

INSTRUMENTS OF MEETING BUDGET DEFICIT  
IN ISLAMIC ECONOMY

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## INTRODUCTION

### **Statement of the Problem and Objective of the paper**

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

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

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

With only a few exceptions, what is written focusses on the causes of debt crisis and suggests that international debt of Muslim countries could have been avoided<sup>1</sup>, rather than tackling needs, forms and alternatives of public borrowing in Islamic economy. This paper recognizes the genuine needs which create a budget deficit in an Islamic economy and suggests instruments for meeting the deficit compatible with *Shari'ah*, i.e. it deals with Islamic substitutes of public borrowing. Therefore, issues related to the size of public sector are outside its scope.

### **Relevance and Significance of the Study**

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

Most Muslim countries today have large amounts of public debt, and many of them are increasing their debts by fresh net borrowing year after year<sup>2</sup>. These public debts would have to be transformed into Islamically acceptable forms of financing if economic, finance and banking activities are to be re-organized to become compatible with *Shari'ah*.

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

This study, thus deals with an applied issue related to the application of Shari'ah in the financial and economic activities in the Muslim countries. It contributes to the studies of Islamization of Muslim economies. Hence it may be of interest to all Muslim countries especially that it helps in the process of mobilizing financial resources for public use in a manner which appeals to the feelings, sentiments and ideology of Muslim masses in their own societies as well as in other countries. In other words, this paper contributes to shed some light on Islamic means of private and public funds transfer among the Muslim countries.

This paper consists of four sections. In section one, I will discuss the principles of financing in Islam. In section two, the provision of public goods is discussed whether by government, private or voluntary sectors.

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

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

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<sup>2</sup> *ibid*, p.2.

## SECTION ONE

### **Principles of Financing in Islam.**

There are several cases of public borrowing during the time of the Prophet (pbuh)<sup>3</sup>. There are also well known cases of borrowing by the Muslim State during the Abbasites<sup>4</sup> and the Ottomans, and obviously by modern Muslim states since the middle of the nineteenth century. Ottoman's and Egypt's borrowing in the nineteenth century were mainly external, from foreign governments and bankers.

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

Additionally public borrowing was known to the classical writers of *fiqh*. For instance, Al Mawardi (P 215) talks about resorting to borrowing for payments of dues on the

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

<sup>4</sup> *Ibid* , pp. 19-23

treasury and argues that successive rulers are bound to pay such loans back.

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One had to wait until the 1960s to witness a substantial increase in public debts in the Muslim countries.

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

Upon the prohibition of *riba* in terms stronger than any terms used in any other prohibition, the alternative mentioned in the *Qur'an* for *riba*-based financing is sale (Verse II: 275),<sup>5</sup>. The *Sunnah* confirmed this principle and added the principle of Profit and loss sharing and output sharing.

### 1.1 Sale Principle

The sale principle of financing is demonstrated in the provision of physical factors of production, intermediate inputs or consumption goods and services against deferred payment. Hence, the object of sale may be goods or services, whether they are used for production or consumption purposes. This mode of financing can be used by financial intermediaries (such as Islamic banks), owners of factors of production and other economic agents and intermediaries.<sup>6</sup>

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

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<sup>5</sup> Verses II: 276 and 280 also mention charity and granting time to the debtor free of any charge, but since both of these are charitable in nature they do not make alternative to *riba*-based financing on the ground that the financier does not expect any material return out of these two practices.

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

It is argued that, unlike riba based financing, *murabahah* and *ijarah* do not create a situation in which the return to financier is known in advance,<sup>7</sup> because the seller-cum-financier (or lessor-cum-financier) carries certain risks involved in purchasing, owning and selling or renting the object of sale or lease.<sup>8</sup> Moreover, in the case of lease the object of the contract remains in the financier's ownership for the duration of the contract. Like Riba-based financing *Murabahah* creates debtor / creditor relationship between the two parties. On the other hand, unlike interest based financing, sale based financing is committed to a complete or perfect correspondence with the physical or real market transactions and it involves the financier in commodity based relationships in strictest sense of the term rather than pure financing.

## 1.2 Profit and Loss sharing principle

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

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

*Mudarabah's* inability to allow the banker to put some hold on the decisions of the management and to exercise effective checking on truthfulness of its financial reports is probably the main reason behind the failure of most Islamic banks to courageously use this mode of financing on the investment side of their activities. This means the neat and

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

<sup>8</sup> These risks are usually mentioned in fiqhi references. They include the risk of the contract discovered to have been void, the risk of discovering an undetected defect, etc.

<sup>9</sup> See M. Fahim Khan ,ibid., pp. 2-5 and table 1 on page 9.

<sup>10</sup> This is according to the majority of jurists. The hanbalites, however, accept that *rabb al mal* participates in managerial decisions along with the *mudarib*. See Monzer Kahf, Maqhum al Tamwil fi al Iqtisad al Islami, IRTI, 1991.

theoretically cherished two fold *mudarabah*, did not succeed to attract Muslim bankers and failed the empirical test. This calls for theorizing a model of financial intermediation based on a formula in which the *mudarib* uses funds of *mudarabah* to provide financing on the basis of the principle of sale.

Lastly, there are two other forms of application of the principle of profit and loss sharing which are not usually given separate names. One is the case mentioned by the Hanbalites in which *rabb al mal* retains the right to share investment managerial decisions with the *mudarib*. They describe this case as: "two persons and one capital."<sup>11</sup>

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

### 1.3 **Output sharing principle**

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

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

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

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<sup>11</sup>

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

## **SECTION TWO**

### **Should Islamic Economics study budget deficit?**

The simple answer to this question is a plain yes. As shown in Section One, most (or all) Muslim countries have resorted to public borrowing. In the past too, the government of the Prophet (Pbuh) has also borrowed. Borrowing also happened at occasions during the Abbasites' era.

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

One may still argue that even if these malaises are cured, there may be justification for public borrowing in an Islamic economy. This section will analyze the reasons of public borrowing and discuss measures which help avoid it.

#### 2.1. Provisions of Social Goods -- Islamic Perspective.

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

The failure of market to provide efficient mechanism for production and distribution of certain goods raises the issue of social or public goods.<sup>13</sup> This failure is caused by the well-known non-rivalry and non-excludability. Both concepts are subject to technological and social influences. A non-rival good may become rival under certain circumstances. For instance the wild life protection regulations make hunting a rival good where each prospective hunter competes with others for a seasonal hunting license. Similarly, installation of a gate and a toll booth transforms a non-excludable good (driving on the highway) into an excludable one and a price for using the highway can be auctioned.

Moreover, the choice of goods for provision by the public sector is very often political. This means that certain rival and excludable goods may be provided by the public sector by virtue of political choice. The most obvious example is public concerts and education<sup>14</sup>. A close look into the public finance of the early Islamic state, especially during the life of the Prophet (pbuh) when revenues were tight, may indicate that the main services provided by the government of Madinah were: defense, judiciary and society's management<sup>15</sup>. Therefore, public borrowing made by the Prophet (pbuh) in cash or in kind may be assumed to be for payment of these kinds of services.

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

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

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

<sup>14</sup> *Education may be considered a mixed good because the benefit of adding one educated person to one colleague may be impossible to internalize. One may also argue that a conversation with an educated person may be made a rival good and all its cost may be internalized through a 900 charge call number.*

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

The historical experience of Muslim society may indicate that the role of philanthropy in providing public goods may be instrumental. For instance, until the introduction of Western system of education in the Muslim countries, education has always been provided free to its users by the Islamic Awqaf. In fact, whenever certain rulers wanted to support education, the help itself would be channelled through Awqaf. This has happened many times and good examples of it are the Ayyubites and Mamluks Awqaf on schools in Palestine<sup>16</sup>

## 2.2 Alternatives to Public Provision of Social Goods:

Provision of social goods by the public sector is the reason for budget deficit. It can be argued that for each feasible level of public revenue, there is a level of provision of public goods which does not cause any budget deficit. Accordingly, stretching the provision of social goods beyond government available resources creates a budget deficit.

Consequently, providing social goods by agents which do not require the use of public funds lessens the financial burden of the budget and may therefore be considered alternative of public borrowing<sup>17</sup>.

Non-government providers of social goods may be either voluntary organizations and individuals or profit motivated private sector.

### A) - Voluntary provision of public goods:

The provision of public goods by voluntary agents is as old as Islam itself. Upon the arrival of the Prophet (pbuh) in Madinah, a mosque was built by voluntary labor and material. Defense activities started on a voluntary basis. People used to volunteer both their labor and weapons. Lights in the mosque and food to the poor were also provided on voluntary basis. Drinking water used to be sold by owner of

<sup>16</sup> *Islamic Research Center for History, Culture and Arts (IRCICA), (The Muslim Pious Foundations (Awqaf) and Real Estates in Palestine, Istanbul 1982.*

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

Bairuha' well and the Prophet called on Muslims to buy the well and give water free. Uthman did that.

Soon after establishment of the Islamic state, voluntary philanthropic work assumed an institutional position. The Institution of Philanthropic *waqf* was established. The early properties of philanthropic *waqf* consist of Mukhairiq gardens, Bairuha' well both in Madinah and Umar's orchard in Khaibar. These *Awqaf* were used to provide income for the Prophet's families (head of state's expenses), weapons for the army, support for the poor and free drinking water for inhabitants of Madinah<sup>18</sup>. As time went by, *Awqaf* Institution became the main provider of education, health care and mosques construction and maintenance and a major contributor to building and maintaining border defense posts and providing financial aid to the poor. This institution of *Awqaf* can be revived to re-assume an important role in providing social goods and in contributing to the infrastructural development of Muslim countries.

Moreover, non-profit voluntary organizations have achievement incentives because of the bondage that links their workers to the organization's objectives. At the same time, they can use free (voluntary) labor while they avoid the bureaucratic structure of government<sup>19</sup>.

The provision of public goods by non-profit organization has now-a-days wide spread application, especially in the area of education, health care and water supply<sup>20</sup>.

#### B) - Profit Motivated Provision of Public Goods

The argument for allocating more goods to the private sector provided market efficiency conditions are fulfilled is well known in the literature.

Whenever market mechanism can be activated, efficiency ideas do not

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<sup>18</sup> Hasan Abdallah al Amin, ed., *Idarat wa Tathmir Mumtalakat al Awqaf*, IRTI Jeddah 1989.

<sup>19</sup> Lance Liebman, "Political and Economic Markets: the Public, Private and Not-for-Profit Sectors" in *Public-Private Partnership*, H. Brooks, L. Liebman and C.S., Selling, eds., Ballinger Publishing Co, Cambridge, Mass, USA 1984, p 354.

<sup>20</sup> Gabriel Roth, *The Private Provision of Public Services*, EDI of World Bank, Oxford University Press, 1987, pp. 11-12.

provide support for public provision. Therefore, if a smaller government means less public borrowing, private provision of public goods may be a feasible alternative of budget deficit.

Education, health care, water, communication, electricity, garbage collection, etc. are examples of goods where almost all cost of production can be internalized<sup>21</sup>.

These traditional public goods can be produced and provided by the private sector. This reduces the financial burden of the public sector and lessens needs for budget deficit.

Two important points deserve our attention from Islamic point of view:

First, the scope of private provision of public goods is flexible and it depends on three decisive factors:

- (1) Shari'ah limits that prevent a very small number of goods from being produced on market basis. Examples of these public goods are spaces in places of worship, exercise of political rights and implementation of law and order<sup>22</sup>. Beyond these and similar public goods, most goods and services may be privatized. For instance, you may go to Court to have a judgement on a dispute or you may agree with the other party to buy the services of a private judge<sup>23</sup>.

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<sup>21</sup> *Technological and organizational changes reduce externalities, allow providers to charge users for all cost of provision and eliminate non-excludability conditions. However, there remain situations in which the size of the market is small and economies of scale prevail or characteristics of natural monopoly (one source of some factors of production) prevail. These situations may be dealt with through tax/subsidy, pricing and other regulatory means while the provision of social goods is kept in the hands of private sector. Alternatively public sector may provide these goods. Additionally, cases of market failure because it is either impossible or very difficult to avoid the free-rider problem remain a concern of public sector. So is the case of political/social preferences for public sector's provision of certain goods. For detailed discussion on this issue refer to Gabriel Roth, op. cit.*

<sup>22</sup> *Obviously goods and services prohibited in Shari'ah are outside the scope of this discussion because they cannot be provided by either private or public sectors.*

<sup>23</sup> *Qur'an refers to private judges in family disputes (4:35). These judges may be paid for their services.*

(2) Sources of public revenues affect their uses. This means that if the government has revenues characterized with flexible usage such as return from public property,<sup>24</sup> it can allocate them to any public goods. On the other hand, if the government does not have such use-flexible revenues and it has to tax citizens for revenues, then necessary public goods, such as public administration, judiciary and defense must be provided.

(3) The choice of what, how and for whom public goods are to be produced must be subject to the Islamic approach of public decision making, i. e., to be taken by means of *Shura*. The *Shura* may decide that certain goods be provided by the public sector and may assign or raise certain revenues for this purpose as long as this is in the best interests of the *Ummah*.

Second, the Islamic system provides individuals with moral encouragement to undertake social work and produce public goods on voluntary basis. It also link social goods to religious duties by means of *fard al kifayah*. More important, in present context, is that Islamic system permits the government to provide incentives to investors to encourage private provision of social goods. An important incentive in this regard is the government guarantee as a third party. This is discussed in the remaining part of this section.

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

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

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

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<sup>24</sup> *Jiziah and state share of Ghanimah are also flexible in their use.*

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

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

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

Third party guarantee, thus, requires that the guarantor must be independent of the two parties of the *mudarabah* both legally and financially. The government may offer this guarantee to private investors in order to encourage them to offer *Mudarabah* funds for projects that would otherwise be financed from the public funds. Consequently, this guarantee saves on the use of public funds and may be treated as an alternative to budget deficit.

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

This argument deserves attention, if we look at it from the angle of *rabb al mal* who enters into a *mudarabah* upon receiving such guarantees.

For *rabb al mal*, seeking (or accepting) a third party guarantee for his/her *mudarabah* is like giving funds for investment without carrying any risk; knowing

<sup>25</sup> *The OIC Islamic Fiqh Academy, Resolutions and Recommendations, for the years 1406H-1409H/1985-1989, Resolution No. 5 of its fourth session held in Jeddah, Saudi Arabia, 18-23/5/1408H equivalent to 06-11/2/1988, p. 62.*

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

that risk bearing, with regard to money invested, is an indispensable feature or implication of ownership which justifies deserving a share of profit.

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

In answering this query, one may point out to many circumstances which call for the application of a third party guarantee. First, contemporary business involves high levels of risks which justify the existence and expansion of insurance business all over the world. The fact that many risks are today insurable and actually insured does not imply the elimination of profit drive in investment allocation nor necessarily reduces economic efficiency.

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

After all, nations collect taxes and spend huge resources for achieving national objectives. Many of such objectives may not be economical in the narrow sense, but the public decision makers may find it rewarding from the point of view of national interest to support certain industries by means of encouraging investors through governmental guarantee of capital and profits.

Thirdly, there may be regional considerations which require providing additional incentives to investors in certain regions in order to fulfil national objectives of equity and justice. Even in an Islamic society, those regions may remain neglected if they are left to the normal play of market forces.

Fourthly, the experience of Islamic banks in the late seventies and in the eighties indicated the importance of establishing special funds for guaranteeing investment risks. These funds proved of important help to Islamic banks in bad years.

With the pros and cons of third party guarantee and reservations against any expanded application of it, it appears that the government may resort to providing private investors with a third party guarantee under certain conditions, but in order to contain its negative effects on efficiency, its use should be restricted to cases related to national security at large so that it does not become a predominant phenomenon in the economy.

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## SECTION THREE

### SUGGESTED FINANCING INSTRUMENTS AVAILABLE TO PUBLIC SECTOR IN ISLAMIC ECONOMY

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

- 1- public goods may be provided by government, voluntary sector, and/or private sector
- 2- the Islamic system encourages the provision of public goods by non-profit organization and by the private sector and offers moral enhancement as well as material incentives for that
- 3- whenever it is possible small government is preferred to big government by Muslim economists
- 4- under all circumstances there will remain certain public goods that are to be provided by the public sector. This may be either because of the nature of these goods, *Shari'ah* requirement, or political choice of the *Ummah*.

This section, therefore, takes it for granted that an Islamic government has a variety of needs for financing. It may need financing for the provision of public goods which may be sold at a fair price, a subsidized price or a surcharged price or it may need financing for public goods which are provided free of any charge. Alternatively, financing may be needed for developmental projects or for current expenditures. In other words, the discussion in this section covers all kinds of financing needs of the government which usually cause a budget deficit.

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

Additionally, many of the instruments of financing can be used for income generating projects as well as for projects which do not generate income. This

means that many of these instruments may suit meeting the deficit in current budget, i.e. they can be used to finance pure administrative expenditures as well as income generating projects and mute infrastructure.

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

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

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

### **3.1 Non-debt Financing instruments**

By non-debt public financing instruments I mean those certificates issued with regard to *Shari'ah* compatible forms of financing which allow the financier certain return and are at the same time negotiable, i.e., can be traded at a secondary

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

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

market. On the other hand, sub-section 3.2 shall focus on modes of financing which either do not provide income to the financier or are not negotiable.

Undoubtedly, negotiability is a desired feature in any financing instrument because it offers flexibility and reconciles the desire for income with that of liquidity and precaution. From *Shari'ah* point of view a certificate must represent (i.e., be a title of ownership of)<sup>29</sup> physical commodities or property in order to be sold at a price other than its face (purchase) price. Consequently, from the point of view of the financier, all instruments discussed in this sub-section represent real or physical income generating properties.

### 3.1.1 *Ijarah* instruments

There is only one form of negotiable instruments of financing based on sale principle: *ijarah* [leasing] instrument<sup>30</sup>. The way it works is as follows:

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

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

Provided *Shari'ah* permits, arrangement to take charge of these responsibilities may

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

<sup>30</sup> It will be shown later in sub-section 3.2 that all other sale based certificates represent debts and are therefore not negotiable.

be made by means of insurance and power of attorney to the lessee or anybody else.

The negotiability of these instruments is unquestionable provided that the issuing body accepts, in the prospectus, that holders may sell the property without any effect on the *ijarah* relationship between lessee and lessor. Moreover, *ijarah* instruments are sold at market prices which obviously reflects the market valuation of the stream of income involved with each instrument.

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

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

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

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

They can be used for construction of infrastructure, productive equipment or even for weaponry (not consumable ammunition), as long as the assets involved have long life and can be identified for a rental relationship.

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

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

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

### **3.1.2 Profit and Loss sharing instruments**

As we have seen in section one, this principle of financing covers *sharikah* and *mudarabah* where losses are distributed in accordance with the shares of capital while profits are distributed as per agreement which may differ from the shares in capital. Noticeably, these two modes of financing are fit for profit making projects only. Therefore unless

combined with some other arrangement as will be shown later they do not suit financing current expenditures deficit.

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

#### **Sharikah-based instruments**

These instruments are similar to common stocks in almost all aspects

provided they do not have any prohibited conditions. For instance, preferred stocks that guarantee a minimum return or less capital risk are prohibited<sup>31</sup>

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

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

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

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

Empirical experience of Islamic banks in the last fifteen years shows that the success of *mudarabah* in mobilizing deposits is very satisfactory. This success, along with the limited ability of most Islamic banks to exercise this mode of financing on their assets side, may at least partially be attributed to the corporate form of the *mudarib* (bank) which reduces the moral hazards in addition to other factors related to trust in management, religious zeal which may be higher among depositors than businessmen who are usually more pragmatic, etc.<sup>32</sup>

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<sup>31</sup> See the Resolutions of the 7th annual meeting of the OIC Islamic *Fiqh* Academy, Jeddah, Shawwal 1412.

<sup>32</sup> See references about studies of these factors in Saudi business and in Pakistan business cited in M. Fahim Khan, "PLS, Firm Behavior and Taxation", IRTI, unpublished 1412, H.

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

### **Mudarabah instruments**

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

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

Additionally, *mudarabah* instruments may be issued by the users of funds themselves so you have *mudarabah* instruments of railway, airlines or communication companies. They may be issued by an intermediary *mudarib* who supplies funds to other users on the basis of *mudarabah* or other modes of financing. This characteristic confers high degree of flexibility on this kind of instrument which makes it possible to establish private or government institutions specialized in issuing *mudarabah* instruments to financiers and allocating mobilized funds to government income generating bodies.

Moreover, specialized institutions may be established to raise funds on *murabahah* basis and use them to supply goods for deferred payment to the government on *mudarabah* and/or *ijarah* basis; or to combine goods and services together and provide financing to the government on the basis of *istisna*<sup>33</sup>

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<sup>33</sup> *Istisna* 'contract is similar to manufacturing or construction on order, in which the supplier of manufacturing or construction may also provide financing, i.e., payment will be made at, or some time after, delivery. The nature of the contract, however, gives room for financing to be given by the orderer to the

These kinds of specialized institutions may work on the basis of *wakalah* [power of attorney] with or without compensation for their services, or they may themselves be profit making similar to Islamic banks. But it should be noticed that there may be certain limitation on negotiability of *mudarabah* instruments which are exclusively used to finance *murabahah* on the ground that these instruments may represent assets consisting mostly of debts and cash since according to rules of *Shari'ah* debts may only be transferred at their face value.<sup>34</sup>

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

Besides, the pool of funds raised through *mudarabah* instruments may make a closed pool as in common stock companies with fixed principal, or they may make an open pool similar to that of open capital companies and to the pools of investment deposits in Islamic banks.<sup>35</sup>

Transfer of ownership of these instruments may be made easy by records in the issuing institutions, endorsement on the certificates, or even by hand over of certificates if they were to bearers.<sup>36</sup>

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*producer, i.e., in the opposite direction, too.*

<sup>34</sup> *Fiqh Academy resolution No.5 in the Fourth Annual Meeting, Jeddah 1408.*

<sup>35</sup> *Bahrain introduced an act permitting the establishment of open-end-capital companies in which part of the capital may take the form of non-voting shares based on mudarabah principle. See Sami Hamoud, "al Adawat al Maliyyah al Islamiyyah" [Islamic financial instruments], paper presented at the seminar on the financial markets from Islamic point of view organized jointly by the OIC Fiqh Academy and IRTI, Rabat Nov. 1989.*

<sup>36</sup> *A workshop organized in Bahrain, Nov. 25-28, 1991, by The OIC Islamic Fiqh Academy, IRTI and Islamic Bank of Bahrain recommended that it is permissible in Shari'ah to issue bearer shares. This was approved by the plenary 7th annual meeting of IFA, Jeddah, Shawwal 1412.*

Lastly, *mudarabah* instruments may be backed by a guarantee from the government if they are issued by corporations and/or institutions having legal and financial independence from the government. Such a guarantee may cover certain kinds of risks especially non-commercial risks but it may also cover commercial risks with regard to capital alone as we have seen in section two above.

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

### **3.1.3 Output sharing instruments**

This principle permits sharing the output provided no valuation of capital is needed, because valuation is subject to value judgement. Hence, this principle requires that income generating property is handed over to a manager on the basis of sharing the output.

Forms of output sharing certificates may be suggested as follows:

The government sells an existing income earning fixed asset such as a toll bridge or highway to certificate holders. The proceeds of sale are needed for another governmental project whatever it may be and the purchasers have nothing to do with this matter. Certificate holders may assign a governmental bridge authority (or any other body they may choose) to run the property on the basis of output sharing while all running expenses are born by the authority. Of course, expenses are taken into consideration in determining the rate of output sharing.

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

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

With regard to negotiability, it should be noted that output sharing certificates represent property actually owned and legally possessed. Therefore, they can be sold at market prices. For new projects, there may be certain waiting period until cash funds are substituted for physical property and/or construction material since the *Fiqh* Academy of the OIC ruled that sale of such instruments at a price other than the purchase price is only permissible after at least majority of property becomes physical commodities and assets.<sup>37</sup>

It must be noted that output sharing certificates, like common stocks, do not necessarily have any embodied process of redemption or amortization as they represent full ownership of fixed assets. Moreover, like *ijarah* instruments they expose holders to risks resulting from natural calamities as well as commercial risk such as diversion of traffic away from the bridge.

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

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

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<sup>37</sup> OIC Islamic Fiqh Academy, *Rulings and Recommendations*, Ruling No. 5 of annual meeting No. 4, Jeddah 1408, pp. 66-67.

### **3.1.4 General remarks on public projects financing instruments**

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

1. While *sharikah*, *mudarabah* and output sharing instruments apply to income generating projects, *ijarah* may be utilized for any kind of public projects regardless of being mute or income generating. Therefore, of the above mentioned instruments *ijarah* financing may prove to be the most flexible.
2. All these instruments are based on holders' ownership of all or a fraction of financed projects, i.e. no public debt is created. This ownership has several implications of which the most important are the following:
  - a) These instruments are fully negotiable at market prices because their sale means the sale of the property they represent. Moreover, they can be issued to a specific name or to holder.
  - b) In principle, there is no need for repayment (by government) of the principal of these instruments, unless this is so specified in the conditions of financing agreement (as diminishing *ijarah*, *sharikah* or *mudarabah*). Therefore, the whole issue of inter-generational equity does not arise.
  - c) Ownership by the public of government projects is in a way a form of privatization. But we noticed that except in *sharikah*, the government retains the management of projects financed by these instruments. This means that the provision of the output of these projects is kept public, not private. Therefore, this is only a special form of privatization, not similar to what is usually meant by the term.
 

In a different paper,<sup>38</sup> I called this form a "democratization" of public projects. This democratization is strengthened by the *Shari'ah* conditions of public borrowing discussed later in this section.
  - d) Except in diminishing *ijarah*, the government has to pay the market

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<sup>38</sup> Monzer Kahf, "*Financial Revenues of the Early Islamic State*", unpublished paper, IRTI, 1986.

price if it wants to regain ownership of projects financed by these instruments. In diminishing *ijarah* the paid price may be contractually determined.

3. The issue of who provides what in public goods is irrelevant to the forms of financing discussed above. This implies that these financing instruments are neutral as far as the size of government is concerned. In other words, these instruments can be used by a government which opts to provide larger variety of goods on a public basis, in as much as they can be used by a government which chooses to contain its role to the provision of goods on which the principle of exclusiveness does not operate through the play of market forces.
4. Whether taxes and/or fresh borrowing become inevitable to pay for public financing through these instruments relates to two points: first, whether a financed project produces a surplus sufficient to pay for the financing services (principal plus return). Efficient income generating projects may be able to pay for these services. Therefore, in this case, future taxes may not be inevitable. On the other hand, projects that do not produce income may call for future taxation to pay for their financing services. Second, what forms of financing is applied for the project. In interest based public debt, future taxation is required to pay for the debt services.<sup>39</sup> In all financing instruments discussed in this subsection, the financing agreement may be formulated in a way that does not require future taxation because there would be no need to pay back the principal financed. In other words, even with *ijarah* instruments used to finance non-income generating assets, the government is not necessarily required to pay back the principal since it may keep renting them for ever or return them to certificate holders.
5. These instruments of public financing are related to specific projects and usages. In case of *ijarah*, this implies that the government can only use the rented fixed assets and in the case of other instruments the government is bound to undertake specified revenue generating projects. This is in contrast with interest based public borrowing which does not necessarily involve such one to one correspondence with acquisition of physical assets or construction of income producing projects. On the one hand, this linkage with physical assets and the profit incentive in such projects reduce the moral hazards on the part of public officers because of added (private) control element, and on the other hand, they increase efficiency because public projects would have to compete

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<sup>39</sup> *Alternatively rescheduling/new public borrowing is the other possibility.*

with private sector's projects for financing.

6. Finally, the nature of these instruments allows their use for external and internal resource mobilization. In other words, these instruments are equally fit for external financial resources from individuals, international institutes and foreign government too.

### **3.2 Public debt modes and certificates**

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

On the other hand, ownership based instruments may not fulfill all financing needs of the public sector. Governments may prefer resorting to public borrowing under certain circumstances. For instance, seasonal needs to bridge the gap in timing between revenue collection and expenditure disbursement, inability to formulate certain financing needs under any of the ownership instruments because of certain legalities and failure of these instruments to attract investors. These and similar conditions make debt-based financing a vivid alternative and supplement to ownership-based financing especially that debt-based modes are basically tuned to serve short term needs although they may be used for long term financing.

However, it must be noted that whenever one moves from the idea of property ownership to the idea of debt, a severe blow to the degree of liquidity of instruments takes place because of two *Shari'ah* requirements: (1) debts may only be exchanged at face value regardless of date of maturity, and (2) debts may not be exchanged for debts, i. e., in a permissible or lawful exchange either price or commodity must be present if the other is delayed.

Consequently, whatever debt-based modes of financing the public sector may have shall not be negotiable. This eliminates the possibility of a secondary market with all effects on the first market itself and makes it necessary that an alternative approach for liquidation must be sought. This alternative is redemption.

Redemption, in this context, means buying back the debt before its maturity

by the debtor. It is done either at the debt's face value or at a discount. discount in debt redemption is called *wadi'ah*,<sup>40</sup> and there are certain **Shari'ah** conditions for its applications such as it should not be part of original contract which initiates the debt.<sup>41</sup>

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

### **3.2.1. Voluntary public debts**<sup>42</sup>

While forced borrowing is obtained by coercion, voluntary public debts must have certain built-in attractions in order to appeal for the self interest drive of individuals. It must be noticed, however, that **Shari'ah** prohibits attaching any fringe

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<sup>40</sup> *Wadi'ah is a reduction in the amount of the debt given up by the creditor in exchange of early payment. The permissibility of it is based on the Saying of the Prophet (pbuh) which means "reduce the amount of debt and get it before maturity" which he said addressing some jews when they were leaving the country and they wanted to cash their debts before due dates. The fact is that if mark up is acceptable because of delay in payment also a reduction may be acceptable if payment is done before it is due. Both mark up in sale with deferred payment and discount at redemption before maturity reinforce the argument that time is important with regard to exchange but it cannot be separated from real business exchanges and become a pure monetary phenomenon.*

<sup>41</sup> *It must be noted that wadi'ah is approved by some **Shari'ah** scholars while others oppose it on the ground that it is a form of riba. For a discussion on the issue refer to Rafiq al Misri, Al Hasm al Zamani [time's discount], Center for Research in Islamic economics, Jeddah. However, the OIC Islamic Fiqh Academy considers wadi'ah permissible under certain conditions. See Resolutions of 7th Annual Meeting, Jeddah, Shawwal 1412.*

<sup>42</sup> *Some ideas of this sub-section derive from M. Fahim Khan and Monzer Kahf, "Financing government deficit through borrowing from the private sector," presented at the sixth annual meeting of experts of Islamic banks held in Bahrain, May 1990.*

benefits to a loan and considers any such benefits a form of *riba* whether they are called *riba* or not. This is on the basis of the famous *fiqhi* rule that a loan which may bring any benefit is a *riba* tinted loan. *Riba*-based fringe benefits are material benefits which may or may not be calculated at the time of lending. They even may not be subject to quantification. For instance, with regard to government borrowing, such prohibited fringe benefits may include a tax reduction, relaxation of deadline condition of tax payment, providing facilities in sale of debt holder products, etc.

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

#### **A- SALE-BASED PUBLIC DEBT**

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

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

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

Public debt creation may take the form of simple deferred payment sale in which the government gives IOU's for future payment to suppliers of goods. By the same token '*istisna*' form of sale may be used for construction with payment taking the form of IOU's due at a point of time subsequent to the date of delivery of completed construction. Since these IOU's are transferable at the face price, they do

not attract secondary market transactions. A provision may be made that they can be used for tax payment, etc. IOU's, which may be of different denominations and maturities, may be redeemed by the government before their due date and at the time of redemption the government may seek a discount (*wadi'ah*) for early payment. *Murabahah* is a version of deferred payment sale in which the seller declares his/her cost and profit or added mark up.

Another form of *murabahah* public debt may quote is the *murabahah* for the purchase orderer. It works as follows:

The government assigns one of its bodies to work as agent of the public in acquiring goods on order for the government. These goods shall be paid for in cash from funds obtained from the public to finance the operation. Upon completion of sale of goods purchased on order and receipt of small denomination *murabahah* bonds from the government for the amount of the contract, the agent will distribute these bonds to contributors of funds in proportion of their principal

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

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

### **Mark down and fixed-price in-kind public debt : *salam*, '*istisna*' and *ijarah***

#### **Salam certificates and '*istisna*' coupons**

Indebtedness in *Salam* is in terms of physical goods not money. It offers a mode of financing the public sector if government is able to provide future goods for which funds are obtained presently. For example, government owned enterprises or farms, which produce consumer goods, may sell part or all of their output on *salam* basis.

*Salam* certificates of indebtedness of small denominations of quantities of goods may thus be issued to purchasers. These certificates are not negotiable

because according to *Shari'ah* one may not sell purchased goods before physical delivery. But they can be redeemed before maturity by canceling the contract if the parties agree and the purchaser may get his/her money back without any increment.

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

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

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

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

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

### **Public utility warrants**

Finally, a special kind of debt-based financing arrangement may be suggested to finance public sector utilities. This arrangement is a kind of combination of a recurrent supply agreement [*istijrar*] combined with some of the

features of *salam*. Provided *Shari'ah* permits, a utility public sector corporation may contract its consumers on sale of certain quantity of say electricity they draw in the future at a price marked down from current price (it may also be fixed, i.e., protected against inflation) against advance payment for the whole contracted quantity. Obviously, the nature of this commodity is that delivery is combined with consumption, so the consumer is the party who determines the quantity delivered at each period of time.

Like *salam* and *istisna'* financing, this financing arrangement creates indebtedness in kind on the part of the public sector for which electricity, water, or telephone warrants may be issued and used for payment of these utilities at locations determined by warrant holders. Warrants are not negotiable and their proceeds may be used at the debtor's own discretion. They may be redeemed at face value by mutual agreement.

### **Ijarah bonds**

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

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

### **B - Loan-based financing**

Two kinds of public loan bonds may be mentioned: foreign currency bonds which invoke the incentive of protection of one's wealth against devaluation and to certain extent inflation (at least in many developing countries where domestic rate

of inflation is higher than inflation abroad) and bonds issued on the basis of appealing to patriotic and religious sentiments of private citizens.

### **Foreign currency bonds**

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

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

### **Benevolent bonds**

It may be possible sometimes to find a reasonable response to the appeal for lending the government by invoking the sentiments of loving one's country and protecting and promoting the religious values and principles it stands for. After all, the Islamic system has a strong built-in mechanism to promote voluntary contributions by tying them to good deed and to appeasing to God and saving for one's hereafter. If the *Qur'an* calls on people to sacrifice their lives for helping the *ummah*, why not also sacrificing one's wealth especially if it is sought only on lending basis.

### **3.2.2. Involuntary public borrowing**

Involuntary loans are acquired by the government on the basis of its

authority and responsibility. They are a version of taxation but with a pledge of refund. According to sources of funds, forced loans may be sorted as: loans from individuals and non banking corporations, loans from commercial banks and loans from the central bank. *Shari'ah* permissibility of payment of certain return on public loans has been raised in some quarters<sup>43</sup>, and a debate was carried over about the return of treasury bonds and other government saving schemes<sup>44</sup>.

In this debate, both prohibition of *riba* and its applicability to government transactions were not disputed. The argument for permitting state loans to offer a return to lenders is centered on a few points which apply -in fact - to all transactions, private and public. These points may be summarized in the following : (1) Government may give (take) *riba* to (from) its subjects in analogy to permissibility of *riba* giving (taking) between a father and his son or between a slave and his master. By the same token *riba* should not apply to transactions between the government and government owned corporations and banks. (2) Governments need to raise funds for development, emergencies or to meet budget deficit. Interest payment is necessary to attract such funds. (3) It is fair to compensate savers for the loss they incur because of inflation. (4) Interest payment by government to holders of treasury bonds and other governmental loan certificates is only a permissible government grant.

In answering these points it should be noticed that *riba* is a matter of inter-personal transactions, that is whenever there are no transactions between different entities the prohibition of *riba* does not apply, and any amount given or taken (principal and any increment) is merely an internal arrangement of the same financial entity. Hence, the issue that there is no *riba* between a slave and his master falls in its right place because the master owns the slave's wealth.<sup>45</sup>

In the same context, some argue that a father has a free hand on the wealth of his son and therefore *riba* prohibition does not apply between them. *riba* does not apply between a father and his son since the father can take (give) any thing from

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<sup>43</sup> See for example the questions raised by the government of Pakistan in 1984 which caused the International Institute of Islamic Economics to hold a workshop on 15-17 Oct. 1984.

<sup>44</sup> Like the debate raised in Cairo in 1989/1990 on investment certificates which caused the publication of many newspapers 'articles and several books.

<sup>45</sup> Since the master owns his/her slave along with any property the slave might own.

(to) the wealth of his children.<sup>46</sup> Here again, though disputed, the argument is based on a premise of intermingling of father/son wealth<sup>47</sup>, not on relaxation of the *riba* prohibition.

Consequently, since no one challenges the fact that individual citizens are independent legal and financial entities, definitely separate of the government entity, the prohibition of *riba* arises with regard to transactions between the government and its citizens. Moreover if a government-owned corporation or bank is considered an independent legal entity from *Shari'ah* point of view, *riba* must also apply between this entity and other governmental entities, but if the government and all corporations it owns represent one single legal entity, the use of any fixed rate in calculation, evaluation, or allocation of funds within the finance of this single entity is not *riba*.

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

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

Additionally, this compensation should be sufficient to redress wealth and income to their levels before inflation or should at least be distributed among those affected in accordance with the damage inflicted. Consequently, inflation can't be used as a pretext for violating the rule of *riba* prohibition, especially that the OIC Islamic Fiqh Academy issued a ruling on this subject which states that charging the

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<sup>46</sup> See for example, the article of 'Abd al Mun'im al Nimr, on this issue in *al Akhbar*, Newspaper, Cairo, 21/10/1989.

<sup>47</sup> This argument is based on a saying that "You and your wealth belong to your father", [reported by Ibn Majah].

debtor to compensate for inflation caused damage to creditor is not compatible with *Shari'ah*.<sup>48</sup>

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

Since the literature is full of deliberation about procedures, forms, and pros and cons of these three kinds of public loans, the present paper will concentrate on three points which have certain peculiarities and special relevance to Islamic Economics. These points are: (A) Conditions of public borrowing in Islam; (B) The implication of the concept of social justice; (C) Demand deposits and seignorage as a basis for justifying imposing loans.

#### A- CONDITIONS OF PUBLIC BORROWING IN ISLAM

Resorting to the private sector to cover a deficit in public funds is unquestionably permissible in *Shari'ah*. It has its own tools which include those

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discussed in this section in addition to taxation. In classical literature, jurists debate whether the government may impose taxes or borrow from the public. They discuss the conditions of each of these two approaches. In other papers, I argued that Islamic government may impose taxes only as a last resort, i.e., after exhausting all other sources including borrowing.<sup>49</sup> Hence I shall concentrate here on the conditions of public borrowing.

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

Al Mawardi<sup>50</sup> and al Juwaini<sup>51</sup> discussed public borrowing and taxation. The question is also addressed by several other scholars including al Shatibi, al Nawawi, al Ghazali and Ibn Hazm. From those discussions and comments on the issue by al Qaradawi and Rif'at al Awadi, one may collect the following points:

1. The permissibility of public borrowing in **Shari'ah** depends on certain conditions and circumstances. That is to say: in principle **Shari'ah** has its own system of financial resources for the government. These resources are

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<sup>49</sup> For details, kindly refer to my papers on "Financial resources of the early Islamic state", Presented at a Seminar on the subject held at Yarmuk University, Jordan, April 1987; "Economic public sector and its role in mobilizing resources for development", in *Al-Mawarid al Maliyyah li al Dawlah al Islamiyyah fi al 'Asr al Hadith*, [Financial resources of the Islamic state in modern time], Monzer Kahf, ed., IRTI, Jeddah, 1989; "The Islamic state and the welfare state", in *Islamic Movement Challenges*, Tariq Quraishi, ed., ATP, Indianapolis, Indiana, USA, 1986; "Taxation policy in an Islamic state", in *Fiscal Policy and Resource Allocation in Islam*, paper presented at the Seminar of Fiscal Policy and Planning Development, held by IIIIE of the International Islamic University, Islamabad, 1986; and "Financing Public Sector in Islamic Perspective", presented at the Third International Conference on Islamic Economics held by AMSS of the USA and Canada, Washington D.C., Dec. 1990.

<sup>50</sup> Abu al Hasan Ali bin Muhammad al Mawardi (circa 450 h), *Al Ahkam al Sultaniyyah*, Third ed., Mustafa al Babi al Halabi, Cairo, 1973.

<sup>51</sup> Imam al Haramain al Juwaini (circa 478 H), *al Ghiyathi*, published by Directorate of Religious Affairs in Qatar, 1400H.

sufficient under normal circumstances. Going beyond these resources is always an exception. Al Juwaini for instance says "It is not right for us to invent methods in bringing good to servants of God and procuring means of wise action which have no roots in *Shari'ah*, since this bears a great deviation and an enormous danger", p.287.

2. Some scholars, e.g., many Shafi'ites argue that the government may not keep any surplus in the treasury since a surplus in *Bait al Mal* is an exclusive right of present generation of people. It should be given away to them in terms of direct distribution like what 'Umar did, or in terms of governmental projects such as building of dams, mosques and shelters for the poor and needy. People who subscribe to this view add that should a need arises, the government can always collect from the public amounts sufficient for fulfillment of its responsibility by means of taxes or loans, (al Mawardi, p. 215 and al Juwaini, p.249). Apparently, this is a reference to budget balancing on an annual basis as well as a license to impose taxes and/or borrow from the public when need arises.

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

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

He further adds that as an obligation, funds acquired by the

government need not be on loan basis since this obligation is based on ground of *fard al kifayah* [a personal obligation on all individuals unless some people discharge of it] and what is given in fulfillment of an obligation should not be subject to refund,[p.275]. Moreover, giving such funds with the condition of returning them later indicates that payers are not original in discharging of what God ordained unto them, [p.276].

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

In the final analysis, al Juwaini does not take a firm position against resorting to public borrowing before taxation. He asserts that the matter must be left to the government in its looking for what is most suitable for each situation (p. 277), he also contends that what the Prophet (pbuh) did in borrowing instead of taxing merely implies that public borrowing is permissible is *Shari'ah* (p. 279).

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

4. To understand the opinions of al Mawardi and al Juwaini on public borrowing, one must distinguish between loans taken from rich citizens in a forceful manner and voluntary public debt. It appears from their mixing discussion of taxation with borrowing that they have in mind a forced kind of public borrowing. However, permissibility of voluntary public borrowing by means of instruments offered to the public may be implicitly derived from their elaborations and reasoning.

5. Both al Mawardi and al Juwaini seem to agree with most other Muslim scholars and jurists that public borrowing must always be related to the needs of the public sector. However, the kind of needs which make it permissi-

ble to borrow may vary.

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

Al Mawardi believes that coercive public borrowing may be resorted to for the satisfaction of kind (A) of needs provided the government anticipates definite future revenues sufficient to pay for the debt along with future regular expenses. Kind (C) of needs do not justify borrowing nor imposing taxes. As for kind (B), the choice between taxes and forced loans depends on whether the government anticipates sufficient surplus resources for debt payment from its regular future revenues (p. 215).

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

Al Juwaini contends that kinds (a) and (c) should be financed by taxes on the rich, regardless of the magnitude of the tax in the case of kind (a) and at moderate but reasonable rates on regular basis in the case of kind (c). For needs that are not so pressing, i.e. kind (b), he suggests that they should be financed from taxes on the "excess of the wealth" of the rich (!).

Interestingly, al Juwaini and al Mawardi both consider construction of dams, improvement of material conditions of living and other public interests

of beneficial nature as of marginal importance activities of the government which may only be carried out if there are surplus funds in the treasury, i.e., they should not be financed by taxes or forced borrowing.

In other words, public needs for which the government is allowed to borrow forcefully may be sorted out in the following points:

- a) Defense requirement in case of aggression or to prevent an expected aggression.
- b) Establishment of a minimum government apparatus which maintains safety and security of persons and property and organizes the essentials of religion as a comprehensive way of life.
- c) Satisfaction of basic needs of the poor and deprived in terms of food, clothing, shelter, indispensable level of health services, marriage if necessary, etc.
- d) Fulfillment of other collective obligations [*fara'id al kifayah*] such as burying the dead, maintaining skills and scientific knowledge essential for indispensable production and distribution, etc.

6. Al Juwaini mentions voluntary contributions as a major source of public funding at the time of the Prophet (pbuh). This gives room to extend the analysis to include public choice with regard to what needs should be financed by which means, public debt or taxation. According to al Qaradawi, such a decision can only be taken by a *shura* council whose decision is binding on the executive branch of government.<sup>52</sup> Rif'at al Awadi considers this condition one of the essential principles of taxation in Islam.<sup>53</sup>

7. Pushing this debate further, one may like to argue that if it is

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<sup>52</sup> Yusuf al Qaradawi, *Fiqh al Zakah, Mu'assassat al Risalah, Amman, Jordan 1972, p. 1085-1088.*

<sup>53</sup> Rif'at al Awadi, *"Al Daribah fi al Nizam al Islami" [Taxation in Islamic System] Al Idarah al Maliyyah fi al Islam, [financial management in Islam], Mu'assassat 'Aal al Bait, Amman Jordan 1990. V. 3, pp. 1053-1126, p. 1088.*

permissible for a duly elected *shura* council to impose taxes and/or obligatory loans under certain circumstance, it must also be permissible for the *shura* council to decide on financing projects of benefit to the society, though they are not necessary, by means of voluntary financing obtained from the public on the basis of certain incentives.<sup>54</sup>

Al Juwaini, however, warns against extending the permissibility of imposing taxes [or by the same token forced borrowing] beyond its proper limits. In his discussion on whether it is permissible to confiscate wealth of criminals and bandits, he said that since seizing their wealth is suggested not for a genuine need for public fund but only as an act of punishment, *Shari'ah's* general rules do not allow a measure like this unless there is a general indication in this religion regarding its permissibility. However, if a genuine need for public funding already existed such individuals may be charged more than others, (p. 287-288).

Consequently, one may argue in favor of voluntary public debt<sup>55</sup>, if the condition of necessity is lacking, since offering financing certificates leaves the choice of whether to finance such projects to the general public. This is a form of voting on government projects by the public.

Furthermore, mobilizing private sector resources for financing public projects may be a social choice for accelerating economic development, and the public acceptance of, or attraction to, this kind of investment is itself a form of public voting on governmental development policy. This may be true from Islamic point of view as long as the attractive features of this financing are compatible with *Shari'ah*, do not jeopardize private savings and investment and are initiated for the public interest of the *ummah*.

8. To complete the conditions of public borrowing, the following should be mentioned:

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<sup>54</sup> M. N. Siddiqi, "Public expenditures in Islamic State", paper presented at the seminar on *Fiscal Policy and Economic Development in Islam*, organized by IIIIE, International Islamic University, Islamabad, 1986.

<sup>55</sup> Or alternative instruments as discussed in this section.

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

#### **B)- SOCIAL JUSTICE IMPLICATIONS OF PUBLIC BORROWING**

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

Inter generational incidence of public borrowing (and all kinds of debt-based financing) is one of the important issues raised in economic literature. It is equally important for Islamic economics because of its sensitivity to the question of justice.

Two view points are often offered in answering the following question: who will bear the burden of public debt, present generation or future generation? Some writers claim that since resources used by the public sector represent a chunk of present output of which private sector is deprived, it is the present generation who carries the load of this utilization regardless of its mode of finance, taxes or debts.<sup>56</sup>

However, it can be shown that public expenditures, whether current or developmental, represent real use of resources for which some one must pay. If these expenditures are paid for by borrowing from the public, future generations

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<sup>56</sup> E.K. and J.M. Browning, *Public Finance and Price System*, 2nd Ed. Macmillan Pub. Co. Inc., New York, 1983, pp. 405-406.

will have to be taxed for the payment of principal and interest (in interest loaded economies). This represents a real burden on future generations. On the other hand, bond holders do not gain at the time of settlement of public debt because for them payment of the debt represents an exchange of one asset for another.

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

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

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

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

All these considerations relate to public debts subscribed to by individuals from within the economy. If public borrowing is done outside the country, further considerations should be added among which are the following: first, payment for servicing the debts will put a pressure on export and other sources of foreign exchange; second, internal inflation, if higher than inflation of the currency of the foreign debt, which is usually the case for developing countries, creates a further increase in the burden of future generations; and third, the burden of foreign debt

will be heavier if debts were not used to increase the production and export capacity of the economy.

With regard to justice within each generation, it has been argued in the previous sub-section that, when permissible, public loans should only be taken from the rich not from the poor<sup>57</sup>. Therefore, any kind of involuntary public borrowing, whether from individuals and private corporations, commercial banks or central bank, must be carefully evaluated from the point of view of its impact on social justice. Whether it affects individuals in proportion to their richness or not, keeping in mind that richness in Islam is measured in terms of both stock (wealth) and flow (income) together.

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

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

### C)- DEMAND DEPOSITS, SEIGNORAGE AND INVOLUNTARY

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<sup>57</sup> *Al Juwaini argues that other considerations may supplement social justice in determining the payers of taxes and/or forced public borrowing. Specifically, he mentioned two additional considerations: (a) financial penalties may be imposed on the wealth of criminals and bandits if there is a genuine need for funds, and (b) if public funds are needed, the government may charge those who are believed to use their wealth for extravagant and other prohibited usages to the extent which prevents such misdeed. See Al Ghiyathi, *op. cit.*, pp. 273 and 288.*

## PUBLIC DEBT

Two facts are well established about deposits in banks' current accounts. one, that depositors are usually not given any share in the earnings of the banks (Islamic or not) although their funds are used in the bank's profit generating activities; and two, primary deposits help the banking system create derivative deposits because of partial reserves-cum-multiplier affairs. Both these two facts, together award banks an opportunity to reap returns unearned by the banks' own property and/or work but caused by the economic system and the behavior of people towards it. This gives rise to the seignorage rights regarding this kind of created credit.<sup>58</sup>

Several ideas are put forward by Muslim economists in order to bring justice in this regard.<sup>59</sup> Some suggests that commercial banks in the Islamic system should maintain 100% reserves of all their demand deposits;<sup>60</sup> others recommend that banks may be permitted to harvest this benefit but they should be taxed accordingly;<sup>61</sup> some others yet suggests that derivative deposits should be used for (a) broadening the base of borrowers from commercial banks to include fulfilling some of the welfare objectives of the Islamic state in supporting the poor and needy and promoting their productive capacity; and (b) whatever is left of created credit should be considered similar to *mudarabah* deposits in the hands of commercial banks the return of which is to be collected by the government and spent on welfare

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<sup>58</sup> *Seignorage is generally caused by the acceptance of the public to use sorts or means of payments which are almost cost free to produce. Hence, it also arises with the use of credit cards in which case consumers get the advantage and with the use of fiat money where the government reaps it.*

<sup>59</sup> *The consideration of justice is provoked along with other points related to stability of the banking system, reducing the power of bankers, providing financial resources for the public sector, etc.*

<sup>60</sup> *See for instance, Mabid al Jarihi, "Monetary and Financial Structure of an interest-Free Economy", in Money and Banking in Islam, CRIE, Jeddah, 1983, pp.69-87, and Monzer Kahf, The Islamic Economy, The MSA of the Us and Canada, Indianapolis, Indiana USA, 1978.*

<sup>61</sup> *Munawar Iqbal, "Fiscal Reform in Muslim Countries with Special Reference to Pakistan" Paper presented at IRTI 1992.*

programs for the poor and needy.<sup>62</sup>

It may also be suggested that commercial banks be asked to maintain say 20% reserves for demand deposits in the usual form of cash and deposits with the central bank and 80% reserves in the form of a combination of short and medium-term *riba*-free treasury bonds. Or to put it in general terms, commercial banks may be forced to lend the government, especially short-term lending, in order to, wholly or partially, compensate for the seignorage reaped by them. This kind of public debt particularly helps in seasonal adjustment of the government's revenues and expenditures and may additionally provide a valuable monetary policy tool which can be used to control money supply by the banking system.

### **3.2.3. General remarks on public debt modes**

1. All modes discussed in sub-section 3.2 create public debt. However, while mark up modes, voluntary and involuntary public borrowing create indebtedness in money terms, mark down modes create in-kind indebtedness.
2. Both mark up and mark down modes of public borrowing are tightly related to goods and services exchange and production.

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

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

The link with commodities supplied and produced puts a tab on public debt which prevents the government from expanding it. This way mark up and mark down public debt avoid one of the major drawbacks of interest-

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<sup>62</sup> M. Umar Chapra *.Towards a Just Monetary System, Islamic Foundation, Leicester, U.K. 1985, pp. 89-94.*

based debt.<sup>63</sup>

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

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

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

5. Since all modes of public debt discussed in this sub-section provide the government with either cash or goods and services, there is no issue of privatization arising from the application of these modes.

6. As all these modes result in creating public debt, the government may provide any form of guarantee on loans it likes. Such a guarantee may be given by the same body which uses the financing or by another governmental body which may be legally and financially independent from the debtor.

7. Except for involuntary borrowing, all modes mentioned in subsection 3.2 can be applied to external as well as internal financing. Consequently government may obtain foreign institutional financing on the basis of *murabahah*, *salam*, *'istisna'* and benevolent foreign borrowing. It can also mobilize foreign financing from individual, citizens and others, on the basis of mark down modes and foreign currency bonds.

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<sup>63</sup> *Al-Qari, Mohammad Ali, "Petroleum bonds as an alternative to treasury bonds", unpublished paper, CRIE, King Abdulaziz University, Jeddah, 1412H.*

## SECTION FOUR

### CONCLUSIONS AND SUMMARY

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

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

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

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

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

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

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

- 1- Whenever public debt is obtained a future liability is created and unless the government generates sufficient future resources to pay back the debt, taxes and/or expansion of borrowing become inevitable. From the point of view of financing instruments this requires certain details:
  - a. Ownership-based instruments do not call for redemption as they do not create liability on the public sector.
  - b. in-kind public debt calls for future production of contracted goods and services. This requires financing. Therefore, unless the production capacity of the public sector is expanded sufficiently, fulfillment of contractual obligations becomes difficult. Default of government in this regard may result in compensatory damages, etc.
  - c. cash public debt cannot be rescheduled because interest is prohibited.
- 2- Sale of public property is an important source of public revenue that may be tapped to meet budget deficit and pay back public debt needs to be investigated thoroughly. The economic development in oil producing countries depends on this source. Moreover, the privatization process in the second and third world countries is capable of generating huge financial resources to pay back public debts and cater to their financial needs. However, a *Shari'ah* investigation of privatization of public property deserves to be subject of a future research.
- 3- The modes and instruments discussed in this paper may be utilized for financial resource mobilization from the private sector within the country. They can also be used for external financing. In a different paper, Tariqullah Khan and myself discussed the principles of external financing for the public sector. It may be worthwhile to mention here that from the point of view of external security of Muslim country, a distinction may have to be drawn on the

basis of sources of external borrowing. This may bring into the analysis the concept of the Muslim *Ummah* and its impact on Muslim/non-Muslim international economic relationships. This is of course an area which falls outside the scope of this paper and it may be suggested for future studies.

- 4- A thorough *fiqhi* investigation and elaboration of detailed conditions of some of the modes and instruments suggested in this paper may also make a good subject of a *Shari'ah* oriented future research in this area. This itself may generate new ideas and result in developing more modes and instruments of public financing.

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