
PUBLIC BORROWING IN EARLY ISLAMIC HISTORY: A REVIEW OF SOME RECORDS

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INTRODUCTION

Public borrowing has assumed great importance in recent years as indicated by the phenomenal rise in the volume of domestic as well as external debt. This is especially true of the Muslim countries most of which belong to the group of poor developing countries of the world. There is a growing literature on the `solution' to the crisis supposedly faced by the world financial system because of these debts, some of which is now considered to be unrepayable. There have been attempts to look at the causes of this phenomenon of permanent indebtedness of nations. Islamic economists have also discussed the implications of abolition of interest for public borrowing. They have tried to find alternative ways of financing public needs hitherto financed by borrowing.

It is in this context that scholars have felt the need to look back and see what lessons can be learnt from the Islamic heritage. Did the Islamic state in the. past borrow? If so, why and how i.e. on what terms? Were there any alternatives to borrowing? With these and related questions one can explore the historical records of the many governments, spanning vast regions of the globe, over the long period of fourteen hundred years. This is, however, a very ambitious project requiring extended teamwork. Yet another problem with such study is the Islamic authenticity of what the Muslim rulers have been doing all these centuries in all these -regions. Authenticity naturally belongs to the decisions and 'actions of the. Prophet. The consensus of the community has extended -this authenticity to the period of the four pious Caliphs also, i.e. to the policies of the Islamic state till the year

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40 after *hijrah* which can serves as examples of Islamic policy making and, taking into consideration other relevant factors such as need, scope and perceived function of borrowing etc., guide Islamic statecraft in the modern period. As regards the other Muslims rulers, their decisions and policies have to be judged on the criteria of *Qur'an* and *Sunnah.* In the context of public borrowing, the most important criterion on which the legitimacy of public borrowing by Muslim rulers has to be judged is prohibition of interest. This means that if an incidence of borrowing on the basis of interest by a Muslim ruler is reported it has to be regarded as an aberration rather than a -precedent, generally speaking. This does not mean, however, that recording and analyzing such cases is of no use to Islamic economists. There is a possibility that such a course of action was resorted to under `extreme necessity' *(idtirar).* In that case it becomes possible to condone the action despite the fact that it can not be a precedent for others, being a violation of *shari'ah.* While a judgement in such cases may be beyond the scope of an Islamic economist's vocation, it is his job to study these cases and analyze the causes and consequences as befits an economic historian. In fact, such a study on his part not only facilitates proper `judgement' on such matters, it is a necessary precondition to it.

Another important dimension of the matter is the linkage of a particular policy decision with the realization of the goals of *shari'ah.* Did public borrowing serve a well recognized goal of *shari'ah, is* an obvious criterion on which its propriety or otherwise should be judged?

This study covers only the periods of the Prophet, the four pious Caliphs, the Umayyads and that of the Abbasids till the year 333 A.H./944 A.D. after which real power passed, in succession, to the Buwaihids and the Seljuks, and this continued till the sack of Baghdad by Holaku in 656/1258 which put and end to the Abbasid Caliphate at Baghdad.

Our. primary task has been to record the reported cases . of borrowing by the ruler for public purposes. Then we look into such details as the need and circumstances which prompted borrowing, the amount borrowed (in cash or kind) the identity of the lender and the terms and conditions attached, if any. We also inquire whether the lending was voluntary or the ruler had to coerce the lender. If available we also look at the details of the repayment of the loan. Having noted these features we try to analyze these cases in relation to their causes and consequences. Finally we ponder over the lessons that can be drawn, if any.

A serious handicap faced by the writer has been the absence of any other study on the subject which could help in posing the questions or looking for the answers. This should be regarded as one of the reasons, should the discerning reader find the present study deficient in some ways.

2. PUBLIC BORROWING BY THE PROPHET

The Prophet, peace be upon him, was known to be a frequent borrower in his private capacity at least in the difficult early years in Madinah, but reports relating to these borrowings do not concern us in this study. We have noted only those cases where the Prophet borrowed as the leader of all Muslims and the head of the state he established at Madinah. It is not at all difficult to distinguish between the - Prophet's personal borrowing and his borrowing for public purposes since the texts themselves facilitate such a distinction.

Our search has so far lead us to six cases of public borrowing by the Prophet which are reported below. A possible seventh case will also be noted in the end.

1. We first present a report by a life-long companion of the Prophet Bilal, who spent his time mostly near him from the early Meccan period till the Prophet breathed his last in Madinah. This report tells us that the Prophet used to borrow frequently in order to help needy Muslims whenever the circumstances called for doing so. Though these borrowings would be for comparatively small amounts, in cash or kind, the borrowing was done even when no means of repayment were in sight.

"It is reported of Zaid that he heard Abu Salman saying that Abdullah al Hawzani told him `I met Bilal, who used to give the call for prayers for the Messenger of Allah, peace be unto him, at Halab. I asked him to narrate about the expenditures of the Messenger of Allah, peace be unto him. He said `He did not have any thing (to spend).1 I used to look after it on his behalf ever since Allah called him to prophethood till his death. It was his practice that when a man came to him as a Muslim and he saw him in need of clothes he would order me and I would go and borrow and buy a cloak for him, clothe him and feed him. This continued till a person from amongst the polytheists accosted me and said: `O Bilal, I have enough resources so you do not borrow from any one other than me'. I did accordingly. One day it so happened that, as I made ablution and rose to give the call for prayer, that polytheist came along accompanied by a group of traders. When he saw me he called, O Abyssinian! I said, yes. He presented a grim face to me and addressed me harshly, saying: `Do you know how many days are left between you and the (end of the) month (when repayment is due)?' Bilal says, `I told him it is near'. He said, `it is only four days between you and it, after which I will capture you against what you owe and return you to grazing sheep as you used to do before'. I felt what people feel (on hearing such a threat). When I had prayed the night prayer (i.e. *isha)* and the Prophet, peace be unto him, retired to his family, I sought permission to see him. He admitted me in. I said "O Messenger of Allah, you are more dear to me than my father and mother, the polytheist from whom I used to borrow has said this and that and you do not have the means to repay him, nor do have I. He is going to humiliate me. Please permit me to abscond to one of these tribes (outside Medina) who have accepted Islam till such time as Allah provides to His Messenger, from out of which provision he can pay back the loan'. I came out (of the Prophet's place) till I reached my home and put in readiness my sword, socks, shoes and shield at the head of my bed. When the first lights of dawn appeared on the horizon I got ready to go. Suddenly I heard a man calling. O Bilal! you are to report (immediately) to the Messenger of Allah, peace be unto him. I set off till I came to him. What I saw there were four camels resting with their loads. I sought permission to see (the Prophet). The Messenger of Allah, peace be unto him, told me `cheer up, Allah has sent what you can pay back your loan with! Then he asked `Did you not notice the four camels in rest?' I said, `I did'. He said, You have the camels as well as their loads. They are laden with clothes and food which have been presented to me by the chieftain of *fidak*. Take possession of them and pay off your debt'. "I did accordingly ...."[2]

This incident must belong to the sixth year after the *hijrah,* or the period after that, since Fidak was subdued during that period.

The one important point emerging from this report is the primacy attached to need fulfillment. It was regarded by the Prophet to be a purpose important enough to borrow even from non-Muslims and without any definite means of repayment in sight.

2. The second report is not explicit as to the purpose of borrowing but there are clear indications of the loan being repaid out of the public treasury. This presumes borrowing for some public purpose. As the details in the Arabic text reveal, the report reproduced below is part of the story of a Jewish person in Medina embracing Islam. This person to whom the Prophet owed (a quantity of dates, most probably) wanted to test the Prophet for the quality of self control and forbearance. Hence his peculiar behavior:

"...Zaid bin Si'na said: `When the due date of the loan was only two or three days away the Prophet came to attend the funeral procession of a man from the Ansar, accompanied by Abu Bakr, Umar, Usman and some other Companions. When, after saying the funeral prayers, he came near a wall to sit by it I came to him and gave him a very hard look. I took hold of his shirt and the outer robe and said, "Pay up to me, O Muhammad! By God what I know about default on part of you children of Abd al Muttalib is based on my direct contacts with you people!" Then I looked towards Umar whose eyes were moving in his face like the rotation of the heavenly bodies. He looked towards me and said, "O jew!, you do this to the Messenger of Allah? By him Who sent him down with truth I would have struck your head with my sword but for what I fear to miss'. (Zaid) said, `the Messenger of Allah, peace be unto him, was calmly looking at Umar and smiling. Then he said, `Myself and he are in need of something -else (from you), that you advise me to pay back gracefully and advise him to ask for repayment politely. O Umar go and pay back what is due to him and give additional twenty *sa'* of dates against your threat to him'. Then (Zaid, son of Si'na) narrated how he embraced Islam."[3]

3. We now report a case in which the borrowing by the Prophet may have been for private purposes. However, there is some likelihood of the debt having been incurred to meet some public need.

"Abu Said al Khudari reports that a bedouin came to the Prophet, peace be unto him, asking for repayment of a debt owed by him. He behaved rudely and said I will continue insisting till you pay up. Thereupon the Companions scolded him and said "woe upon you, do you know whom you are addressing". He said, "I am only claiming my rights." The Prophet said: "why did not you side with him who had the rightful claim?" Then he sent a message to Khawla, daughter of Qais, that if she had some dates she should lend it to him till his own dates arrived out of which he could pay back to her. She responded by saying `yes, you are dearer to me than my father, O Messenger of Allah!" (The narrator says) so she lent to him and he paid up to the bedouin and presented some food to him. Thereupon he said: `you have fulfilled your obligation, may Allah repay you well.' The Prophet then said, `these are the best of the people. A community in which the weak cannot get their due right without trouble will not be regarded as pure. "[4]

The phrase `till our dates arrive' most probably refers to the annual share from Khaibar out of which a fifth was earmarked for family of the Prophet and rest for other beneficiaries. These shares would naturally be channelled through the public treasury. That the dates lent by Khawla were to be repaid out of the dates coming from Khaibar leaves both possibilities open: It could be paid out of the fifth assigned to the Prophet's family in which case the loan would have been a private loan. Equally possible, it could have been paid out of the part earmarked for other beneficiaries in which case the original debt must have been incurred in order to meet the urgent needs of the same beneficiaries.

A significant point to be noted in the above report is the practice of obtaining a loan in order to pay back an earlier one.

As distinguished from the first two cases, in this case the lender was a Muslim. The second lender whose lending made possible the repayment to the first lender was also a Muslim.

4. The fourth case is a case of borrowing in kind, the object being a camel of a particular age. Repayment was made of the camel collected in *zakat.* This rules out the possibility of the loan being in the Prophet's name since he was barred from *zakat.*

`Abu Rafi' reports that the Prophet, peace be unto him, borrowed a small camel from a man. Then some camels from those collected as *zakat* were given to him and he asked Abu Rafi' to pay back the man the camel (owed to him). Abu Rafi' came back and said he could find only better camels (older in age) who had their fourteenth grown. He (the Prophet) said, `give it to him. The best among people are those who are good at paying back."

As noted by Ibn-a-Hajar al Asqalani[6] while commenting upon a version of the same *hadith* in Bukhari's *Sahih,* this debt was most probably incurred for helping somebody meet his basic needs.

The main point that emerges from this case is the propriety of' borrowing for public purposes when there is a definite source of revenue in sight. The Prophet borrowed for need fulfillment intending to repay from *zakat* to be realized in the future.

5. In the fifth case to be reported, the purpose of borrowing is to meet the requirements of *jihad* - war in the cause of Allah. This occurred on the eve of the battle of Hunain in the eighth year after *hijrah.*

"When the Messenger of Allah, peace be unto him, decided to march up on Hawazin to meet them (in battle) he was informed that Safwan bin Ummayya had coats of arms and other weapons. He sent for him - still a polytheist - and said to him, "O Abu Ummayya lend us your weapons so that we can face our enemy tomorrow with their help." Safwan asked, `O Muhammad do you want to confiscate them?" He said, `No I want them temporarily with their return guaranteed till we bring them to you.' He said, -there is no harm in (doing) this. So he gave him one hundred coats of arms with the accompanying weapons. They also claim that the Messenger of Allah requested him to transport them too, which he did.'

6. The sixth case is that of borrowing a substantial sum of money from *a* Muslim individual for financing a major battle.

"Ismail, son of Ibrahim', son of Abdullah, son of Abu Rabi'ah al Makhzumi has-reported to us from his father who reported about his grandfather that when the Prophet was to attach Hunayn he borrowed thirty or forty thousand from him. He repaid it when he came back. Then the Prophet, peace be unto him, told him: `May Allah bless you with prosperity in your family and your property. The proper recompense for lending is repayment and gratitude.[8]

In the version of this tradition recorded by Nasa'i[9] the amount of the loan is' a definite forty thousand. The same is true of Ahmad bin Hanbal in his Musnad.[10] As regards the source of payment both these versions mention money that accrued to the Prophet subsequently,

The battle of Hunayn took place in the eighth year after "*hijrah* immediately after the conquest of Mecca. These were comparatively better days for state finances, The accrual of money referred to in the tradition could have been from the spoils of war consequent to the victory at Hunayn:

The above is a. clear case of borrowing for defense purposes. It is also evident that the sum paid back equaled the sum borrowed and no extra payments were involved.

7. The last case is that of Abbas, the Prophet's uncle, paying a year's *zakat* in advance, along with that of the current year. Since this was presumably done at the request of the Prophet," it has been construed as a kind of borrowing. The Prophet significantly used the word *aslafa* for the act, a word normally used for lending.

Ibn-e-Abbas is reported to have said that the Messenger of Allah, peace be unto him, sent Umar as collector of *zakat:* He (Ibn-e-Abbas) says, Abbas was rude to him so he came to the Prophet, peace be unto him, and informed him. He (Ibn-e-Abbas) says, then the Messenger of Allah, peace be unto him, told him `Abbas has advanced to us this year's *zakat* of his wealth as well as that of the coming year. [12]

The summary, the following can be noted.

The Prophet borrowed both in cash and kind, in small amounts as well as large, from Muslims as well as non-Muslims, from men as well as women. The purpose of borrowing was need fulfillment or defense/jihad. But he also borrowed to pay off more urgent debts. No coercion was involved in his borrowing. Nor did it stipulate repaying more than what was received as a loan. He borrowed when he did not possess, in cash or kind, what could meet the purpose in view. 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 always repaid the debts he incurred.

To put the above in proper perspective it should be noted that the usual sources of revenue from meeting public expenditure during Prophet's time were the following :

a. *Zakat* (including *ushr)* which gradually grew in volume after the second year after *hijrah* when it was introduced.

b. *Fai,* including the product share from Khaibar which was a steady source of revenue.

c. Spoils of war out of which a share accrued to the public treasury.

d.. Voluntary donations, often in response to appeal from the Prophet.

The first three sources brought nothing during the first year of the Prophet in Medina, hence exclusive reliance must have been placed on the last. In the light of available reports, revenue from all these sources was meager till year seven when Khaibar was subdued. Some cases of small borrowing for need fulfillment seem to belong to this period. But, as we have noted above, the two cases of big borrowing (case 5 and 6) belong to the post-Khaibar period and relate to defense purposes.

. These records of the Prophet's borrowing for public purposes do not mention any attempt by him to appeal for donations before resorting to borrowing, though the absence of a report to this effect does not eliminate the possibility.

3. PUBLIC BORROWING IN THE PERIOD AFTER PROPHET

We could not find a single instance of public borrowing during the reign of the *Rashidun* Caliphs, i.e. years 11-40 A.H. This is not surprising as revenues from *zakat* including *ushr, fai* including *kharaj*, as well as spoils of war were steadily rising throughout this period. These revenues would have been sufficient to meet all public expenditure including need fulfillment and *jihad/defense.*

The same applies to the next hundred years of Umayyad rule (41-132 A.H./661-749). We could not find any instance of state borrowing at the level of the central administration. However, there is a report from one of the provinces where an army commander borrows from traders to buy provisions for a twelve thousand strong army.[13] He pays them back after some weeks."

The incident belongs, probably, to the year 65 A.H./684 A.D. The commander concerned is *a tabi'i (i.e.* one who has met a companion of the Prophet, peace be unto him) Muhallab bin Abu Sufra, who died in the year 83 A.H. He was asked by the governorate of Basra[15] to take care of the *Khariji* rebellion which dominated Persia and threatened parts of Iraq.

"They took stock of the public treasury and discovered that it had only two hundred thousand dirhams. This was insufficient. Muhallab then sent for the traders and told them: For a whole year your business is depressed because the supplies from Ahwaz and Persia have been cut off from you. Let us have some transactions. Then you come with me and I will, God willing, fulfill all my obligations toward you. They sold to him and he took whatever he needed to equip his army and to provide for it **....**"[16]

This is a case of purchase on credit on a very large scale. Even though no extra returns are involved the traders have a big stake in the whole thing as the success of Muhallab's mission would eventually restore their supplies from Persia. It is not difficult to imagine that such `borrowing' or purchase on credit would be repeated elsewhere too, though not necessarily at the central government level. The report underlines an important point not any less relevant of our age than it was in the seventh century: Sometimes it is possible to meet a deficit by purchasing what you need on credit.

The first century of Abbasid rule, from 1232 A.H. to 232 A.H. was blessed by firm central administration and robust finances. Then started the period of weak rulers, domination of Turkish army chiefs and gross financial mismanagement. The Caliphs ruled only nominally as power was, in fact, exercised by the army commanders while the finances were managed by *wazirs.* The chief interest of the Caliph lay in the huge sums of money flowing into his private treasury *(Bait mal al Khass)* thanks to the appropriation of lands over the past and the customary gifts presented to the Caliph, especially by the aspirants to public offices. It was not unusual, in this period, for the public treasury to be empty while the royalty rolled in money. The army did not get paid in time. Unusual delays in the payment of salaries led the infantry to protests which sometimes culminated in riots in the capital city, Baghdad.

The first reports of public borrowing in our sources appear during the reign of the eighteenth Abassid Caliph Muqtadir who ruled from 295 A.H. to 320 A.H (908 A.D. to 932 A.D.) Muqtadir ascended the throne at the young age of thirteen. Real power was wielded by his mother and the *Wazirs* who were changed very frequently. As we shall see below the urgent need to pay the army while the state coffers were empty was behind most of the public borrowing that occurred.

The nine reports relating to public borrowing given below all belong to the period 300 A.H. to 333 A.H. This period was ruled by four Abbasid Caliphs, Muqtadir (295-320 A.H.), Qahir (320-322 A.H.), Radi (322-329 A.H.) and Muttaqi (322-333 A.H.). We could not cover the later periods for many reasons, not the least important among them is the fact that by then the world of Islam was divided into a dozen units having separate rulers and independent finances. Any study covering only the nominal Abbasid caliphate with its seat at Baghdad could no longer be credible.

It also deserves mention that we have relied on sources almost contemporary to the events being reported, e.g. Suli (d. 335 A.H.),. Tanukhi (d. 384 A.H.), Miskwaih (d. 421 A.H.) and Sabi (d. 448 A.H.). One of the greatest of the early historians of Islam, Tabari (d. 310 A.H.) does not report any case of public borrowing. Later historians draw upon these and other early sources.

4. PUBLIC BORROWING IN EARLY FOURTH CENTURY A.H.

1. "Ali bin `Isa[17] used to borrow from traders when some payments came due and he had no other means to make it. He borrowed on the basis of letters of credit *(safatij)* coming from the provinces but not yet due for payment. (He borrowed) ten thousand dinars against payment of -a profit of one and a half *daniq*[18] of silver for each dinar. Every month he owed two thousand and five hundred dirhams as profit.[19] This practice continued with Yousuf bin Finhas and Harun bin Imran, or their deputies, for sixteen years, and till after their death. They were not turned away till their death. They had gained this position (of state bankers) during the *wazirate* of Obaidullah bin Yahya bin Khaqan.[20]

The ruler did not consider it wise to turn them away so that the *jahbazah* retained its credibility among the traders and the traders would lend the *jahbadh* in time of need. If the bankers were to be turned away and others[21] were given that position and the traders refused to deal with these, the affairs of the Caliphs would collapse."[22]

2. Tanukhis' above statement follows his narration of an incident which culminates in the *wazir*, Ali bin **`Isa** making a special arrangement with the two bankers named above'. He is reported to have told them:

'Every lunar months I need a sum of money to be paid to the infantry troops within the first six days of the month. This amounts to thirty thousand dinars which sometimes is not available to me on the first day of the month, even on the second. I want you two to lend me one hundred and fifty thousand dirhams which you can recover within the month out of the revenues from Ahwaz,[23] because the administration of Ahwaz revenue is already in your charge ......[24]

Significantly, no `profits' are promised in this case, nor is there any mention of letters of credit. The author has quoted his source in giving this report whereas the statement quoted earlier is given on his own authority. It is also to be noted that the two bankers named above were Jewish not Muslims.[25]

3. The two Jewish bankers were given official positions by Muqtadir's second wazir, Abul Hasan Ali bin Muhammad bin al Furat[26] whose first round in this office lasted from 196 to 299 A.H.[27] Sabi reports one Abdullah Muhammed bin Ismail al Anbari al Zanji telling him about this *wazir* that:

"He called Yusuf bin Finhas the Jewish *jahbadh*, who was the *jahbadh* of Ahwaz, and told him, `This situation has arisen and our colleagues had not made the necessary preparations to deal with it. I have assigned their emoluments to (the revenue from) Ahwaz. Now it is very necessary that. you pay them in advance for two months. He (Yusuf bin Finhas) mentioned the large sums already assigned for advance payment on Ahwaz account and that it was not possible for him to take on any more demands. He (the *wazir)* continued to argue with him till he agreed to release one month's pay that very day .... "28

4. Another instance of interest bearing loan is cited by Miskwaih. It relates to the *wazir* Kaluzani who held office briefly in the year 319 A.H.

"Ibn Qarabah used to indicate to Muqtadir and Mifleh al Aswad that it was he who helped the affairs of the *wazirate* being performed and that no *wazir* could do without him. He used to make himself continuously available at Kaluzani's place and to lend him, one behalf of bani al Baridi and others, at the profit of one dirham per dinar. He lent him two hundred thousand dinars which helped the management of Kaluzani's affairs ....." [29]

5. The same person, Ibn Qarabah, is reported to be lending to Husain bin al Qasim, who succeeded Kaluzani as *wazir* in 319 A.H. `At the rate of one dirham per dinar as was his practice.' [31]

6. Facing a very tight financial situation, Husain is also reported to have sold some public property to raise five hundred thousand dinars and to have realized in advance half the money due in the year 320 A.H., some months before the beginning of that year.[31]

7. After a couple of years, in 323 A.H. during the reign of Caliph Radi, we find another *wazir,* Abu Ali bin Muqlah, `borrowing' from traders who used to supply flour against what was due from Mosul. He raised four hundred thousand dinars in this manner.[32] Significantly, no `profit' is involved in this `borrowing'. However, it becomes clear after a few pages that the `borrowing' actually amounted to advance payment for grains to be collected from the region as taxes and delivered to traders.[33]

8. We have yet another report about the same year, 323 A.H. This time the wazir tried to borrow from traders in order to pay the troops, offering traders letters of credit *(safatij),* the traders disappeared and the effort did not succeed.[34]

9. Another report by the same author, Suli, relates to the year 331 A.H. The then Amir al-Umara, Nasir al Dawlah, upon learning that the money changers were dealing in interest openly, warned them against doing so and obtained their pledges to that effect. According to Suli, however, this helped restrain- them only a little.[35]

This last one is not a report of public borrowing. We have noted it only to underline the fact that despite the practice of interest-based lending in the market, the authorities remain committed to its elimination till the close of the period we have studied in this paper.

It is difficult to deny, however, that interest was involved in some cases of public borrowing also. This reflects the gross mismanagement of the financial affairs of an otherwise prosperous regime as well as the compulsions of circumstances created by the maintenance of a large force of mercenaries in the capital city of Baghdad. The most surprising case of borrowing on interest relates to the *wazir* Ali bin `Isa `probably the first to obtain a loan by paying interest.'[36] Ali bin `Isa is reputed to have been a pious Muslim, well versed in *shari'ah* sciences and possessing extraordinary managerial skills.[37] The only direct report of this *wazir* borrowing from bankers is found in Tanukhi and that too does not mention interest (case 2 above). But the same author reports Ali bin `Isa borrowing regularly with interest on the basis of letters of credit, without quoting any specific source. Even if we are to accept this sweeping generalization, not corroborated by other historians, the question remains: Did he, under compulsion of circumstances, deliberately violate the prohibition of interest; or, did he look differently at using letters of credit the way he did according to the second report quoted above?

On the basis of the scanty material we could obtain, we can distinguish between four types of public borrowing in early fourth century after *hijrah.*

A. Advance payments realized in *a salam* type transaction, i.e. cash obtained against food grains to be delivered in future (case 7).

B. Discounting letters of credit or bills of exchange, i.e. obtaining cash by surrendering the right to receive a larger amount of cash later. (Cases 1 and 8).

C. Cash obtained by promising to pay later with an addition of a percentage on the sum borrowed (Cases 4 and 5).

D. Cash obtained by allowing the lender to recover the sum borrowed from revenue due in the near future (Cases 2 and 3).

As regards case 8 noted above, it is not clear from the report if it belongs to category 2 or category 4.

In all the cases reported above it is not the Caliph who borrowed, but the *wazir*, who actually ran the administration. Most of the borrowing is done in cash to pay the army on time, but sometimes it is done to make some other payments. Public borrowing in this period was largely in the nature of bridge-financing, to be repaid from sure sources of revenue in the near future. Loans are repaid out of the *kharaj* revenue (or land taxes). The lenders are Jewish bankers as well as Muslim traders. The amounts involved are large, but not out of proportion with the state revenues in those times. .

One significant point to note is the absence of any reference to need fulfillment as the purpose of public borrowing.

As regards the use of coercion in borrowing we have no. clear evidence, even though the sources abound in reports of confiscation of the properties of high officials once they fell from favor and of all sorts of extortions from traders.

It is very difficult to opine whether there were any alternatives to public borrowing in so far as it was resorted to. Apparently all other means were exhausted before doing so. Ali bin `Isa especially reported to have curtailed public expenditure to a very great extent, side by side with abolishing many extra-shariah laxes.[38]

What circumstances forced a pious man and efficient financial manager, who curtailed public expenditure in an otherwise wasteful affluent society, to borrow an interest, and how could he justify it to his own conscience, remains an enigma - at least till further details are available. This deviation from clearly defined shari'ah rules seems, however, to be a culmination of many other deviations in the financial management of the state, the details of which fill the pages of history books.

5. SUMMARY AND CONCLUSIONS

The records of public borrowing examined in this brief study present an interesting contrast. On the one hand we have the most responsible of rulers borrowing for need fulfillment and jihad/defence even when no future revenue was immediately in sight. On the other hand, we have irresponsible regimes in an age of affluence forced to borrow for bridging-finance, even if they had to violate the prohibition on interest. The strongly worded indictment of public borrowing by jurists like Imam al Haramain al Juwaini[39] (419-478 A.H.) is largely in response to the sorry state of affairs that the Abbasids had reached in the fourth century A.H. Given fiscal responsibility and adherence to the *maqasid al shari'ah* a different view is more convincing. Much further research is needed to trace the history of public borrowing in the thousand years that separate us from. the period studied in this paper. Any guidelines for contemporary policy making will be better drawn after such research, even though the decisive factors should be the contemporary situation and the example of the Prophet and his companions.

Meanwhile we can draw some lessons of contemporary relevance from this study:

1. Borrowing, when there is a need, is a legitimate activity even if it is from non-Muslims.

2. Fulfilling needs is one genuine reason justifying borrowing, while *jihad is* another.

3. While early history does not present any record of borrowing for financing economic development, it does provide an indirect justification of the same in an age in which economic development (especially of the third world countries) has become a sine qua non for need fulfillment as well as for *defence/jihad.*

4. Since the lender receives no worldly return, public borrowing presumes the lender being motivated by moral and religious consideration. Projects directly related to *jihad,* those directed at feeding, clothing and housing the poor and providing medical care to those who can not buy the same, as well as educational and moral-spiritual orientation programs, are most likely to motivate people to give *qard hasan.* The social authority should, therefore, make public borrowing purpose specific and select purposes most likely to motivate lenders, in order to succeed in mobilizing interest free loans to the government..

5. The state must repay what it borrows even if doing so. necessitates further borrowing.

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15
PROVISION OF PUBLIC GOODS : ROLE OF THE VOLUNTARY SECTOR (WAQF) IN ISLAMIC HISTORY

ABDUL AZIM ISLAHI*

INTRODUCTION

The present paper aims to study the nature and extent of public goods provided by the voluntary institution of *waqf* in Islamic history. It also tries to present the voluntary sector in general and waqf in particular as an alternative sector that has the potentiality to resolve, to a great extent at least in an Islamic system, the issue of an efficient supply of public services. Thus we propose to explore the possibility of utilizing this institution in developmental activities with respect to pure public good and mixed or quasi-public activities in contemporary Muslim economies. To begin with we shall briefly point out the controversy associated with the supply and allocation of public services. We shall also discuss the nature of the voluntary sector and different constituents of this sector especially the development, scope and dimensions of *awqaf* (plural of *waqf)* as the important ingredient of the voluntary sector. After discussing some evidence from Islamic history, the organization as well as the composition of services provided by this institution will be discussed. Making an analytical study of the whole we shall examine the role of the state in the supervision and regulation of *awqaf* in Islamic history and a desirable role for it in the present context. To conclude we hope to establish, in the light of our discussion, some suggestions that a modern state may adopt to make the best institution for the provision of public welfare and to reactivate and revitalize this gradually diminishing source of general good.

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PUBLIC GOODS AND THE QUESTION OF THEIR EFFICIENT SUPPLY

Socially desirable goods that provide benefits which are not marketable to individual purchasers are referred to as public goods. Such goods must automatically be provided to more than one member of the society simultaneously if it is to be offered to any one of them. Private firms do not find it profitable to produce them due to their nature of externality and non-rivalry. Thus public goods may be defined as ones "that everybody can enjoy without diminishing the enjoyment of others, and from which it is impossible to exclude people from participating".' These are pure public goods. Defence, lighthouses, weather forecasting and improvement of the quality of atmosphere are a few good examples of "pure public good". Because of the impossibility of excluding anyone from enjoying benefits once the good has been provided, this involves the problem which is termed the "free rider effect." That is, every individual being sure that the benefit of public goods has to cover him, is not willing to contribute towards the cost of its supply.[2] However, there are some other benefits which fit the first half of the definition of public good. That is, anyone can enjoy them without diminishing anyone's else enjoyment but it is possible to exclude someone from enjoying it. For example provision of health services, education, bridges and roads, stage performance, etc. These benefits lie in the intermediate range of a spectrum between wholly private and purely public. They may be called quasi-public goods or mixed goods. In our discussion of public goods we mean both pure public goods and non-pure public goods yielding external benefits. Since public goods are used by all but their enjoyment cannot be made subject to price payment, they cannot be satisfied through the market mechanism. Therefore, their provision is considered as the subject of public budget policy. The traditional stand on public goods mentioned above is not a universally accepted view. Ronald Coarse of the University of Virginia in one of his learned papers "The Problem of Social Cost"[3] argues that as a rule, no form of government action is required to deal with externalities or public goods, so long as property rights already exist. He showed that "though the initial. allocation of property right affects the distribution of income, the allocation makes no difference at all to the amount of resources directed to control an externality. Economic forces ensure that the same effective allocation will happen in all cases".[4] This idea known as the Coarse Theorem, sets out to demolish traditional thinking on public goods and externalities and it has converted many more economists to the liberal, anti-interventionist wing of their trade. But the issue remains as controversial as when it first appeared. There is no direction available to resolve this controversy.

Instead of the public sector or market, in early Islamic history, the voluntary sector especially the waqf, was relied upon for the provision of such goods. In fact, its role continued throughout Islamic history along with the public sector.

VOLUNTARY SECTOR OF AN ISLAMIC ECONOMY

The voluntary sector, as distinguished from private and government sectors, is a relatively new terminology. In an earlier theorization on the three sectors in Islamic economy it has been stated that "an Islamic economy will comprise of the private sector motivated by profit, the private sector free of any profit motive (the voluntary sector) and the public sector where profit motive is substituted by social welfare".[5]

At present, various works have appeared in the West that emphasize the role of voluntary actions to achieve different social and economic ends.[6] Nevertheless, if we compare the voluntary institutions of the West to those of their profit motivated private sector, the former will appear to be very insignificant, while the comparative size and importance of voluntary institutions in Islamic economy is very large. Therefore, Islamic economy is apt to be called a three sector economy.

The following are the main components of the voluntary sector of an Islamic economy:

a) *Al Sadaqat al Nafilah* (voluntary or recommended Charity). A Muslim is always advised to spend his money for the help of others. No minimum exemption limit, rate or time is prescribed for it. *al nafaqat al ghair al wajibah* (non obligatory expenditures) for which the state or its 'agencies cannot force someone to contribute are examples of recommended charity.

b) *Hibah, hadiyah or atryah* (gift and grant). A gift or grant made for some public purposes is also a voluntary action for helping others. *Alumra* (life long *hibah)* and *Al ruqba (hibah* in waiting) are two special types of provisions for gifts.'

c) *Al Wasiyah* (a will in the legacy). It is generally in favor of those relatives who are not getting a share in the legacy or in favor of some public purposes).

d) *Al ariyah or al qard* (lending). *Al ariyah is* to lend something to someone for a certain period of time so that person may enjoy its benefits. The *Qur'an* condemns those so called worshippers who does not follow this prescription.

e) *Al Nadhr* (the vow or dedication). The vow or dedication, in order to obtain a good fortune in a particular respect or to seek escape from a difficulty in this way is called *al nadhr* (plural *al nudhur).* The vow must be vowed of good deeds or spiritual services which also includes humanity.

f) *Alwaqf* (endowment). It may be defined as taking the corpus of any property from personal ownership, transferring it permanently to the ownership of Allah and dedicating its *usufruct* to purposes recognized by the *shari'ah* as pious or charitable. Permanence and irrevocability are two essential characteristics of the *waqf.* The income from a waqf property must be spent according to the terms and conditions of the *waqif* (donor).

g) Cooperative Associations. Cooperation for the sake of securing goodness is imperative in Islam.[9] Any association or organization for this purpose is harmonious to Islamic spirit.

Some pioneer writers on the voluntary sector in Islam have listed *zakah* especially on invisible property *(al amwal al batinah)*, *sadaqat al fitr* and expenditure on relatives under voluntary institutions along with some other forms of voluntarism.[10] But Islamic history shows that they have been compulsory payments. Even in the absence of official collections of *zakah*, the standing divine enjoinder and its binding nature excludes it from the category of voluntary actions. Similarly, *al nafaqat al wajibah* (the obligatory expenditure on relatives and others) for which the government or its agencies may compel a person may not be considered as voluntary actions.

Apart from the above mentioned, different voluntary institutions that involve material expenditure Islam has also encouraged its followers to extend voluntarily physical services to individual and social welfare. Dedication to teaching and preaching, voluntary participation in the defence of the country, removal of hardship, planting trees etc. are a few examples to mention here. However, we are concerned in this paper with the institution of waqf and its role in Islamic history regarding the provision of public goods.

THE INSTITUTION OF *WAQF :* ITS SCOPE AND DIMENSION

Pre-Islamic Arabia did not have a waqf system for the support of general welfare. It was the Prophet (SAW) who initiated the institution of waqf in the light of the Qur'anic teachings to spend and dedicate valuable and lovable belongings in the way of achieving goodness and the pleasure of Allah." There are two main categories of *awqaf.*

a) *Waqf* for the benefits of oneself and family called family *waqf*, and
b) *Waqf* for supporting the general good and welfare of the poor called *public waqf.*

The voluntary sector is defined as `all individual and social activities which are not by intent or design, undertaken to attain any economic or material benefit for the doer or doers"[12] excludes the former from our discussion. We mainly deal here with *public awqaf* that generates wide ranging economic repercussions.

As compared to the other voluntary institutions enumerated above, the *waqf* has been of enormous importance with respect to provision of public goods. While voluntary charity is generally done for satisfaction of a temporary need, *waqf is* made for the lasting object of public utilities. Similarly, the concern in the case of gifts or grants is love, affection and recognition, while in the case of *waqf* the need of beneficiaries is more important. As far *al wasiyah is* concerned, it may take a form of *waqf* also but its scope is limited as it would be effective at the maximum of only one third of the whole property. [13] Similar is the case of *al nadhr*. It is not always related to avow or dedication of property. In many cases it is related to performance of physical worship. Sometimes *a waqf is* created to fulfill *a nadhr*. Thus it may be one of the ways of creating *waqf Al ari ah*, in spite of being an act of voluntary help, cannot be compared with *a waqf* which is an irrevocable permanent source of benefit. Cooperative association, although an act of benefaction, is limited in scope to the members association. Thus the scope, effect, magnitude and viability of *waqf is* far greater than any other voluntary institution.

At present vast literature is available on the legal and religious aspects of *awqaf* but similar attention has not been paid to exploring its role in economic life of Muslims and its significance in the provision of public goods. Historically it had played a very important role in this respect and still has potentialities to do so.

PRECEDENTS FROM ISLAMIC HISTORY

Islamic history is full of vivid and rich evidences of *awqaf in* all its ages and in every region. Their number and magnitude is so much that an encyclopedia-like work would be required to prepare a directory of them for every Muslim country. Here are a few precedents from countless examples of *awqaf* in Islamic history starting from the Prophet's time up to the present age.

It is reported by Anas (RA) that when the Prophet (SAW) came to Madinah he ordered the construction of a mosque. He asked Banu Najjar to sell him land. They said, "By Allah, we expect its reward from Allah the Almighty" (And gave their land for the sake of Allah to construct the mosque).[14]

Ibn Umar (RA) reports that Umar (RA received a land at Khaibar and came to the Prophet (SAW) to consult him about it. He said, "O messenger of Allah, I have received land at Khaibar, I have never got a property more valuable than that. So what do you advise me regarding it?" He replied, "If you wish, you can retain its corpus and give it away in charity". At this Umar dedicated it providing that it should neither be sold, nor gifted, nor bequeathed. He gave it away for the sake of poor, the relatives, (freeing) slaves, in the way of Allah, for guests and for the wayfarers. It would be permissible for its caretaker to eat from it according to commonly accepted pattern and to feed a friend who does not enrich himself from it.[15]

Ahnaf (RA) reported that .... in the presence of Ali, Zubair, Talhah and Sa'd, Uthman the third caliph said, "You do know that the Prophet (SAW) said, whoever purchases the *mirbad* (land for keeping the camels) of such and such person, Allah would forgive him, so I purchased it and came to the Prophet (SAW) and told him that.I had purchased that land, at which he said, "Dedicate it to our mosque and you will be rewarded". They. confirmed, saying `Yes". Then Uthman (RA) said to them, "You do know that the Prophet (SAW) said, "Whoever purchases the well of Rumah, Allah will forgive him." Then I came to the Prophet and told him that I had purchased the well of Rumah. He said, "Dedicate it to Muslims and you will be rewarded". They answered, "Yes". Then you do know that the Prophet (SAW) said, "Whoever provides for the army of Misery, *jaish al Usrah)* Allah will forgive him". Whereupon he provided for them so much so that they were not missing even a rope or a ring." They confirmed it saying "yes". At this he said three times, "O Allah, be a witness.[16]

Ibn Abbas (RA) reported that the mother of Sa'ad,b. Ubadah died when he was away from home. He told the Prophet (SAW) that in his absence his mother was dead; would it benefit her to give something in charity on her behalf? The Prophet replied "Yes". He said, "I make you witness that I give my garden al Mikhraf as charity on her behalf'.[17]

After the Prophet (SAW), the practice of endowment continued to. expand throughout the Muslim world. Ibn Battutah (d. 1377) who visited Damascus in the first quarter of 8th century *hijrah* describes that *"awqafs* in Damascus are in such a large number that their kinds and purposes cannot be counted. There are *awqaf* for those who are unable to perform *hajj;* one who wants to perform *hajj* on behalf of someone is given full expenses. There are some *awqaf* for supporting those-girls whose guardians are not rich enough to help them financially to find husbands. Some *awqaf* are for freeing captives and some others are for-wanderers- they are provided with food, clothes, and expenses to return to their countries. There are also some *awqaf* for the paving of roads and foot paths, as streets in Damascus have platforms at their two sides on which the pedestrians walk, while the riders pass in between them. And there- are *awqaf* for some other welfare purposes

and good deeds. In later period, most of the Muslim rulers, along with their people, created *awqaf* from their personal property or from the state treasury. Jalal al Din Suyuti (d. 1505) in his book *Husn al Muhadarah fi Ahwal Misr wa l Qahirah* gave detailed accounts of *awqaf* created by Ahmad b. Tulun (254-370 A.H.), Fatimid Caliphs, Ayyubid Salatin, and Mamluk Salatin in Egypt for mosques, schools, libraries, hospitals, *khanqahs,* etc.[19]

The situation has been similar in India where most of the *awqaf* came from kings of the past, and from scholars, saints and nobles. [20] One of the earliest records is that created by Muhammad Chori (1175-1206 A.D.) who made an endowment of two villages to meet the expenses of the grand mosque of Multan and its related affairs.[21] Evidences relating to *awqaf* during the Mughal period are too numerous to be noted here. Apart from *awqaf* for objectives approved by *shari'ah,* there are a large number of them for upkeep of tombs, *khanqah zawiyah imambara,* celebration of a Shaikh's birthday or martyrdom, etc. One such *waqf is* that created for the tomb of Shaikh Muinuddin Chishti of Ajmer, a spiritual saint of 7th century *hijrah.* Since centuries it attracted *awqaf* from rulers as well as from common devotees from all over the country. Due to its importance several acts have been passed for its management.[22]

In the recent past, *awqaf* for Aligarh Muslim University, Aligarh, Nadwatul Ulama of Lucknow, Darul Musannifin of Azamgard and Hamdard University of New Delhi are a few examples that help Islamic sciences and culture to survive and flourish in this part of the subcontinent. At present there are more than one hundred thousand public *awqaf* with an estimated annual income of Rupees 50 million.[23]

The situation of *awqaf* in Pakistan, Bangladesh and most of the far eastern Muslim countries is not very different. In a limited research paper it is not possible to go into detail.[24] In the following pages, we just selected different examples of *awqaf* from Islamic history of various public works and welfare activities. They are as follows:

1. Places of worship.
2. Defence and fighting for the cause of Allah.
3. Help to the wayfarer and road services.
4. Food and lodging for the poor.
5. Water resources.
6. Education.
7. Preaching and call to the Religion.
8. Hospitals for the sick.
9. Celebration and adornment of tombs.
10. Marriage provisions for the poor.
11. Release of captives.
12. Support of handicapped.
13. Inner purification centers.
14. Research institutes, etc.

In the earliest history of Islam, when the departments were not fully established, the institution of *awqaf* substituted for the state's role. On different occasions, the Prophet (SAW) appealed to believers and drew their attention to the need to the provision of certain public benefits and his companions readily responded to his call and met the social need voluntarily as it is clear from the instances of preparations for different wars; help to *As'hab al Suffah* who needed state support as they were engaged in learning; provision of drinking water, etc. The establishment of a full state in Islam did not reduce the importance of this institution. In fact it supplemented the state in fulfillment of its obligations towards the provision of public the good. By' providing certain infrastructure such as roads, means of irrigation, health care, better nutrition, and research and educational institutions it also paved the way for the growth of the economy. During foreign domination of Muslim countries, *awqaf* helped Muslims to preserve their identity, culture and system of education and it served as a source of strength for the *mujahidin.*

ORGANIZATION AND COMPOSITION OF AWQAF

There are at least five aspects of *awqaf* through Islamic history which deserve our attention. They are: motives for creating *awqaf,* purposes, kinds of properties, management, and its supervision by state agencies.

Motives: The driving force of dedication or *waqf* creation has been the desire to win the pleasure of Allah. Verses of the *Qur'an* and *hadith* provided a helping hand. This gave voluntary actions among Muslims and edge over the secular thinking that limits them to altruism, man's nature of interdependence, love, sense of social duty and urge for recognition and approval. No doubt, all such factors motivate man to voluntary actions, and a desire for the pleasure of Allah and hope of unending reward in the Hereafter sharpens these factors except the last one, i.e. an urge for recognition and approval which are negative factors in the eyes of Islam as they are antagonistic to deeds for the sake of Allah. Since *waqf* property cannot be inherited and ordinarily cannot be sold, and generally is exempted from any tax, motives-for "creation of *waqf* may be to deprive the legitimate heirs, or to deny...the repayment of loans, or to avoid taxes. Ibn Taimiyah noticed this- incident and expressed his opinion that such *a waqf* would not be allowed unless a preferable welfare consideration *al maslahah al rajihah* was expected therefrom as it was in the case of Umar's precedent.[25]

Purposes: As far the purposes of *awqaf* are concerned, they have been of diverse nature. In the above pages we have enumerated some of them which involved the public good. Apart from that, *awqaf* were also created for celebration of saints' *(mashaikh's)* birth anniversaries, decoration and upkeep of tombs, *imambara, khanqah*, recitation of the *Quran* at the graveyard, etc. Due to individual limitations and lack of perception of the socially required goods, generally an unbalanced selection of purposes took place. Due to the indifference of the state and lack of guidance, deviation and failure of effective allocation of resources prevailed in this sector. People followed their local customs, traditions, and pseudo concepts of devotion and *thawab.* We do not find *awqaf* for scientific researches, technical education, and general economic welfare to the extent we find for worship places, traditional *madrasahs,* tombs and monastery, etc. In the sub-continent; where several hundred thousands public *awqaf* are found, the situation until half a century ago was that there was only one *waqf* worth mentioning, i.e. Dar al Musannifin which was created for religious and historical researches, and not a single *waqf* was founded for social, economic or scientific purposes.

Kind of waqf properties: The earliest examples of kinds of property dedicated in Islamic history are those of mosques, fruit gardens, water resources, agricultural land, schools, residential buildings, etc., and they continued through the ages. In many cases, past *salatin* dedicated villages was *waqf* for different purposes whose produce or tax revenue was to be spent on those purposes. We do not have clear examples of cash endowments. The reason may be that-many jurists did not consider it proper as it lacked the character-of permanence.

Management: Management of this institution .was traditionally entrusted to *a mutawalli* or caretaker who was appointed by the *waqf* creator *(waqif).* Thereafter it became hereditary or the *mutawalli had* the right to nominate after him. He enjoyed vast powers -and had chances to misuse them. Mismanagement and misappropriation of *waqf* properties had been a common complaint against *mutawallis.*[26]

Supervision and regulation: The institution of *waqf* started with a separate identity between the private and government sectors. When different Companions of the Prophet (SAW) voluntarily offered their properties for public uses, he did not take them over in the name of *Bait al mal. This* shows that he wanted an independent and voluntary sector to develop among the Muslim *Ummah.* In its early history, the role of the state was limited to solving disputes or appointing caretakers in case the *mutawalli's* post fell vacant and his appointment according to *waqf* deed was not possible. In some countries, it was required to get confirmation from a new sultan at the succession of a (new) *mutawalli.*[27]

It was Umar b. Khattab, the second Caliph who first established a department named *diwan al nafaqat* which also kept the account of *awqaf.*[28] With the increasing number of waqf properties and expansion of this sector, a separate department named *diwan al ahbas* was established in the 2nd century after *hijrah* under the supervision of a chief justice. There is evidence of a very early central waqf administration under the Umaiyads in Cordova. There was a treasury for the *waqf-bait al mal* in contrast to the treasury - *khazinat al mal.*[29]

In the beginning, *diwan al ahbas,* was a section of the court. Later in - the Fatimid and Mamluk a period it became one of the most important government departments.[30] When Muhammad Ali (1805-1849) came to power in Egypt he found the most of the agricultural land was dedicated as *a awqaf* which were least efficiently used and caused a heavy burden to the treasury. Thus he confiscated such lands and compensated the beneficiaries. In Egypt in 1851 a central administration was created which after various transformations was raised to a ministry in 1913 (1) But Turkey was the pioneer in creating a ministry of *awqaf* as early as in 1840.[32]

In India during the Mughal period, the supervision over *awqaf* was entrusted to the *qadi* or *sadr* appointed by the king.[33] In the post of

Mughal period, the British government, as against its French and Italian counterparts in Tunis, Algeria and Tripoli, followed a-non-interference policy regarding *awqaf* for many years and considered it as the Muslims' personal affair and so avoided any confrontation or resentment from Muslims. It was Muslims themselves who made several representations and demanded a government administration. In 1913, the government abandoned its policy of non-interference and in subsequent years a number of *waqf* acts were passed. After independence the government passed the *Waqf* Act of 1954, bringing a uniform administrative establishment throughout the country.[34] At present, a union *waqf* ministry and in some provinces state *waqf* ministries exist.

THE VOLUNTARY SECTOR AND THE EFFICIENT SUPPLY OF PUBLIC GOODS

The Coarse Theorem and its supporters tried to demolish the presumption that externalities and public goods automatically call for government intervention. they showed great economic insight in their presentation. But the question remained unsettled as the advocates of the private sector's efficiency in supplying of public goods ultimately assign the government the role of allocating the property right that can cope with the problem of externalities in public goods. Moreover, the Coarse theorem admits the market failure in case where the transaction costs are prohibitively high. Further, in spite of its rejection of the standard example of lighthouses on historical and empirical grounds, in many cases a satisfactory answer could not be obtained to deal with the problem of free-riders.[35] There are sufficient reasons to presume the voluntary sector in general and *waqf* in particular are alternative sectors that have the potentiality to resolve the issue of the efficient supply of public goods. We have seen that in Islamic history, the role of this sector started rather earlier than that of state and much before the evolution of the market. Public requirements at that time, such as defence, worship places, traveling facilities, sources of water and clean air, education and research, etc. were provided voluntarily, before the establishment of the state. It was the proven efficiency of the voluntary sector that many times in the past encouraged government, instead of having such public utilities in its own hands and exercising control to give it to voluntary organizations.

It should be underlined that in case of *waqf,* the free rider is not a problem. It is a desirable phenomenon because the more living souls (such as the free riders) benefit from the dedicated public facility the more will be fulfilled the objective of the dedicator in terms of *thawab* and satisfaction in benefiting the greatest number. The Prophet (SAW) said, "He who grows a crop or plants a plant from which a person or beast or bird eats that will be accounted as an act of *sadaqah* by him (i.e. he will be rewarded for it) [36] Thus the Islamic teachings of *sadaqah jarryah* (a continuous source of rewarding), *ihsan ila al khalq* (benefit the creatures of Allah) and *shukr li Allah* (thanks giving to Allah) encourage the believers to provide externalities in terms of benefits; and its teaching of *la darar wa la dirar* (no injury and no inflicting injury), *kaff al sharr waladha* (stop harm and evil to others) and *`iqab fi'l akhirah* (punishment in the Hereafter) will force him to control externalities in terms of social costs.

PROBLEMS WITH *AWQAF*

In our brief study of *awqaf* in Islamic history we have seen that the voluntary institution of, *waqf* had performed a very active role in provision of public services. It also provided some infrastructure in the past in the form of roads, canals, bridges, health services and educational centers. But with the passage of time, in spite of increasing the volume of *awqaf,* it did not perform the role for which it was meant and decadence crept in as has been the case with many other Muslim institutions. Beneficiaries of *awqaf* missed the spirit of the *awqaf* creators and treated the *waqf* property as a source of easy and lethargic living. It lessened the incentive to work. Thousands of lazy and idle people sat around the *awqaf* on the tombs of saints *(mashaikh)* in the subcontinent and in some other Muslim countries. This is also a common phenomenon. Evils associated with public and common ownership such as negligence, less efficient utilization of the property, carelessness towards the maximization of its profits all crept in the *waqf* property. Capital accumulation, the source of growth, became negative.

There were many factors responsible for that. In the Prophet's days, the. Companions used to consult him or he used to guide them regarding the needs of the society. This close relationship between the authority and *waqf* creators did not continue. Thus lack of state guidance has been one of the important factors leading to an unbalanced selection of public goals.

Another factor which harmed the *waqf* institution was the one man basis of its organization. Hereditary and sometimes arbitrary appointment or *mutawalli* for *public waqf* was liable- to mismanagement and abuse of powers, the performance of *waqf* institutions would have been far better, had the management been given to a committee or a consultant body, with *a mutawalli* as its head.

Following the literal interpretation of the saying of some jurists that the words of the donor are like a (divine) text *(`ibartl al waqif ka'I nass),* the will of the *waqf* creator was held as supreme regarding purpose, beneficiaries and management and was followed very rigidly and strictly. Generally these words were defined very specifically and narrowly when interpretation might not remain valid with the passage of time.[37] Imam Ibn Taimiyah gave very good and wise interpretation of that saying. According to him the sense of the saying of some jurists that the conditions of the *waqf* creator are texts like the words of the lawgiver *(shurut al waqaf ka nass al Shari') is* that they are like text to denote the desired meaning. Their status is not to make the action obligatory. The will of the donor is understood from his conditional words as the lawgiver's intention is learnt from his words.[38] He further states, "To make the words of *waqif* or any contracting person like the text of the Lawgiver for obligatory action is a disbelief *(kufr)* by the standards of all Muslims, as no one has the authority to be forever correct in all his sayings except the Prophet (SAW). If the conditions are in agreement with Book of Allah, they are right, and if opposed to it, they are wrong."[39] Since the benefits and frequency of public services provided by *awqaf* had temporal and spital limitations, the need for alteration in the object of *waqf* has been felt in all ages. Sometimes the purposes of *awqaf,* with the passage of time, became redundant or non-economical. But the belief in the sanctity of *waqf* property, the purpose and the will of the donor, ordinarily did not allow modernization or reorganization which caused decay and disorder of the *waqf* property. Again it is worthwhile to quote Ibn Taimiyah who is against such extreme views. He says, "A person's saying that transformation or replacement (of *waqf* . property) is not permissible except when utilization of the property is impossible, is not correct; they do not have any *shari'ah* or legal evidence in support of their stand ....In this context, Imam Ahmad's stand is more flexible who says that if a mosque is congested, then there is no harm to shift it to a place more spacious. It should be noted that congestion is not a loss of benefit. Actually benefit is as usual; it is people whose number has increased."[40]

Waqf creation is, to a great extent, a function of *taqwa* (piety) and *thawab* (reward in the Hereafter). The narrow and sometimes wrong concept of *taqwa* and *thawab* caused by ignorance *(jahalah),* bad innovations *(bida'ah)* and blind imitation *(taqlid jamid)* have much affected the terms and conditions of *awqaf* and their purposes. It is this reason that we see more *awqaf* for mosques, traditional *madrasahs,* tombs and graveyards than modern colleges, universities, libraries, hospitals, research institutes, etc.; and almost no *waqf* for such public good as the protection of the environment, the supply of information and social cohesion about which it might safely be said that only the voluntary sector can prove to be more efficient and more beneficial.[41]

ROLE OF STATE IN REGULATING THE *WAQF* ORGANIZATIONS

We have seen in the preceding pages that from the earliest days of Islam, the state supervised *awqaf* through the court or by establishing a separate department. Many scholars have emphasized the government role in this regard. Ibn Taimiyah says, "The ruler has the right to exercise a general supervision and take action if something prohibited is done. He should appoint some honest person if the caretaker is not efficient or accused of misconduct. The purpose is to achieve the desired objectives.[42] On another occasion he said, "The ruler should establish a department to check the accounts of *waqf* property, according to needs and this may become obligatory if the collection of fund and its disbursement is not carried out properly without such a department because the principle is that provision of all those means is obligatory on which fulfillment of any obligation depends."[43]

As we mentioned earlier, generally the role of the state was confined to general supervision or solving disputes, removal of a *mutawalli* if allegations against him proved to be correct, and appointment of another in his place. The state did not pay attention to reorganization, rationalization, modernization or development of *awqaf.* The result was an increasing number of agricultural land and real estate as *awqafs* without proper utilization. At the same time abuse and misappropriation also increased' which led the state to confiscate, abolish or strictly regulate the *awqaf.* This has negatively affected the existing *awqaf* and discouraged the creation of new ones.

It should be noted that the creation of *awqaf,* though a voluntary action, still involves opportunity cost. In view of the scarcity of resources and the needs for the balanced growth of Muslim society, the present situation of this institution seems to be far from satisfactory. The Islamic principles of *al masalih al mursalah* (general welfare consideration), *al Istihsan* (preference of the better) *al istislah* (consideration of public interest), *al hajr* (interdiction), *al dururah* (necessity), *nahy an'l diya' wat israf* (prohibition of wastage), *istihbab al kifayah* (desirability of efficiency), and *al walayat al ammah lit imam* (general guardianship of the state, all require that the state's role should not be confined to resolving disputes over *mutawallis,* controlling misappropriation and finally confiscation of *waqf* property on different pretexts. Confiscation of property is not a solution. It will discourage the creation of a new *awqaf* and put an end to this important organ of the voluntary sector. There is need for the positive role of the state in reorganization and activization of this institution so that it can perform the same role in provision of the public good which it performed during its early history.

According to the modern analysis of demand and supply of the public good, "benefits are available to all, so consumers will not reveal their preference by bidding in the market but will act as free rider. Hence a political process or voting system based on a given distribution of money income, is needed to induce the revelation of preference. "[44] In the context of public god by the voluntary institution of *awqaf,* the problem of free riders is not be a big concern. In fact, the very nature of the voluntary institution of *awqaf will* eliminate "stealing free riders"; rather it will aim at providing everyone with "free rides" which will generate a positive response from other members of the society. The state's cooperation with such' volunteers for the better utilization of *waqf* resources will relieve the former from a substantial burden regarding the provision of public goods. In this connection the following points may be emphasized:

1. The appointment of *a* consultative committee. To assist and guide the *mutawalli,* the formation of a committee by the donor should be made desirable during his life to accomplish the action according to the *ayah: wa amruhum shura bainahum* (their matter is decided. by mutual consultation), [45] and obligatory after his death, in the better interest *al istihsan* of the *waqf* objectives. The *mutawalli* being the head of such a committee, criteria relevant to the *waqf* property and purposes should be predetermined.

2.- Removal of narrow and rigid conditions. To make the *awqaf* more purposeful all such conditions which are not approved by the *shari'ah* should be abolished because they create hurdles in the way of a better. utilization of *awqaf.* This will be according to the Islamic teaching which says: "Every condition not found in the book of Allah must be rejected", and "the terms prescribed by Allah ate more apt to be fulfilled". [46]

3. The- rationalization *of Awqaf Awqaf* and offerings *(nudhur)* made for a cemetery; tomb, 'monastery, *etc.*- should be rationalized by using their revenues to spread the message of Islam, and to provide technical education centers, training and research facilities,' preferably for those who are attached to them and later extending to others. Thus removing

their unemployment open or in disguise. It is sad fact that in India some Hindu temple trusts have established colleges research centers and industrial estates which helped the growth of their trust revenue as well as the intellectual and economic upliftment of their community. We can hardly find such examples among the thousands of *awqaf* made for tombs of *mashaikh* and *awlia.* Lamenting on this situation once, an expert on Indian *awqaf* observed, "What Trupati temple has been able to achieve in terms of its reorganization, raising an income of about Rs.500,000 (Rupees five lakhs) in 1955 to about Rs. 80,000,000 (Rupees eight crores) in 1975 benefitting every one concerned including the counterparts of *khadims is* a great eye opener. By contrast the receipt to the *darqah* (tomb of hadrat Muinuddin Chishti) administration in the case of Ajmer set up is only about Rs. 200,000 (Rupees two lakhs) and has not increased much!"[47]

4. The consolidation of scattered *awqaf.* The state should encourage and facilitate consolidation of *waqf* properties scattered all over a country. This will reduce the cost of administration and will contribute towards the better utilization of the property. If replacement of the *waqf* corpus can fulfil the objective of the *waqf* in better way, it is permissible in the opinions of many jurists.[48]

5. Investment opportunity. To perform its function properly, and to fulfil its objective permanently, investment opportunities and better techniques should be provided by the state to the *waqf* management. Thus, there should be full cooperation between the state and the public *waqf* .[49]

6. Exemption from adverse rules and regulations. Since *awqaf, by* supplying the public good shares in the responsibilities of the government, they should be exempted from rules and regulations that adversely affect the income and performance of this sector such as rent control acts, etc: To tax public *waqf* means to tax the government itself.

7. Ambiguous awqaf. *Awqaf* whose donors are not known; nor their terms and conditions; or the purpose for which they were created is no longer needed may pass in to the hand of an Islamic state *(ulil amr*

minkum) treating them as heirless property and to be used for general welfare purposes.

8. Educative efforts are required. The state should try to alter the pattern of *awqaf* and their creation through its educative efforts. It should provide necessary information abut public needs as the Prophet (SAW) used to inform his Companions about the need for *jihad,* patrolling, water, worship places, etc. In the modern context provision of the public good such as remedial measures relating to pollution, scientific research, weather forecasting, etc. should be emphasized.

9. Individuals may have insufficient information about the fund needed for the provision of certain public ventures and their urgency for some regions and undesirability for others. The state with its vast machinery may provide better information in this respect. Getting such information, individuals, it is hoped, will act accordingly and imbalances in kinds of property, purposes, and regions may be avoided.

10. In spite of regional differences, there may also be a common purpose. Thus the state may be given the right to transfer the resources from one region of the state to another if income of the *waqf* in that region on that particular purpose is surplus. We have support on this suggestion from an outstanding thinker in Islam, Shaikh al Islam Ahmad Ibn Taimiyah, who on an enquiry about the same issue, answered, "The surplus revenue should be spent in that direction *(jihah).* For example, if the income of a *waqf* on a mosque is more than its requirements, it should be spent on other mosques, as the intention of the donor must be to spend on that kind of good deed and the two are of the same kind *(Jins).*"[50]

In the end we feel that the time has come to internationalize the voluntary institution of *awqaf* by setting up a non-government world Muslim foundation which should provide public goods on a large scale and in a much more significant fashion than has been the case up till now, to combat illiteracy, sickness, lack of technical know-how etc. and to establish world center for *da'awah* utilizing all modern and scientific methods for propagation of the message of Islam. An Islamic news agency, telecasting programs, rehabilitation of refugees, and supporting the suppressed fighting for the religion, and securing dignity and human rights may be some other functions of this foundation. Its benefits should cover all Muslims living in different parts of the world and should work for their intellectual, social and economic upliftment. Muslims being similar to a single organic body, their backwardness in one country means backwardness of the whole body.

There is also a need to issue an international journal specializing on *awqaf*, research and application oriented, to publish the research outcomes in this area, exchange views and provide information on new avenues for investment of *waqf* funds and how to make the *awqaf* more purposeful in meeting the public wants of the Muslim Ummah. Some voluntary organization such as International Association for Islamic Economics may volunteer for this task.

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16
THE RELEVANCE OF THE OTTOMAN CASH *WAQFS* (AWQAF AL *NUQUD)* FOR MODERN ISLAMIC ECONOMICS

MURAT CIZAKCX*

INTRODUCTION

The cash *waqf* constituted a special category of Islamic endowments and played a major role in Ottoman economic/financial history. As such it can be considered as an important Islamic financial institution which facilitated the flow of funds from those who were able to save to those who needed capital, i.e., primarily the entrepreneurs, but also to the members of the general public. This institution is also considered to be one of the most significant Ottoman contributions to Islamic civilization.'

The cash *waqf* was basically the establishment of a trust with money, the return from which, would be utilized for serving mankind in the name of God. These endowments were approved by the Ottoman courts as early as the beginning of the 15th century and by the end of the 16th, they had become extremely popular all over Anatolia and the European provinces of the empire. Yet, they found little, if any, application the Arab provinces. In a society where health, education and welfare were entirely financed by gifts and endowments the cash *waqfs* carried serious implications for the very survival of the Ottoman social structure. Moreover, they were also instrumental in the emergence of a legally sanctioned and well developed money market.

Looking at the relative importance of these institutions with respect to the more traditional *awqaf, i.e.,* the *land waqfs,* we note that while the cash *waqfs* constituted about 16% of the *awqaf* established during

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the reign of Mehmed the conqueror, in the year 1505 the ratio increased to 50% and by about 1560 they had become the dominant mode of endowment.[2]

2. LEGAL BACKGROUND

The legal issues pertaining to the legitimacy of the *cash waqfs* are complex and have constituted the essence of a long lasting debate among the jurists. The debate revolved mainly around three issues: endowment of moveable assets the problem of perpetuity and the potential danger of *riba* in transferring the endowment funds. The main points of this centuries - long debate are summarized below, where due to space restrictions only the Hanefi point of view, the most relevant perspective for the Ottomans, will be emphasized.

2.1 Position of the Classical Islamic Jurists

Being devoted Hanefis, the Ottomans, naturally, conducted their affairs within the general guidelines established by this school of thought. It is, therefore, imperative that this analysis should start with a summary of the classificial Hanefi position pertaining to the *cash waqfs*.

Let us first consider the endowment of the moveable assets; since the perpetuity of the endowed asset is the essence of any *waqf*, in principle, the endowment should consist of real estate. There are, however, three recognized exceptions to this general principle among the Hanefi scholars. First, the endowment of moveable assets belonging to an endowed real estate, such as, oxen or sheep of a farm, is permitted. Second, if there is a pertinent *"Hadis"*, and third, if it is the custom *(ta'amul)* in a particular region. Indeed, exercising *"istihsan"*, Imam Muhammed al-Shaybani has ruled that even in the absence of a pertinent *"Hadis"*, the endowment of a moveable asset is permissible if doing so is customary in a particular location.[2] Apparently, even custom was not a required condition, for, according to Al-Sarahsi, Imam Muhammed had in practice approved the endowment of movables even in the absence of custom.[3] Furthermore, both Imam

Muhammed Al-Shaybani and Abu Yusuf had confirmed, absolutely, the endowment of movables attached to a real estate. In view of this, it is not surprising that we see, often, such combined cash/real estate *waqfs* in the Ottoman records.

The next problem concerns the definition of a moveable asset. More specifically, can money be considered as a moveable asset and therefore be permitted as the basis for the establishment of a foundation? It was Imam Zufer who answered this question affirmatively and ruled that the endowment of cash was absolutely permissible. Zufer went into details as to how such an endowment could be organized: Accordingly, the endowed cash could be given as the capital of a *mudarabah* partnership and the profit thus obtained would be spent in accordance with the general purpose of the *waqf* as stated in its charter. If the moveable assets endowed were not cash, they could be sold in the market and the cash thus obtained could be utilized as described above, i.e., as the capital of a *mudarabah.*

Thus, the approval of Imam Muhammed Al-Shaybani and Abu Yusuf of movables as the basis of a *waqf,* in general, and the fact that Imam Zufer considered cash as a moveable asset and approved the cash endowment, constituted the foundation upon which the later Ottoman jurists built the structure of the cash *waqfs.*

The establishment of cash *waqfs* by the Ottomans during the 15th century appears to have taken place smoothly, without any legal complications. But when during the next century, these *waqfs* became very popular and began to dominate the *awqaf* system, the military judge of Rumeli (the European provinces), Civizade, challenged the situation. He was almost immediately answered by the Shay" ul-Islam, Ebussuud Efendi, and a fierce debate began. Since the details of this debate have been already published,4 a summary of it will not be made here. It should suffice here to say that the debate lasted for more than a century, and that it was inconclusive. Supported by the state, the cash *waqfs* continued to exist and flourish. The remainder of this article will address itself on this paradigm of continuation and seek the answers to the following questions:

1. Since, as mentioned above, one of the main points of the debate was concerned. with the problem of perpetuity (proponents arguing that these *awqaf* had as good a chance for survival as any other real estate, and opponents believing that they would collapse within a relatively short time), would it be possible now, during the last decade of the 20th century, to look into this problem in retrospect and judge which side was correct?

2. What exactly were the reasons for the outcome of the answer to the first question? In other words, if these endowments, indeed, rapidly disappeared, what were the reasons behind this failure, why were they so badly managed? Where did they go wrong and what were their mistakes? If, by contrast, 'they succeeded surviving for any length of time, then what were the reasons for their relative success?

3. In what way did this institution contribute to the process of capital accumulation? This question has to be tackled from both perspectives, i.e., from the point of view of savers as well as the users of funds. More specifically, did the savers pool their capital to form joint cash *waqfs,* or add their capital to the already existing ones? Did the users of capital have recourse to several cash *waqfs* so as to enlarge the available pool of capital at their disposal?

4. In the process of transferring funds to the entrepreneurs or to the public, to what extent, was the Islamic prohibition of *riba* observed? In other words, to what extent were Barkan[5] and Mandaville[6], justified in their accusations that cash *waqfs* violated Islamic law?

All of these questions pertain to an analysis of the cash *waqfs* in retrospect. The following questions, by contrast, are about the future. Namely;

5. To what extent can the cash *waqfs* can be considered as relevant to modern Islamic economics? Assuming that it is possible to reform these institutions, in what way can they contribute to the economy of contemporary Islamic countries?

6. Any process of modernization must be based upon a thorough and objective study of the past. Therefore, as an off-shoot of the second question above, would it be possible to initiate a process of modernization of this institution whereby the mistakes of the past can be avoided and the virtues maintained? If yes, what characteristics should be avoided and what others should be kept? Let us now try to answer these questions in the order they were put.

3. CASH *WAQFS* IN HISTORICAL REALITY

3.1 The Problem of Perpetuity

Since perpetuity is considered to be the sine qua non of any *waqfs,* an analysis of the survival rate of the cash *waqfs* assumes great importance. Although the Turkish archives are extremely rich, some 400 million documents are being preserved in the Istanbul Prime Ministry Archives alone (!), unfortunately, only a small fraction of these sources have so far been studied by the historians. In this context, the Barkan-Ayverdi study is a great help.' According to this study, there were 1139 cash and cash/rent *waqfs* in Istanbul during the period 927-953 (1520-1546). Out of these only 324 survived to be included in the census of the next period; 953-986 (1546-1578). But in this period 138 new such *awqaf* were established, thus bringing the total number to 462. Most of these, 452 of them, survived into the next period; 986-1005 (1578-1596). In this period 75 new such *awqaf* were founded, thus bringing the total number up to 527. The Barkan-Ayverdi study ends here leaving us in darkness about the fate of these *527 waqfs.*

But even this incomplete data reveals some important insights. For some obscure reason there appears to have been a massive decline in the number of cash *waqfs* between the periods 927-953/1520-1546 and 953-986/1546-1578. But then, the *awqaf* survived from the earlier periods and the newly established ones during the period; 953-986/1546-1596, survived more or less intact into the next period; 986-1005/1578-1596, when the numbers of the newly established *awqaf* increased impressively and we observe an upswing in the overall trend. Just what forces were behind these fluctuations is difficult to ascertain.

But one thing is certain; the cash *waqfs* do not exhibit a downward linear trend and disappear into oblivion at the end as suggested by Barkan and Ayverdi[8], instead we observe cyclical fluctuations. This is supported by my own on-going research: I have found four *waqf* censuses belonging to the city of Bursa covering the period; 1077/1666 to 1220/1805, the registers; B 135/150, B 199/423, B 211/434, B 352/736, which indicate that the cash *waqfs* at this late period were alive and well.

It is too early yet to attempt an answer to the first question above. To do so, will demand that continuous series of *awqaf* censuses covering several centuries be identified, and studied. Only then can we pretend to judge which side of the perpetuity debate is actually correct. In short, since such records exist we will be able to answer this question but not the present time.

Concerning the second question, let us now go deeper into the management issue. Obviously the most fundamental reason for the collapse of a cash *waqf* was the mismanagement of its funds. Such mismanagement could have occurred in a number of ways; the funds could have been usurped by unscrupulous managers or entrepreneurs. Or, even more likely, the returns achieved by these funds could simply be less than the inflation rate leading to a slow exhaustion. Let us now examine what kind of precautions that were taken to avoid these problems.

First of all, there is no doubt whatsoever that a well developed system of collaterals and sureties was applied. To give but one example; in the year 1002/1593 the foundation for supporting the mosque of the. Gurbetler village in the vicinity of Bursa was managed by a certain El-Hac Mehmed. Mehmed transferred the funds of *waqf* to 11 different individuals. Seven of these had to provide collateral and three had to bring along other individuals who stood as sureties.[9]

The only person who did not have to provide a collateral or a surety was certain Mehmed bin Abd-el-Rasul, who was in all probability well known to and trusted by the *waqf* manager.

Let us now look into the question of the rate of return. The *waqf* census from the year 1181/1767 cataloged under the number; B 199 423 in the Bursa Ottoman Court Registers reveals important information. All the *awqaf* were registered in this "defter" according to a pattern: First comes the name of the *waqf,* which reveals briefly the overall purpose of the foundation. Then the name of the trustee is stated. The amount of the capital *(asl-i-sene-i mal) is* immediately followed by the statements *"murababah fi sene-i kamile", i.e.,* rate of return in a full year. This is followed by the statement *"minha elmesarif", i.e.,* the total expenditure of the foundation in that particular year.

Just prior to the writing of this article, I was able to collect a sample of 69 cases out of the above mentioned "defter" containing some 300 *awqaf.* The statistical details pertaining to this sample are as follows: In most cases the annual rate of return was preserved for *"Sadakah",* which was usually paid as salaries to the muezzin or Imam of the local mosque and to those who would read a section of the Quran everyday. 22 of the *awqaf* enjoyed a rate of return greater than the expenses they incurred. 14 of these had also made profits above the expenses in the previous year and these profits were added to the capital. Thus, it is reasonable to assume that in all the 22 cases the profits would be added to the *"asl-i mal", i.e.,* capital of the foundation in the following year. In all cases, the rate of return was usually 10% to 12%. In eight of the *awqaf* there was a merger with other foundations and the capital was thus enlarged.

The vast majority of the cases studied were cash *waqfs* (61 in total) versus only 8 combined cash/real estate *waqfs.* Thus, it is clear that despite the legal debate mentioned above the cash *waqfs* maintained their popularity and continued to dominate the *awqaf* system as late as the second half of the 18th century.

Most of the *awqaf* studied were fully utilizing their capital. That is to say, they regularly transferred all of their funds to the entrepreneurs or the members of the general public. Only four of them kept idle money in their safes.

Concerning the second question posed above, i.e., the management of the *awqaf*, the following conclusions can be drawn: First of all, these foundations were profitable. This is attested by the fact that whereas the *awqaf,* in general, were generating a profit rate of 10-12 per cent per annum, the rate of inflation was less than 5% throughout the 18th century.[10] Thus, there is no doubt that these foundations were enjoying substantial profits, at least, in the short run. The long term profitability, on the other hand, is a different story altogether. Normally, the long term profitability - could easily have been ensured by reinvesting the above mentioned profits and adding them to the capital. This, however, was not done. As we have seen above, the profits *(murabahah fi sanai kamile)* were distributed as salaries to a number of individuals who were performing certain religious, educational or health services. Although, no doubt of great social importance, nevertheless, from the perspective of the long term survival of the foundation, such expenditure was unproductive. Consequently, the long term resilience of the *waqf* was endangered.

On the positive side, these recipients of the *waqf* income had in addition to the social services mentioned above, another very important function. Since they were receiving regular salaries from the profits of the *waqf,* they were the first ones to notice if there was any irregularity in the *waqf* management. Indeed, there are many cases indicating that whenever these individuals suspected the trustees of the *waqf* of embezzlement they immediately notified the courts. In short, the recipients not only fulfilled social services but also functioned as a control mechanism.

At this point, one wonders, if there was any link between this problem of long term profitability/survival and the rapid decline in the numbers of cash *waqfs* observed by Barkan during the second half of the 16th century. Although the unproductive investment of the *awqaf* profits could explain a gradual decline and disappearance of the cash *waqfs* over the long term, it cannot explain such a rapid disappearance as observed by *Barkan.* In this context I would like to hypothesize that what *Barkan* observed was not so much a disappearance of the cash *waqfs* but rather a massive conversion of them into real estate *waqfs* *(istibdal).* After all, the period in question was marked by one of the most severe inflations in Ottoman history." Faced with an inflation of such shocking proportions the trustees probably chose the most rational avenue open to them; the conversion of the cash capital of the *waqf* into real estate.

Testing this hypothesis requires a thorough investigation of the *waqf* censuses during the inflationary second half of the 16th century. Since the results of such a comprehensive and difficult research will probably take years to see day-light, let us for the moment do the only thing we can, i.e., look into the problem from the judicial perspective and determine if conversion of the endowed assets was permitted by the authorities.

The legal term *istibdal* simply means the conversion of the endowed asset into another type of asset. As such, *istibdal* considered as one of the ten conditions *(shurut-u ashere),*[12] which the founder of the *waqf* may dictate when he establishes the *waqf.* Since *istibdal* has important implications for the perpetuity of the *waqf (te'bid)* and since it is open to unscrupulous exploitation, it has been carefully scrutinized by the jurists both before and during the Ottoman era.

According to the Hanefi jurists the *istibdal* procedure may be resorted to under three conditions:

1. If the founder includes *istibdal* within the original charter of the foundation and thus permits himself or the trustees in the future to. resort to this procedure.

2. *Istibdal* would still be possible even in the absence of this condition if the foundation has ceased to become profitable or begun to suffer losses and thus endangering the perpetuity.

3. Even if there is no imminent threat to the perpetuity, *istibdal* may still be permitted if there is a convincing argument that conversion of the endowed asset would enhance the financial situation of the foundation. It is well-known that Ebu Yusuf had confirmed this

procedure subject to the approval of the judge. This third condition, however, was challenged later on by the Egyptian jurist Ibn-i Nuceym in response to some misuse. Finally, the matter was settled once and for all by the imam-i azam of the Ottomans; Ebussuud Efendi in the year 951/1544 who ruled that *istibdal* would be valid only if approved by BOTH the Ottoman Sultan AND the local judge. [13] Thus, it can be concluded that whereas *istibdal* could be resorted with relative case before 951/1544, after this date it would be far more difficult to do so. In this context it is revealing that the rapid decline, observed by Barkan, in the number of cash *waqfs* took place during precisely this critical period; 1520-1546 and 1546-1578, thus giving use the impression that large numbers of cash waqfs might, indeed, have been converted into real estate before 1544 when it was relatively easy to do so. In the next period, that is two years after Ebussuud's decision, the decline in the number of cash *waqfs* suddenly halted, followed in the next period by a recovery. [14]

As for the third question pertaining to the process. of capital accumulation, we can learn the following from the *waqf* census of 1767 in the city of Bursa.[15] First of all, as we have already noted above, out of the 69 cases examined, 8 were mergers. That is to say, the assets of *a waqf* were added to those of another. Thus, waqf mergers represented a certain type of capital accumulation. In this way, obviously, not only the assets of a declining *waqf* would be protected from an inevitable demise, but also they would be utilized to enhance the financial power of another.

As far as the simple citizen is concerned, the cash *waqfs* provided as substantial opportunity, perhaps the single most important one, in the difficult process of capital accumulation. In a society where the deposit banking system did not exist due to the prohibition of *riba,* cash *waqfs* must have constituted, in all probability, the only source of capital for ordinary folk. In reality, it seems they successfully performed the most important function of banks, i.e., the diffusion of capital from those who had been able to accumulate to those who had not been able to do so. Among the cases examined a bewildering variety of borrowers have been observed. Some *waqfs* lent to only one person, while others diffused their capital to as many as 31 in a single year. Only 4 out of 69 kept their capital idle, while all the rest lent and thus diffused it.

The recipients of the *waqf* capital belonged to all the strata of the Ottoman society, textile entrepreneurs, women, Christians, brick makers, porters, fur makers, collectors of the *jizyah* tax, tailors etc. Practically everybody who needed cash can be found on these registers. While a detailed, computerized study of this enormously rich data will soon be attempted by this author, even a quick look shows clearly that there was capital accumulation at the individual level also. That is to say, an entrepreneur could easily pool capital from two different *awqaf.* This was certainly the case for a certain Christian tax farmer, Anderyas, who obtained funds from two different *awqaf* in the district of Alaca Mescit.[16]

Let us now turn our attention to the thorny question of *riba.* As we have seen above, both Barkan and Mandaville have dismissed the provision of capital by the cash *waqfs* to the borrowers as *riba.* Were they justified in their judgement or are we face to face with something more complicated? First of all, it was mentioned above that the register referred to the annual return with the term *"murabahah"* and although *"murabahah" is* considered to be a synonym of *riba* in contemporary Turkey, [17] it obviously carried a different meaning during the 16th century. The term comes from the root *riba* which simply means profit. In the foundation charters the formula used by the Ottoman jurists was the following :

"... the above mentioned woman has decided to endow the said amount which will be profitably invested through muamele-i shariye and *murabaha-i-mer'iyye* at the rate of 1.25 dirhams for every 10 dirhams. The trustees will see to it that their financial operations will be free of *riba* or even a suspicion thereof'.[18]

Muamele-i shariye is a general term meaning a commercial operation in conformity with the *shari'ah,* while *murabaha-i mer'iyye* means a rate of return which should be observed in commercial operations. The expression "at the rate of 1.25 dirhams for every 10 dirhams" refers to the situation knows as *"itzam-i rib"*, *i.e.*, necessitating the profit. It indicates whether the money advanced by the *waqf is* in the form of a *"Qard"* or in the form of profit sharing. Therefore, the specific rates given above, it has been argued, do not refer to *riba* but rather, state that for every 10 dirhams earned by the borrower or entrepreneur 1.25 dirhams should be returned to the *waqf* [19]

Another document supports the view that *"murabahah"* was used as a general expression meaning profitability. Accordingly, a cash *waqf* was founded with a capital of 5000 akces. The *"murabaha"* of the *waqf* was stated as 2000 akces thus indicating a rate of return of 40%. Clearly, such a high rate of return could only have been earned through profit sharing. Here, therefore, we have another evidence that *murabahah* was used as a general expression meaning profitability and could refer to other financial instruments such as *mudarabah* or *musharakah.*[20]

In view of all this, dismissing the cash *waqfs,* as Barkan and Mandaville have done, simply as *riba* institutions, is an unfair over simplification. In any case, until we find many more cases of actual transfer of funds by the cash *waqfs* we should avoid risky generalizations. Furthermore, the bulk of the debate among the Ottoman jurists on the issue of the cash *waqfs* pertained to the problem of establishing *waqf* with moveable assets. This can be taken as an indication that the contemporary jurists had no qualms about the way these *awqaf* transferred their funds to the entrepreneurs. For, had there been any suspicion in their minds about *riba,* they would certainly not have- ignored this situation and dealt a devastating blow to these *awqaf.*

We can draw the following conclusions from this historical analysis: First of all; concerning the problem of perpetuity *(te'bid),* the conclusion, has to wait until a computerized analysis of many *waqf* censuses covering several centuries is completed. For the moment, we can only assert that the "disappearance" 'observed by Barkan may only indicate to a massive *istibdal* in response to the economic conjuncture' prevailing at that period. This argument is a mere hypothesis and needs to be tested.

Second; if Barkan was right and the cash *waqfs,* indeed, tended to vanish, a probable explanation can be found in the way the profits generated by these *awqaf* were utilized. Only 32% of the cases examined generated profits above costs, which were incurred entirely for religious and educational purposes. The majority of the *awqafs* studied allocated their entire profits to such expenditure. Consequently, re-investment of the profits and enlargement of the original capital was curiously lacking in most of the cash *waqfs.*

Third; notwithstanding the above mentioned problem, all the *awqaf* studied generated real profits exceeding the prevailing rate of inflation. Thus, it was the utilization of the profits and not the profitability itself which was the real problem.

Fourth; the cash *waqfs* contributed to the process of capital accumulation. They pooled capital through mergers among themselves and among the entrepreneurs they financed by allowing them to obtain capital from other cash *waqfs.*

Fifth; these *awqaf,* in transferring the funds to the entrepreneurs or borrowers, in general, did not resort to *riba.* The earlier claims that they did are due to misinterpretation of the complex legal terminology.

Having drawn these conclusions from the historical analysis above, let us now turn our attention to the modern world.

4. CASH *WAQFS* AND THE MODERN WORLD

The basic function of the cash *waqfs* was to transfer the excess savings of the well to do to those who needed capital. Moreover, this institution performed this function within the framework of Islamic financial principles. At the present time this function is performed by modern Islamic banks. As such, cash *waqfs* should be considered as complementary, not an alternative, to the Islamic banks already successfully operating in most Islamic countries.

It has been explained elsewhere that while Islamic banks have proven themselves, at least in case of Turkey, by generating profits well above conventional *riba* interest-based banks, they are nevertheless subject to criticism for resorting overwhelmingly to *murabaha* in transferring their funds to the entrepreneurs. The *murabahah*, in modern context, however, is considered to be dangerously close to *riba.* Consequently, Islamic banks are face to face with a dilemma; while on the one hand they generate handsome profits thanks to *murabahah*, on the other they are criticized for achieving this profitability through this particular instrument. In response to such criticism Islamic banks have made earnest efforts to deadlock persists and *murabahah* dominates the investment portfolio of these banks at the rate of 95%.[21]

In another paper, yet to be published, this author has suggested that the inability of Islamic banks to transform their investment portfolio in favor of *mudarabah* or *musharakah* partnerships was due to several reasons.[22] These were, first; those individuals who were given positions of power in the Islamic banks, usually, had learned their trade in the conventional banking system and therefore preferred those Islamic instruments of finance closest to the methods utilized by conventional banks. Since risk minimization is one of the best established principles of conventional banks, more risky *musharakah* and, particularly, *mudarabah* partnerships were naturally avoided. Second; Islamic banks found themselves in fierce competition with the conventional banks and felt obliged to pay their depositors a profit share commensurate with the rate of interest paid by the latter. Particularly in Turkey, where the current of interest paid to the depositors exceeds 50%, the surest way to achieve such rates in the short term was considered to be the *murabahah* and not *musharakah* or *mudarabah.* Third; in an economic situation characterized by high rates of inflation and interest rates these managers did not dare to venture into long term investments which *mudarabah* or *musharakah* usually entail. Consequently, they were forced to design their entire investment portfolio for the short and very short term. Finally; *mudarabah* or *musharakah* partnerships involve continuous and close contacts between the investor *(rabb ul mal)* and the entrepreneurs financed, and a willingness to lend support to them whenever they encounter problems. Islamic banks simply do not. have the patience or resources for such a demanding activity.

In view of these problems it should not be surprising that the Islamic banks failed to transform the structure of their investment portfolio. In the same study, it was suggested that the Islamic banks should not be expected to alter their portfolio but that if *mudarabah* and *musharakah* partnerships were considered to be desirable instruments of finance then they ought to be utilized by smaller and specialized Venture Capital Companies (VCC's).[23]

There are remarkable similarities between the VCC's and *mudarabah/musharakah* partnerships, so much so that Venture Capital (VC) is considered to be, for all practical purposes, the same as these classical Islamic partnerships. Although a detailed comparative structural analysis cannot be attempted here due to the space restrictions, it should suffice to say that VCC's have successfully demonstrated in the United States, where they were born, that they provide not only long term capital to entrepreneurs, but are also willing to support them in case of difficulties.

Combining the experience of the Islamic banks with that of the West, it was suggested that financial and managerial support to entrepreneurs in the Islamic countries must be provided by small, yet financially potent VCC's and these companies must resort to only *mudarabah* and *musharakah* or equity purchase when financing the entrepreneurs.

The implicit problem in this suggestion is the source of finance for the VCC's. Indeed, from where are they supposed to obtain the funds which they will transfer to the entrepreneurs through *mudarabah, musharakah* or equity purchase? One obvious source already suggested was, again, the Islamic banks. It has been recommended that Islamic banks be obligated by the governments to allocate 5% of their investment portfolio per annum, cumulatively, to the purchase of VCC equities.

5. CASH *WAQFS* AND VENTURE CAPITAL

The provision of finance to the venture capital companies can now be linked to the main subject of this article. -What the VCC's will ultimately need is long term capital. Equity purchase by Islamic banks cannot by itself solve this problem, as these banks may unexpectedly encounter liquidity shortages and be forced to sell the shares of the VCC's on the stock exchange. In such a situation, they would also inevitably deprive the VCC's of much needed capital.

It is at this point that the cash *waqfs* may enter the picture. For, after all, by definition, *waqf* capital once endowed cannot be withdrawn by the founder. Thus, cash *waqfs* could solve the most serious problem faced by the VCC's, shortage of long term capital.

Let us now envisage how the cash *waqfs* can be combined with venture capital. Assume that person A wishes to establish a cash *waqf* with his savings. The purpose of this *waqf would* be to help finance entrepreneurs who wish to establish their own businesses. The founder of the *waqf, A,* approaches a VCC and informs them of his intention. Then he deposits his savings with the VCC which constitutes the capital of this cash *waqf.* The VCC would then sign *a mudarabah* contract with the *waqf,* thus becoming in reality its *mudarib.* When it comes to the transfer of *waqf* funds to the entrepreneurs, the VCC also agrees that the capital' of the *waqf* would be invested solely in *mudarabah/ musharakah* partnerships, thus eliminating all doubts about the legitimacy of this investment from an Islamic point of view. Structurally speaking, this would be a triple *mudarabah* with three parties involved; the *waqf,* the VCC and the entrepreneur.

In order to minimize/diversify the risks, the VCC can and should invest the *waqf* capital with several entrepreneurs. Once profits are generated they can be distributed among the parties as follows: In a normal mudaraba partnership the usual profit sharing ratio is 1/4th to the *mudarib* (entrepreneur) and 3/4th to the *rabb ul mal (VCC). So,* the VCC obtains 3/4th of the profit of the entrepreneur plus the original capital whenever the project matures (no time constraint here).

Since the VCC has signed *a mudarabah* contract with the *waqf,* the same ratios are observed while distributing the profits between the VCC and the *waqf.* Thus, the *waqf* obtains the original capital 3/4th of the profit earned by the VCC, the latter keeps 1/4th of it for venture capital services rendered. Thus, in short, the *waqf* obtains 3/4th of the 3/4th, or 9/16th of the profit generated by the entrepreneur. Put differently, if the entrepreneur earns a profit of 100 dollars, the *waqf* gets 56.25 dollars as its share, plus, of course, the original capital invested by the *waqf.*

Since, what is involved here is essentially *waqf* capital, the issue of perpetuity, hence the risks, assumes great importance. Risks and the danger of loss can be minimized by forming two separate investment portfolios: The first one by the founder A, who can divide his total savings among a number of VCC's, thus in effect establishing several cash *waqfs,* and the second one by each of the VCC's which can invest the *waqf* capital with several entrepreneurs.

While reducing the risks to a bare minimum by setting up two sets of portfolio constitutes once aspect of ensuring the perpetuity *(te'bid)* of the *waqf,* the other is the re-investment of the profits generated. As it will be recalled, the greatest weakness of the Ottoman cash *waqfs* was their inability to do so - that is instead of reinvesting the *"murabahah fi sanai kamile"* by adding it to the *waqf* capital, most *waqfs* had spent it for religious and social purposes. In view of this, it will be proposed here that the modern cash *waqfs* add their profit share to the original capital of the *waqf* thus ensuring the perpetuity of endowment.

Actually, it is quite possible that not only the perpetuity will be assured, but also, managed properly, the original endowment will grow in real terms.

Needless to say, the since qua non of success is proper management. In this context it may be suggested that the involvement of a third party in the affairs of the *waqf* may be desirable. The Ottomans, it will be recalled, had successfully involved the recipients of the *"murabahah"* in the management of the *waqf*. We have seen that whenever these individuals suspected a mismanagement they immediately informed the courts. By allocating, say, 1/10th, of the *waqfs* profit share to a neutral third party, a body of "inspectors" can be recruited. Ideally, these persons should be capable of analyzing the income and balance sheets of the VCC. More pacifically, the business administration department of a nearby university can be declared a recipient of this 1/10th and can be given the authority to inspect the records of the VCC in the charter of the *waqf* and in the original *mudarabah* contract signed between the VCC and the latter.

6. CONCLUSION

Cash *waqfs (awqaf al-nuqud)* fulfilled a variety of tasks in the Ottoman economy. While, on the one hand they were instrumental in transferring the savings of the well to do to those who needed cash, i.e., the entrepreneurs or members of the general public, on the other, they financed a myriad of religious, educational and social services.

While the state of our knowledge does not yet permit us to draw conclusions pertaining to the important issue of perpetuity, we have, nevertheless, been able to identify certain weaknesses that may have jeopardized it.

This author believes that combining the cash *waqfs* with Venture Capital sector, not only the problem of *waqf* capital's perpetuity but also the problem of *riba* can be solved, while providing the much needed long term capital to the Venture Capital Companies which are essential in enhancing entrepreneurship in Islamic countries.

This author believes that combining the cash *waqfs* with the Venture Capital sector, not only the problem of *waqf* capital's perpetuity but also the thorny problem of *riba* can be solved, while providing the much needed long term capital to the Venture. Capital which are essential in enhancing entrepreneurship in Islamic countries.

ENDNOTES

1. Jon E. Mandaville, "Usurious Piety: The Cash *Waqf* Controversy in the Ottoman Empire", *International Journal of Middle Eastern Studies,* Vol.10, 1979, p.289.

2. Based upon Al-Sarahsi, AL-MEBSUT, Vol.V, 2083-2087; Hamid Donduren, "Islam'da va Osmanli tatbikatinda Para Vakfi va Finansman Olarak Kullanilma Yontemleri", *Altinoluk,* 1990, August-November.

3. Hamdi Donduren, ibid.

4. Mandaville, op.cit., passim.

5. Omer L,. Barkan and Ekrem H. Ayverdi, *Istanbul Vakiflari Tahirir Defteri,* (Istanbul: Istanbul Fetih Cemiyeti, Istanbul Enstitusu, 61, Sayi, 1970), passim..

6. Mandaville, ibid.

7. Barkan-Ayverdi, op.cit., p.VIII.

8. Ibid., p.XXXI.

9. Bursa Ottoman Court Registers, A 151/183-41 b, 42 a.

10. I am grateful to Mehmed Genc for this unpublished information about the 18th century inflation rate.

11. For the rate of inflation during the second half of the 16th century see; Murat Cizakca, "Price History and the Bursa Silk

Industry: A Study in Ottoman Industrial Decline, 1550-1650", *The Journal of Economic History,* Vo.XL, September 1980, No.3.

12. These were; teksir-taklil (the power to increase or decrease the allotment of a recipient), idhal-ihrac (the power to declare someone who is not among the original recipients, a recipient, or to abolish a person's previously given rights), i'ta-hirman (the power to continue paying the allotments, or the power to stop paying the allotments on a temporary basis),' tagyir-tebdil (the power of the original founder to alter the conditions of the charter, or the 'power 'to alter the conditions of perpetuation *(intifa).* This is tantamount to -altering the original purpose of the waqf, iddal-istibdal (the power to sell an asset belonging to the waqf, or the power to convert the original endowment into another type of an asset.

13. Ahmet Akgunduz, *Islam Hukukunda Va Osmanli Tatbikatinda Vakif Muessesi,* (Ankara: Turk Tarih Kurumu,, 1988), part IV, Chapter 2.

14. O.L. Barkan, EM. Ayverdi, op.cit.

15. Bursa Court Registers, B 199/423-1A.

16. Ibid.

17. It was through a series of imperial decrees dated 1852, 1864 and 1887 that the rate of interest was legalized in Turkey during the Ottoman era. The most important one of these decrees, that of 1887 which fixed .the legal rate. of interest at 9% is known as the *"murabaha* decree".

18. Bursa Court Registers, A 21/27, 33A'

19. Hamdi Donduren, op.cit:

20. Bursa Court Registers, A 155/207-25A.

21. Murat Cizakca and Tansu Ciller, *Turk Finans Kesiminde Sorunlar Va Reform Onerileri*, (Istanbul: Istanbul Sanayi Odasi, yayin no.1989/7, 1989), passim.

22. Murat Cizakca, "Islamic Banks and Venture Capital: Origins, Evolution and Reform Proposals", unpublished paper.

23. Ibid.

APPENDIXES

Foreword by Hon. Dato Seri Anwar Ibrahim Foreword

by Dr. Abdul Hamid Ahmad Abu Suleyman

Resolutions of the Conference

INAUGURAL ADDRESS

Y.B. DATO' SERI ANWAR IBRAHIM
Finance Minister of Malaysia
and President, International Islamic University Malaysia

I congratulate the International Islamic University for organizing the Third International Conference on Islamic Economics in collaboration with the Islamic Development Bank, and the International Association for Islamic Economic. This joint effort between scholars and an international organization promoting economic development in Muslim countries is certainly an encouraging development. It will provide an opportunity for greater interaction between scholars of Islamic economics and policy makers.

Muslim countries are now in various stages of economic development. Some have implemented economic policies with varying degrees of success in improving the livelihood of their people and in promoting growth, while some are still struggling to feed their population and battling with natural disasters. Islamic economics has to come to terms with these realities. The development of Islamic economics has to be relevant to development issues in the Muslim Ummah.

Neither can we be oblivious to the rapid changes in the global scenario in the post-Cold War period which will have tremendous effects not only on political, economic and international relations, but also on the intellectual plane. Old concepts and categories which were previously considered as intellectual imperatives in analyzing economy and society need to be redefined. The monolithic and totalitarian perspective of modernism is now giving way for pluralism.The role of values in the study of human sciences is now increasingly being felt.

These developments pose tremendous challenge as well as provide opportunities for practitioners of Islamic economics to enter into the general discourse of the intellectual community. Muslim intellectuals can no longer isolate themselves form the international intellectual community. As communication technologies and travel facilities turn the world into a global village and interactions between cultures become a daily affair dialogue is inevitable.

I am confident this conference will be a useful platform for eminent Muslim scholars to deliberate on intellectual as well as practical issues relevant to the future of the Ummah. My best wishes for the success of the conference. May Allah (SWT) guide us in our deliberations.

WELCOME ADDRESS

Dr. ABDUL HAMEED AHMAD ABU SULAYMAN
Rector
International Islamic University Malaysia/
Vice-Chairman, Steering Committee
Third International Conference on Islamic Economics

The International Islamic University, Malaysia is privileged to host the Third International Conference on Islamic Economics. In the emerging scenario, Islamic economics has brought in its wake a complete socio-economic system that prescribes value-based patterns of behavior for all individuals. Indeed, the main objective of the system is to foster economic development with social justice and to enhance and balance the role of individuals and society. For Muslim countries, Islamic economics proposes a balanced blueprint of guidelines for policy making. It symbolizes a philosophy to improve welfare of the Ummah.

The nascent discipline of Islamic economics needs careful nurturing and unfailing support of scholars, government administrators, public and private sector managements, professionals, research institutions and all other dedicated to the cause of promoting the above objectives of Islamic economics in all walks of life.

With the collapse of the totalitarian approach and the persistent crisis within the capitalistic approach, the balance provided by the Islamic approach is greatly needed not only to help the Ummah but humanity as well.

Any effort in the direction of Islamization of Economics, combining public welfare with efficiency and initiative and justice with growth is commendable. Hence, I would like to express my gratitude to the Islamic Development Bank, the International Association for Islamic Economics, and all other institutions and individuals for supporting this Conference. I welcome the participants in the Conference. I hope, their ijtihad will be functional and fruitful. may Allah (SWT) guide us all to the straight path.

RESOLUTIONS OF THE CONFERENCE

Thanks to Allah Almighty, the Third International Conference on Islamic Economics was held at Kuala Lumpur on Rajab 23-25, 1412H (January 28-30, 1992) under the joint sponsorship of the International Islamic University, Malaysia, Islamic Development Bank, Jeddah and the International Association for Islamic Economics. The Conference theme was Financing Development from Islamic Perspective.

The Conference regards development to be high priority task for all Muslim countries and communities. The Ummah of which these countries and communities are parts is required by Allah to communicate His message to humanity and demonstrate Islam by its living example. This the Ummah cannot do unless it has the strength and resilience which comes from development. At present a majority of the over one billion Muslims are in a state of poverty, illiteracy and suffering which is quite destructive of Islamic living and is sure to keep the Muslim Ummah weak, dependent and ineffective. Yet, the Muslim countries are, by the grace of Allah, also endowed with rich resources, human and natural, which constitute the potential for the Ummah effectively playing its God assigned role. Every Muslim individual, group, community and country is therefore called upon to make all possible efforts to achieve the aspirations and goals of development based on freedom, stability and justice.

Means and policies necessary to develop to the level of material and moral standards required in the light of the above must be explored by Muslim economists, *shari'ah* scholars, and other professionals and knowledgeable persons in each field of knowledge.

The Conference calls upon all concerned to contribute towards creation of the proper environment for the flowering of development efforts and required activities. The foremost characteristic of this environment is shura with all the meaningful freedom it requires, e.g. freedom of thought, expression and association, etc. Along with this freedom is the need to institute mechanisms that will ensure responsibility and accountability in decision making in the context of a broad based participative system. Without these, pragmatic and prudent policies for development cannot be expected when they are most needed especially to overcome rampant inefficiencies and significant wastage of public resources.

Financing development by interest bearing loans from abroad has already led many countries into severe crises and it is high time Muslim countries drastically reduce their reliance on this mode of finance. It leads to conflict and ill-wills among nations, contributes to instability as debt servicing is unrelated to the debtor country's ability to pay and, also, reduces the efficiency of investment by affording opportunities for financing non-productive and uneconomic projects, even corrupt expenditures. The same applies to domestic borrowing with the additional disadvantage that it increases the inequities and disparities in the distribution of income and wealth. Debt financing of budget deficits has been especially instrumental in creating imbalance, accelerating inflation followed by its evil consequence.

The Conference calls upon Muslim countries increasingly to' sue - Islamic modes of finance, rely on their own resources and those generated by cooperation among Muslim countries. External resources, whether private or official, should be welcome on a participation basis. Simultaneously it urged Muslim countries to improve their investment climate and provide adequate guarantees to investors so that increased investment flows in while outflow of capital is checked.

The Conference considered the various Islamic modes of finance being practiced by Islamic financial institutions e.g. *murabaha, mudarabah, musharakah, salam, istisna'*, leasing, etc. The Conference, in endorsing these modes felt uncomfortable with the predominance of murabaha and urged all concerned increasingly to adopt sharing-based as well as other suitable alternative modes of finance wherever feasible.

It felt a strong need for developing suitable financial instruments on the basis of these and other contracts which are free of interest and other non-permissible features. It also urged the creation of a secondary market for shari'ah-compatible financial instruments in order to facilitate mobilization of resources for development. In this regard, there is a special role to be played by the Central Banks of Muslim countries by way of extending needed assistance to Islamic financial institutions while guiding and supervising them without sacrificing public interest. This Conference calls upon the Governors of the Central Banks to play a positive and active role in the promotion and strengthening of Islamic finance. Whereas in the past Islamic financial institutions felt discriminated against, it is hoped they will receive normal treatment in the future especially with respect to the Central Banks' function as the lender of last resort.

The conference notes with satisfaction the valuable individual and collective efforts being made in this regard, especially those by some Muslim governments which are trying to get rid of interest and switch over to Islamic finance. We are also hopeful about similar moves in other Muslim countries and urge Muslim economists, *shari'ah* scholars, bankers and experts in all relevant fields to fully cooperate with those practicing Islamic finance.

There is great importance attached to the practice of Islamic finance in Muslim countries as it is only after making significant progress in this regard that we can hope the world at large to listen to us when we call upon it to eschew interest and adopt the alternatives. It will also be in the fitness of things for the international financial community in general and the international financial institutions in particular to take favorable notice of Islamic finance as it represents the aspirations of a sizeable section of humanity. In fact, humanity will greatly benefit if interest which is prohibited by the three major world religions and endorsed by none, is abolished and replaced by alternatives that ensure fairness and equity.

The Conference also feels that *Zakah* can play a significant role in the realization of the social and economic goals of Islam and its implementation should go hand in hand with other developmental efforts.

This Conference assures all that in seeking to serve humanity in general, it is not a matter of confrontation with anyone but a search for peace in a harmonious and balanced vision for the economy of man based on individual initiatives inspired by social goals and with the aspiration to please Allah, the Lord of all mankind, the Creator, the Sustainer.

The Conference also expressed its gratitude to the host institution, the International Islamic University of Malaysia and the two other sponsoring institutions, the Islamic Development Bank and the International Association for Islamic Economics for their efforts in making the Conference a success. It was especially thankful to the people of Malaysia, Honorable Prime Minster, Dato' Seri Dr. Mahthir Mohammad, the Finance Minister and President of IIU, Dato' Seri Anwar Ibrahim, the Education Minister, Datuk Amar Dr. Sulaiman Hj. Daud and Tan Sri Dato' Jaffar Hussein, the Governor of the Central Bank of Malaysia for their unqualified support and encouragement. The overseas delegates to the Conference have a special word of thanks to the Rector, IIU, Dr. AbdulHamid Ahmad Abu Sulayman, Dean, Kulliyyah of Economics and Management,Dr. Syed Abdul Hamid Al Juandi and the staff and students of IIU who worked hard to ensure the delegates comforts.

Legal Deposit No. 1432/16
ISBN; 9960 - 627-61-6

ISLAMIC DEVELOPMENT BANK (IDB)

Establishment of the Bank

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

Purpose

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

Functions

The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms of economic, and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially in capital goods among member countries, providing technical assistance to member countries, extending training facilities for personnel engaged in development activities and undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to the *Shari'ah.*

Membership

The present membership of the Bank consists of 48 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of the Islamic Conference and be willing to accept such terms and conditions as may be decided upon by the Board of Governors.

Capital

The authorized capital of the Bank is six billion Islamic Diners. The value of the Islamic Diner, which is a unit of account in the Bank, is equivalent to one Special Drawing Right (SDR) of the International Monetary Fund. The subscribed capital of the Bank is 3,654.78 million Islamic Dinars payable in freely convertible currency acceptable to the Bank.

Head Office

The Bank's head office is located in Jeddah in the Kingdom of Saudi Arabia and the Bank is authorized to establish agencies or branch offices elsewhere.

Financial Year

The Bank's financial year is the Lunar Hijra year.

Language

The official language of the Bank is Arabic, but English and French are additionally used as working languages.

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