INSTRUCTIONS AND ALTERNATIVES OF PUBLIC DEBTS IN ISLAMIC ECONOMY

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INTRODUCTION

<u>Statement of the Problem and Objective of the paper</u>

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

Islamic literature on public debts 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 by the same institution.

Yet with only a few exceptions, what is written is mostly marginal because it focuses on the causes of debt crisis and alternatives to international debtso[1], rather than tackling the needs, forms and alternatives of public borrowing in Islamic economy. This paper attempts to deal with the genuine needs for public borrowing in an Islamic economy and suggests instruments for public debt compatible with *Shari'ah*.

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[1] Μυηαμμαδ Υμαρ Χηαπρα∋σ παπερ ον ∀Ισλαμ ανδ τηε Ιντερνατιον–
αλ Δεβτ Προβλεμ∀ ισ αν εξαμπλε. υνπυβλισηεδ παπερ ανδ λεχτυρε γιϖεν ιν τηε Ισλαμι
χ Φουνδατιον, Δακκα Βανγλαδεση, ϑυλψ 25, 1991.

Relevance and Significance of the Study

Most Muslim countries today have large amounts of public debts, and many of them are increasing their debts by fresh net borrowing year after year[2]. These public debts would have to be transformed into Islamically acceptable forms of financing if the 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 for expansion of their economic infrastructures, for which they require to mobilize fresh financial resources, both internally and externally. Also unforseen 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, banking and economic activities in the Muslim countries and 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 Muslim countries. In other word, this paper may contribute to private, and probably public, funds transfer among the Muslim countries.

The present paper consists of two main sections and a summary. In section one, I will discuss the principles of financing in Islam and their applicability to the public

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2 Iβιδ ,.π. 2.

sector. In this section, issues related to public sector's borrowing will also be discussed. These include the prohibition of Riba between State and its citizens, third party guarantee in relation to Mudarabah conditions stipulated in *Shari'ah* on public borrowing in general and borrowing from external sources in specific, needs for the problem of intergenerational equity in Islamic perspectives and the needs for public borrowing in an Islamic economy.

In section two I will suggest instruments for public resource mobilization which can be developed on the basis of the Islamic principles of net income sharing, gross income sharing, sale based instruments, debt in kind instruments and foreign currency instruments. This will come after an introduction about the characteristics of successful public debt instruments in general. In this section, I will also make a brief mention of non market instruments of public borrowing, i.e., borrowing from commercial banks and from the central bank.

Finally, the summary will state the conclusions of the paper.

Historical background

There are several cases of public borrowing during the time of the Prophet (pbuh)[3]. There are also cases of borrowing by the Muslim State during the Abbasites[4], the Ottomans[5], and obviously modern Muslim states since the middle of the nineteenth

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[3]M. N. Σιδδιθι χιτεσ σεϖεν χασεσ οφ βορροωινγ βψ τηε Προπηετ (πβυη). Ιν τωο οφ τηεμ τηε συμσ οφ λοανσ ωερε ρελατιϖελψ λαργε. Ονε λοαν ωασ ιν κινδ ανδ ονε ιν χαση. Ηε βορροωεδ φορ δεφενχε πυρποσεσ ασ ωελλ ασ φορ περσοναλ νεεδσ φυλφιλλμεντ φορ χερ ταιν πεοπλε. Σεε Μ.Ν. Σιδδιθι, Πυβλιχ βορροωινγ ιν εαρλψ Ισλαμιχ ηιστορψ.∀ παπερ π ρεπαρεδ φορ τηε τηιρδ Ιντερνατιοναλ Χονφερενχε ον Ισλαμιχ Εχονομιχσ, Κυαλα Λυμπ υρ, ϑαν 29–31 1992, ππ. 4–14.

[4]Ibid., pp. 19-23

[5]See ....

century[6]. However, none of these public debts resulted in issuing negotiable instruments, as loans used to be taken from rich citizens. However, Ottoman's and Egypt's borrowing in the nine hundred were entirely external from foreign countries 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 "IOY's" to lenders because at that time, transactions of *Bait al mal* were always recorded and documented but there is no available reports about the forms of these "IOYs" nor their negotiability.

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

One had to wait until the 1960s to witness a substantial increase in public debts in the Muslim countries as shown in table 1.

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[6]See....

Table one shows the weakness of internal debt in the mentioned member 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 Muslim overseas whether they are citizens of the borrowing country or not.

SECTION ONE

PRINCIPLES OF FINANCING IN ISLAM:FROM PRIVATE TO PUBLIC

This section will give a brief expose of the financing principles in Islam. It will show that these principles are the same for private as well as public sectors. It will also discussed a few issues usually raised with regards to the application of the financing principles to the public sector. consequently, this section is divided in two sub-sections which deal respectively with the principles of financing in Islam and those problems of moving from micro to macro application of these principles.

1.1- Principles of Financing in Islam:

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 the principle of sale (Verse II: 275),[7] and the *Sunnah* confirmed this principle and added the principles of Profit and loss sharing and of output sharing.

However, these three principles are equally important in theory as well as in application and jurists usually devote for them many chapters. Since this issue has been discussed at length in the literature, this paper shall only depends on secondary and contemporary sources in providing a brief description of these principles and I will summarize the main precepts of financing in Islam before the conclusion of this sub-section.

[7]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.

I)- The 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, and 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.[8]

Since renting or leasing is a sale of the usufruct of a durable asset, for the purpose of generality , it can be said that leasing is a special form of sale. Hence, this principle covers transactions based on sale (*bay'*) as well as lease (*ijarah*) contracts although there are a few differences in the *fiqhi* specifications and conditions mentioned by jurists for each of these two contracts. When practiced by Islamic banks, deferred payment sale is usually referred to as sale to the purchase orderer, or *murabahah li al 'amir bi al shira'*. However, lease or *ijarah* is also practiced by these banks in the form of leasing to the purchase orderer too, i.e., the bank purchases an asset on the order of the person who is going to take it on lease basis.

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,[9] because although the seller (lessor) receives definite amount of return known at the time of contract, the seller-cum financier (lessor-cum-financier) carries certain risks involved in purchasing, owning and selling or renting the object of sale or lease before and after it is handed over to the buyer or lessee.[10] Moreover, in the case of lease the object of the contract

[8]Monzer kahf and Tariqulla Khan,"Principles of Islamic Financing: a Survey," unpublished paper, IRTI 1409, pp. 29 - 31.

[9]M.Fahim Khan,

remains in the financier's ownership for the duration of the contract.

On the other hand, both these contracts create debtor\creditor relationship between the two parties and are therefore similar to *riba* based financing in being debt based financing. This resemblance apparently confused the unbelievers of Makkah and made them say what the Qur'an reported "sale is like usury," (Verse II: 275).

From the point of view of management, the *Shari'ah* conditions of both sale and lease require the financier or Islamic bank to act as purchaser of goods and assets which are offered respectively for sale and lease. Thus is it not sufficient that the intermediary remains a pure financing entrepreneur, it rather has to act as an entrepreneur that deals in real goods and services like any other dealer in the physical or real market. Consequently, 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 strict sense of the term rather than pure financing.

In addition to *murabahah* and *ijarah*, there are endless forms of financing sale. These include *salam* based financing (cash payment against future delivery of the object of sale), *Istisna'* based financing (production and\or construction against immediate cash or cash delayed till some time after delivery of object of sale), *ju'alah* based financing (services are rendered against advanced cash or cash delayed for certain period after the completion of service), etc.

II)- Profit and loss sharing principle

The principle of profit and loss sharing covers partnership (*sharikah*) and

[10]These risks are usually mentioned of *fiqhi* references, they include the risk of the contract discovered to have been void, the risk of discovering an undetected defect, etc.

commendam partnership (*mudarabah*). The Islamic principle of profit and loss sharing implies that profit may be distributed among 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* can be considered a special case of *sharikah* in which one partner provides zero share of capital and has therefore no share in the loss.[11]

Partnership requires the financier to share both capital and management and to contribute to the decision making process. The financier becomes a full fledged manager-cum-entrepreneur like in direct investment. On the other hand, *mudarabah* requires that financier or *rabb al mal* provides capital and remains sleeping with regards to all investment and managerial decisions.[12]

While *sharikah* provides the financier with certain control power along with the managerial burden, giving investment funds on the basis of *mudarabah* provides Islamic bankers with the opportunity to practice their role as financial intermediaries away from the burden of real business decision making. If Muslim bankers take funds from depositors on *mudarabah* basis and provide them to businesses on the same basis, then a simple model of pure financial intermediation arises in which Muslim bankers can be specialized in mobilizing resources on one hand and finding good investment opportunities on the other.

Unfortunately, *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

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[11]See M. Fahim Khan, ...

[12]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, *Mafhum al Tamwil fi al Iqtisad al Islami*, IRTI, 1991.

means that the always neat and theoretically cherished two fold *mudarabah*, in which the *mudarib* uses the funds of *mudarabah* by giving them away to investors on *mudarabah* basis, did not succeed to attract Muslim banker and failed the empirical test. This gives way to a very much needed analysis to theorize a model of financial intermediation based on a formula in which the *mudarib* uses the funds of *mudarabah* in providing 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 of them is the case mentioned by the Hanbalites in which one party provides funds but retains the wright to share the investment and managerial decisions along with the *mudarib*. This case they describe as: "two persons and one principal."[13]

The other form is the case in which the *mudarib* mixes his\her own principal with the funds he/she obtained from *rabb al mal*. This latter form is very much utilized by Islamic banks today and it may even be preferred to the normal *mudarabah* because it increases the personal incentive of the *mudarib.* In both cases, however, the principle of profit and loss sharing applies, i. e., profits are distributed according to agreement and losses according to principal.

<u>III)- Output sharing principle</u>

A third and important principle of financing in Islam is derived from an ancient practice in agriculture which is approved in Islam and reorganized in accordance with the Islamic ideals. *Muzara'ah* and *musaqah* are crop sharing for cultivable land and fruit trees orchards respectively. The basic idea in these arrangements is that output (and not profit) is shared and one party provides land, trees, and possibly as per mutual agreement seeds, fertilizers, pesticides and agrarian machinery while the other provides

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[13]Ibn Qudamah, <u>Al Mughni,</u> ......

labor which, by mutual agreement, may be coupled with seeds, fertilizers, equipments and other agricultural inputs.

The Hanbalites are the only *fuqaha'* who seem to accept extending to other sectors such as industry and services the application of the basic idea of *muzara'ah* and *musaqah,* which is in simple words: one party provides the fixed assets, the other privdes labor and they share output while running cost is left to mutual agreement in the contract.[14]

Consequently, output sharing-based financing implies that the financier owns durable productive assets which are given to the manager\laborer who becomes in charge of daily decision making against certain a percentage share in 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 that 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 and it 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 sometime until it is formulated in contractual terms which can readily be used by Islamic banks.

IV)- The main precepts of financing in Islam

By careful look into the prohibition of *riba11he* *fiqhi* discission of lawful and

[14]Monzer Kahf, "Mafhoom al tamwil," op.cit. and Rafiq al Masri, ...

unlawful conditions in the contracts of sale, lease, *sharikah*, *mudarabah*, loan, etc., one can identify a set of axioms stipulated by *Shari'ah* to govern financing in Islam. These axioms apply to all forms of financing whether they fall

under the principle of sale of sharing. These axioms are the following:[15]

1- Ownership of invested assets belongs wholly to the provider of funds, *rabb al mal*, until a point in time when any profit appears or begins to generate. Whence a profit exists, even before its distribution, the *mudarib* becomes a partner in ownership in as much as corresponds to his\her share of profit.

   Whether the Islamic bank uses the funds of depositors, *rabb al mal*, on the basis of sale or sharing, ownership of assets in which depositors' funds are invested remains that of depositors until a profit is generated. Consequently, when the bank deals in *murabahah* and *ijarah*, depositors are the legal owners of goods and assets readied for sale and rent respectively. But when it deals in *shari'ah* or *mudarabah*, depositors own those assets in the hands of the new *sharikah* or new *mudarabah.*

   Moreover, this ownership is the basis for carrying losses by owners of the principal alone since losses are defined in *Shari'ah* as a decrease in principal.

2- Profit can be earned by either labor or property. Consequently, it is by virtue of ownership, and nothing else, that depositors deserve an agreed upon share of profit. There is no other justification for profit in the case of *rabb al mal.*

[15]For details and supporting evidence of these axioms refer to Monzer Kahf and Monzer Kahf and Tariqullah Khan, both Op. cit.

As for the *mudarib*, he\she deserves a share in the profit on the basis of labor provided. This labor takes the form of practice of trade or business in case of the *mudarib* uses the modes of sale, leasing, or partnership. However, when the *mudarib* gives the principal of the *mudarabah* to a second *mudarib*, the two *mudaribs* together earn the share of *mudarib* in resulting profit.

This means that in two fold *mudarabah,* the first *mudarib* is not treated as a *rabb al mal* vis a vis the second *mudarib*. Consequently, the second *mudarabah* contract does not change anything in the distribution of the profit in the first contract, i.e. the percentage share of *rabb al mal* stipulated in the first contract remains fixed and binding through the implementation of the second *mudarabah* contract.

If the bank uses funds obtained on *mudarabah* basis in sale based financing, the share of *rabb al mal* is earned on the ground of being owner of those goods bought to be sold against deferred payment, while the share of the bank is earned because it is the *mudarib.* This means that in *Shari'ah* time alone is not an acceptable reason for earning any return.

3- Factors of production, i.e., capital, labor including entrepreneurship and land, may enter the production cycle on the basis of risk taking or risk aversion. a risk taker factor exposes itself to a reduction in principal, which is termed as a loss in the strict sense of the word as used in *Shari'ah* . This risk applies to money capital alone.[16] It also exposes itself to loss of potential reward or opportunity cost, a risk which applies to all factors of production. While *rabb al mal* in a *mudarabah* carries both kinds of risks, theM *mudarib* or entrepreneur carries only the second kind of risk at the time that he\she is the person who takes all

[16]It may also be said that land looses value because of continuous use in cultivation which makes it loose fertility, and labor may also loose value because of cumulative experience in failure. These forms of losses are in terms of value and not necessarily physical.

management and investment decision, i.e. those decision which involve risk for him\her as well as for *rabb al mal.*

On the other hand, risk averter factors may enter the production cycle on the basis of renting their services, against definite indebtedness,to an owner of a factor who accepts to take risk.[17] However, unlike physical capital such as plants and equipment, this choice is not open to money capital since money capital cannot be used in production without being perished,i.e., giving it away for acquiring production inputs. In other word, among all factors of production, money capital is the only one whose usufruct cannot be obtained without consuming the capital itself by exchanging it for other goods and services.

4- The Islamic approach to financing requires that financing be always intrinsically attached to real goods and services. whether it provided on the basis of sale, profit and loss sharing or output sharing, financing must be related to production or exchange of goods and services. In contrast, *riba* based financing does not have to be correspondent to real goods and services production or exchange. Thus while rescheduling of debts is possible in *riba* based systems, rescheduling is restricted in Islam to the case were no increase in the amount of debt or any other benefit to creditor is involved.

Moreover, Islamic financing can be effected for the exchange or production of goods or services whereas financing on the basis of *riba* may be done on personal grounds.

1.2- Financing and the public sector

Fiqhi discussion with regard to public sector's finance is usually focussed on three main points which are: 1- sources of revenues, 2- uses of funds by the state, and

[17] Since by its nature, any production process entails risk, there ought to be at least one party who takes risk.

3- deficit and surplus and what to do with them. Obviously, the third point relates to the subject of this paper since it deals with public debt. But before discussing the conditions of budget deficit and what to do about it, it is important to address the questions of *riba* between the state and individuals, third party guarantee, inter-generational justice and the financing needs of the state from Islamic perspectives.

A)- *riba* between the state and individuals

From the previous presentation and looking into the discussion on *riba* in the classical *fiqhi* references it becomes clear that jurists do not make any distinction with regard to the prohibition of *riba* between individual Muslims, state transactions, and transactions of the voluntary sector, i.e., trusts (*awqaf*) and charitable organizations. This means that the prohibition of *riba* cover all kind of transactions regardless of the personality of parties involved. In spite of this, the issue of whether this prohibition applies to state's transactions with individuals was recently raised sometimes in the form of questions,[18] and sometimes in the form of a debate on treasury bonds or government saving schemes.[19]

However, in this dialogue the prohibition of *riba* and it applicability to all exchange relationships including state's transactions were not questioned. Moreover, no claim was made that the government may have different financial regulation in *Shari'ah.* Consequently, the argument for permitting state transactions to include *riba* is centered on a few points which apply to all transactions regardless of parties involved and may be summarized in the following points:

[18]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.

[19]like the debate raised in Cairo in 1989\1990 on investment certificates which contributed to the publication of many newspapers articles and several books.

1- The state may give (take) *riba* from (to) its subjects in analogy to the permissibility of *riba* giving and taking between a father and his son or between a slave and his master. By the same token *riba* should not apply between the government and government owned corporations and banks.

2- There are cases where the state needs to raise funds for development, emergencies or current budget deficit, and interest payment is needed to attract financial resources.

3- There is also a need for using interest rate in evaluation of government projects and in distribution of funds among enterprises.

4- It is fare to compensate savers for the loss they incur because of inflation.

5- *Shari'ah* allows The government to, at wish, grant individuals any amount of funds and what the government gives to holders of treasury bonds or any other governmental certificates is only a permissible government grant.

To dispose of the first and third points is 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 of taken (principal and any increment) is merely an internal arrangement. Hence, the statement

attributed to Ibn 'Abbas that there is no *riba* between a slave and his master falls in its right place because the master owns the slave and the slave's wealth.[20]

Also the use of a fixed rate of discount in evaluation and comparison is

[20]find source......

permissible as long as no financial transactions which include *riba* are concluded.[21] This may include the use of certain fixed rate as an internal devise in one's own accounting within the same financial and legal entity without effecting any exchange with others.

In the same context, some argue that *riba* does not apply between a father and his son since the father can take (give) any thing from (to) the wealth of his children.[22] Here again, though

disputed, the argument is based on a premise of intermingling of father\son wealth.[23]

Consequently, since no one disputes the fact that individual citizens are independent legal and financial entities, definitely separate of the state 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* also applies 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.*

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[21]Although many Muslim economists argue that the rate of interest in not the best discount rate for project evaluation in a Muslim economy because of many reasons which they elucidate and they suggest alternatives such as an expected social rate of return. See for instance Anas Zarqa,".........." However non disputes the permissibility of using a fixed rate of discount for accounting purposes only.

[22]See for example, 'Abd al Mun'im al Nimr,.......al ahram....

[23]This argument is based on a correct saying that "You and your wealth belong to your father," [reported by ....]. it is interpreted by *fuqaha'* to mean that a father may, incase of need, use his son's wealth and he is not punishable if he uses it without the knowledge of the son, but not mixing their financial entities. [See ....any comment on the saying].

Moreover, the financing modes which are compatible with *Shari'ah* offer adequate alternative for *riba* in the allocation of funds among government enterprises which makes resorting to prohibited devises irrational and unacceptable.

With regard to the second argument, the issue of necessity is discussed at length by jurists and the conditions that it ought to be unequivocally proven that there exists a necessity and that its only solution is committing what is prohibited. Both of these two things are not granted and Islamic modes of financing provide good substitute to *riba* based mobilization of resources for the public use. This is, however, the subject of the present paper.

The issue of compensating savers for losses they incur because of the erosion of their savings by inflation seem to be reasonable argument. 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 whose are hurt by the government action in terms of erosion of their income or wealth, not only to lenders to the government alone.

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 *Fiqh* Academy issued a ruling that charging the debtor to compensate for inflation caused damage to creditor is not compatible with *Shari'ah.*[24]

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. Government grants are not alternative to interest payments.

[24]Decision No. 4 of Session No.5 of the *Fiqh* Academy.

B)- Third party guarantee

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's been argued that if such a guarantee is granted by some other party, stranger to 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.

From the point of view of guarantee risks may be classified in two groups: risks related to the *mudarib* honesty in reporting and revealing factual reality and to his\her sincere and faithful fulfillment of the contractual conditions, etc. and risks related to natural and commercial events and circumstances which affect the fate of investment. The first group of risks is normally guaranteed by the *mudarib* who may provide extra security in the form of a guarantor, or what not.

It is the second group of risks, i.e., risks arising from management inefficiency and\or inability to cope with events, market circumstances, business legal and other conditions, government regulations and interference, natural calamities, etc., which is intended when the issue of third party guarantee is raised.[25] This is because *Shari'ah* considers the *mudarib* faithful (*amin*) in doing his\her best for the prosperity of the

[25]Monzer Kahf," Sanadat al qirad and daman al fariq al thalith" [*mudarabah* bonds and third party guarantee] in Journal of King Abd al 'Aziz University, V. 1, 1989, pp. 43-77.

mudarabah business unless proven otherwise, and a faithful person is not held responsible for the result of his\her actions as long as these results did not come out of neglect or dishonesty.[26]

The *Shari'ah* permissibility of third party guarantee is beyond doubt. It was discussed by the *fatwa* committee of the ministry of *awqaf* of Jordan in 1977 with regard to the then proposed draft of the law for the establishment of the Islamic Bank of Jordan, and the establishment of an independent fund for guaranteeing depositors' funds was approved. It was also discussed once more by an other *fatwa* committee in Jordan with respect to the Act of *sanadat al Muqaradah* [*mudarabah* bonds]. This committee approved government guarantee of *mudarabah* bonds issued by for the construction of *awqaf* properties on the ground that government is a third party with regard to the *awqaf*'s *mudarabah with bonds holders.*

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

> There is nothing to prevent, in *Shari'ah,* 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 to the contract, in terms of legal personality or financial statu, to donate a specific sum, without any counter benefit, to meet losses in a given project, provided that such
>
> commitment is an independent commitment out of the *mudarabah* contract.....[27]

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[26]This issue is well elaborated in all classical works. However one may refer to Hasan Abdallah al Amin, <u>Al Wadai' al Masrafiyyah</u>, ..., and <u>*Al Mudarabah*</u>, IRTI,........

[27]The OIC Islamic *Fiqh* Academy, <u>Resolutions and Recommendations</u>, for the years

Third party guarantee, thus, requires that the guarantor must be independent of the two parties of the *mudarabah* both legally and financially. The guarantor may have real interest in getting the *mudarabah* concluded between its two parties, e.g., to promote certain business which is considered essential for the economy or national security,etc. but the guarantee must be granted free of any reciprocity or contractual, explicit or implicit, benefit to the guarantor.

Third party guarantee may cover losses, i.e. any reduction in invested principal, as lucidly mentioned in the *Fiqh* Academy resolution. But it seems that the argument given applies equally to guaranteeing certain profit too as long as such guarantee is given by an independent third party without any attached conditions or benefits.

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.[28]Still it looks that this argument applies to guaranteeing both profit and principal and it is difficult to distinguish between them from the point of view of the conditions and spirit of the *mudarabah* contract, nor from the point of view of efficiency and performance and if one is permissible the other must also be permissible.

On the other hand, the argument that third party guarantee of the principal and\or any margin of profit violates the nature and spirit of *mudarabah* seems to deserve attention, especially from the point of view of *rabb al mal* who enters into a *mudarabah* upon receiving such guarantees.

1406-1409 h / 1985-1989, resolution No. 5 of its fourth session held in Jeddah, Saudi Arabia, 18-23 / 5 /1408, equivalent to 6-11 / 2 /1988, p. 62.

[28]Monzer Kahf, op. cit., 1989, appendix No. 2.

For *rabb al mal*, seekin (or accepting) a third party guarantee in for his\her *mudarabah* is like giving funds for investment without carrying any risk; while risk, with regard to money invested, is ultimately the only thing which justifies deserving a share in profit. Additionally, considerations of disruption in economic efficiency and in the role of profitability in allocation of investable funds become very important if third party guarantee in applied en mass. Moreover, it may be argued that whoever is going finally shoulder the cost of this guarantee is a net looser, so why doing it?

Yet, there are many circumstances which call for the application of a third party guarantee. First of all, contemporary business involve high levels of risks which justifies the existence and expansion of insurance business all over the world. The fact that many risks are today insured never implies the elimination of profit drive in allocation nor reduced 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 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 military 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 very well economic and 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 fulfill national objectives of equity and justice. Those regions may remain neglected if they are left to the normal play of the market forces, even in an Islamic society.

Fourthly, The experience of the Islamic banks in the late seventies and in the eighties indicated the importance of fund for guaranteeing risks of investment, which were established by contributions of depositors and kept independent from the funds of the *mudarib*. These funds were able to help the Islamic banks in bad years, especially, that Islamic banks are all working in interest load environment and that government come rarely to their rescue.

With the pros and cons of third party guarantee and all the 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 its use should be restricted to cases related to national security at large, and it should not become a predominant practice in the economy in order to contain its negative effects on efficiency.

C)- Inter-generation justice and public debt

Several issues are usually raised with regard to resorting to public debt to finance government expenditures. These issues include: shifting private savings away from private sector's investment, effects of debts on private consumption, their effect on the capital market, final incidence of public debt, etc. These issues are usually discussed in the literature at some details. But since the Islamic system and mentality are normally sensitive to the question of justice, the equity inter-generational effect of public debts will be discussed here.

Two view points are often offered in answering the question; who will bear the burden of public debt, present or future generations? Some writers claims 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 is carrying the load of this utilization regardless of its mode of finance, taxes or debts.[29]

[29]E.K. and J.M. Browning, Public Finance and Price System, 2nd Ed. Macmillan

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

as for the present generation, holders of public debt bonds did not loose 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 an other, 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 left-word shift in supply of loanable funds. 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 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 the 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 add the cultivable acreage, or if they are spent on

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Pub. Co. Inc., New York, 1983, pp. 405-406.

building of human capital, the increment in income resulting from additional material and human capital also lessens the burden of debts or may overweigh 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: firstly, payment for servicing the debts will put a pressure on export and other sources of foreign exchange; secondly, 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 thirdly, the burden of foreign debt will heavier if debts were not used to increase the production and export capacity of the economy.

D)- Conditions of public borrowing in Islam

Resorting to the private sector to cover a deficit in public funds is unquestionably permissible is *Shari'ah.* However, Muslim scholars debate whether the government may impose taxes on the public or borrow from them, and 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.[30] Hence I shall concentrate here on the conditions of public borrowing.

[30] For details on this point,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 tome,] 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, Z. Ahmad, M. Iqbal and M.F. Khan, ed. ICRIE, Jeddah 1983; "Toward a theory of Taxation in Islam," paper presented at the Seminar of Fiscal Policy and planning development, held by IIIE of the International Islamic University , Islamabad 1986; and " Financing Public sector in Islamic perspective," presented at third international conference on Islamic economic held by AMSS of the US and Canada, Washington D.C. Dec. 1990.

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 in his book Al Ahkam al Sultaniyyah,[31] and al Juwini in his book Al Ghyathi[32] discussed public borrowing and taxation. Also the question id addressed by several others including al Shatibi, al nawawi, al Ghazali, 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, and these resources are sufficient under normal circumstances, and that going beyond these resources is always an exception. Al Juwaini for instance says "it is not wright 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 a magnificent

[31]Abu al Hasan Ali bin Muhammad al Mawardi (circa 450 h.), Al Ahkam al Sultaniyyah, Third ed. Mustafa al Babi al Halabi, Cairo 1973.

[32]Imam al Haramain al Juwaini (circa 478 h.), al Ghiyathi, published by Directorate of Religious Affairs in Qatar, 1400 h.

danger," (p. 287)

2- Some scholars, e.g., many Shafiites argue that the government may not keep any surplus since the surplus in *Bait al Mal* [in this regard, budget] is an exclusive right of present day people and it should be given away to them in terms of direct distribution as what 'umar did or in terms of governmental projects such as building of dams, mosques and houses of refuge 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 as a tax or as loans,(al Mawardi, p. 215 and al Juwaini, p. 249). Apparently, this

is a reference of budget balancing on an annual basis. But it is also a license to impose taxes and\or borrow from the public.

However though himself a Shafiite, 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 may arise, (a; 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 otherwise could be saved to be spent on the army, (p. 251).

3- While al Mawardi seems to suggest that borrowing comes before taxation in case there is a need for mobilizing funds for the government (p. 215), Al Juwaini appears to prefer taxation though he 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 and it is therefore a financial obligation on individuals which is, like physical obligation 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 paid to the government need not be on loan basis since this obligation is based on ground of *fard al kifayah* [a personal obligation on all unless some people take charge 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 refunding 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 a taking funds from the public and returning them after a while why taking then without returning at all? 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).

Al Juwaini does not take a firm position against starting with 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).

Finally, 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 taxation 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 debts, one must distinguish between loans taken from rich citizens in a forceful manner and voluntary public borrowing. It appears from their mixing the discussion of imposing taxes with of borrowing that they have in mind a forced kind of public borrowing. However, permissibility of voluntary public borrowing by means of certain instruments offered to the public may be implicitly derived from their elaborations and reasoning.

5. All Muslim scholars and jurists seem to hold that public borrowing must always be related to the needs of the public sector. However, the kinds of needs which make it permissible to borrow may vary.

Al Mawardi (p. 214-215) for instance differentiates between three kinds of public expenditures as follows: A) expenditures due against goods and services contracted or bought by the government, the example he gives of this kind is salaries of soldiers and value 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 farther.

Al Mawardi believes that coercive public borrowing may be resorted to for the satisfaction of kind A of needs provided the government anticipate definite revenues sufficient to pay for the debt along with future regular expenses. Kind C of needs do not justify borrowing not imposing taxes. As for kind B, the choice between taxes and forced loans depends on whether the government anticipate sufficient surplus resources for debt payment from its regular future revenues (p. 215).

On the other hand, reading through <u>al ghiyathi</u>, it seems to also distinguish between three types of public needs which are: a) military and other needs for survival of the *Ummah* such as actual defence of the Muslim land and people in case of 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 preve%' ression 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'd 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, kind b, he suggest 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 excess funds in the treasury, i.e., they should not be financed by taxes or forced borrowing.

The above discussion on public needs for which the government is allowed to borrow may be summarized in the following points:

a- Defence requirement in case of aggression or expected aggression on the Islamic state,

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'd al kifayah*] such as burying the deceased, maintaining skills and scientific knowledge essential for 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 elaborate on the conditions of public choice in deciding on the need for financing certain government projects as well as on the type of such financing, i.e., 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.[33] Rif'at al Awadi considers this condition one of the essential principles of taxation in Islam[34]

7- Pushing this debate further, one may like to argue that if it is permissible for a duly elected *shura* council to impose taxes and\or obligatory loans on the public under certain circumstance, it must also be permissible to the *shura* council to decide on financing projects of benefit to the public, though they are not necessary, by means of voluntary loans obtained from the public on the basis of certain incentives.[35]

Al Juwaini, however, warns against extending the permissibility of imposing

[33] Yusuf al Qaradawi, Fiqh al Zakah, Mu'assassat al Risalah, Amman, Jordan 1972, p. 1085-1088.

[34] Rif'at al Awadi, "Al Daribah fi al Nizam al Islami" [Taxation in Islamic S(+30'5 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.

[35] M. N. Siddiqi, ...expenditure...

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 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[36] if the condition of necessity is lacking, since offering debts certificates to the public leaves it to the conviction of potential buyers to accept financing projects for which the financing is sought. This is a form of approval of 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 projects. 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- There are other conditions of public borrowing which may not require much of elaboration:

i)- Lack or inability to mobilize regular public revenues which are stipulated in *Shari'ah*.

ii)- Public loans should avoid *riba* and any other form of transaction

[36]Or alternative instruments as will be discussed in section two of this paper.

prohibited in *Shari'ah*.

iii)- They must not endanger the internal and external security of the *ummah*.

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.

SECTION TWO
SUGGESTED INSTRUMENTS AND ALTERNATIVES OF PUBLIC DEBT

Because *rabb al mal* in profit and loss sharing and output sharing agreements is not a creditor to the working partner,[37] we may not talk about public debt whenever these principles of financing are provoked. Hence, Islamic alternatives to public debt instruments are those instruments of mobilization of funds for use by the public sector which are derived from the Islamic principles of finance as discussed in section one. On the other hand, since *Shari'ah* does not prohibit borrowing by the public sector, Instruments and modes of public debts should also be explicated. Therefore, this section shall cover two titles, namely, public sector financing instruments and public debt instruments and modes.

2.1- Financing instruments available to public sector in Islamic economy

By public financing instruments I mean those certificates issued with regard to

[37] In fact as we've seen earlier in this paper, return to financier in sale based modes of financing is based on ownership of goods by the financier. Therefore, although the financier-cum-seller becomes a creditor and the beneficiary of the financing becomes debtor, financing legalities require that financier begins the operation as an owner selling goods and services he\she owns. This situation is undoubtfully inapplicable when there are numerous offerers of funds each of them has a small amount as in the case of treasury bonds.

forms of financing which, within the limits of *Shari'ah,* allow the financier certain return and are at the same time negotiable, i.e., can be traded at a secondary market. On the other hand sub-section 2.2 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. But from *Shari'ah* point of view a certificate must represent (i.e., be a title of ownership of)[38] physical commodities or property in order to be sold at a price other than its face (purchase) price. Consequently, whether sale based or sharing based, all instruments discussed in this sub-section represent real or physical income generating properties.

Sale based financing instruments

***Ijarah* instruments**

There is only one form of negotiable instruments of financing based on sale principle: *ijarah* [leasing] instruments[39]. The way they work is as follows:

[38]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 possessed 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 instrument or a certificate, in itself is just a piece of paper, what matters in all transactions is the commodity, property and\or debt it represents.

[39]It will be shown later in this sub-section and in sub-section 2.2 that all other sale based certificates either represent debts and are therefore not negotiable, or sharing instruments in corporations which that provide sale based financing.

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 and certificate holders receive their share of the rent.

As owners, shareholders 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. But arrangement to take charge of these responsibilities may easily 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 evaluation of the stream of income involved with each instrument.

A spectrum of variety of *ijarah* certificates may be suggested. 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 looses its value at regular intervals. This kind of instruments is suitable for investments where fast changes in technology is expected such as computer equipment, etc.; 3)- declining *ijarah* instruments, where the lessee desires to own the property after a period of time and assign certain installments of the value of the property to be paid to the lessor along with the rent.

Additionally, *ijarah* instruments may be used for income producing fixed assets as well as assets which do not produce income. A commercial airport is an example of the former while a military airport is an example of the latter. They can also be used to bridge the gap in current budget and in developmental budget as well. They can be used for construction of infrastructure, production equipment or even for weaponry (but not ammunition that are consumable), as long as the assets involved have long live and can be identified for the 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. Even assets of variant life spans may be combined together, thus providing this instrument with the ability of having fixed or declining return.

Moreover, *ijarah* instruments may be issued against fixed asset rented by the government per se 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.

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

It was also mentioned that the difference between them is a matter of combination of management with ownership in the first and separation of management from ownership in the second. Consequently, 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 that they do not have any prohibited conditions, keeping in mind that many forms of preferred or privileged stocks may not be permissible in *Shari'ah* because they involve guaranteeing minimum return or lesser capital risks than common stocks. It should be noticed that *sharikah* mode of financing does not offer much of freedom for the public sector as it gives equal shareholders equal share of managing right.

However, *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 performed, entrusted to good management while keeping certain managerial control. Shares would be negotiable and the government may increase (decrease) its stake in the corporation through the secondary market. on the other hand, the government may preserve a majority right by holding 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.

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 inability of most Islamic banks to exercise this mode of financing on a large scale 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 the trust in management, religious zeal among depositors more than pragmatic minded businessmen, etc.[40]

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[40]See reference in studies of saudi business and in Pakistan....................
..........see fahim's paper on PLS and firms behavior.....
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Consequently, *mudarabah* has a good chance to succeed in mobilizing resources for the 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 for 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* may be running.

Mudarabah instruments may be issued for any kind of investment or trade which is permissible in *Shari'ah*.[41] They may be issued for short, medium or long term investment. They may be issued by the government itself, a local branch of it, 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 user of funds themselves so you have *mudarabah* instruments of a 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

[41]There is an argument that it only apply to trade or commerce, but the repeated *fatawa* of the several *fiqhi* boards of different Islamic banks and most contemporary *fiqhi* opinions given by scholars specialized in Islamic business law go along with what I mentioned in the text.

establish

specialized government institutions which issue *mudarabah* instruments to shareholders and distribute mobilized funds to government income generating bodies.

Moreover, specialized institutions may be established to raise funds on *mudarabah* basis and use them to supply goods for deferred payment to the government on *murabahah* and\or *ijarah* basis; or to combine goods and services together and provide financing to the government on the basis of *istisna'*[42].

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 be profit making themselves similar to current Islamic banks. But it should be noticed that there may be certain limitation on the exchange of *mudarabah* instruments which are exclusively used to finance *murabahah* at market prices on the ground that these instruments may represent assets consisting mostly of debts and cash since according to rules of debts may only be transferred at their face value.

Furthermore, *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 in which the prospectus allocates certain proportion of the *mudarib*'s share in profit to buy up the shares of *rabb al mal*.

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

[42]*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 some time after delivery. The nature of the contract, however, gives room for financing to be given by the orderer to the producer.

open pool as in open capital companies and the pools of investment deposits in all Islamic banks.[43]

Transfer of ownership of these instruments may be made very easy by records in the issuing institutions, endorsement on the certificates, or even by hand over of certificates if they were to bearers.[44]

lastly, *mudarabah* instruments may be backed by a guarantee from the government if they are issued by corporations and\or institutions having legal 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 one.

Accordingly, a very large variety of *mudarabah* instruments may be issued by government and its branches and circulated in an Islamic financial market. These instruments 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 *mudarib* they can also serve non income generating government heads of expenditures.

[43]Bahrain introduced a system permitting the establishment of open end capital companies part of its capital may take the form of non voting shares based on the *mudarabah* principle. See Sami Homud,"*al Adawat al Maliyyah al Islamiyyah"* [Islamic financial instruments], paper presented at the seminar on the financial market from Islamic point of view organized jointly by the OIC *Fiqh* Academy and IRTI, Rabat Nov. 1989.

[44]A workshop organized in Bahrain, Nov. 25-28, 1991, by The OIC *fiqh* Academy, IRTI and Islamic Bank of Bahrain recommended that it is permissible in *Shari'ah* to issue bearer shares.

Output sharing instruments

This principle permits sharing the output provided no evaluation of capital is needed, because whenever evaluation of capital is needed, distribution of output may face difficulties from *Shari'ah* point of view since as seen in section one profit can only exists and become subject to distribution after capital is restored to its original amount.

However, one form of output sharing certificates may be suggested as follows:

> The government sells say of an existing income earning fixed asset such as a toll bridge or a toll highway to certificates holders. The proceeds of sale are needed for another governmental project whatever it is and the purchasers have nothing to do with this matter. certificates holders may assign the 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).

Obviously, similar bonds may be offered for a new project with or without a gestation period for beginning to give return. But in new projects, there will be two forms of relationships, at two consecutive stages, between say the bridge authority and certificates holders. In stage one, the authority shall be an agent of certificates holders in constructing the bridge. It may be paid certain fees of may act voluntarily until the construction is done. 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 certificates 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 bonds at a price other than the purchase price is only permissible after at least majority of property becomes physical commodities and assets.[45]

It must be noted that output sharing certificates, like common stocks, do not 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.

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 is made or not. In the latter case, periodically distributed output represents both the principal and the return. This approach may be suitable for projects to exploit 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 of time.

Finally, before closing this sub-section it may be noted that government may offer a third party guarantee to holders of any of the instruments based on ownership. This guarantee may unquestionably cover their principal investment and it may be extended to include certain profit margin. But as mentioned earlier such a guarantee,though an exception, requires strong justification from the point of view of justification of use of public fund to pay for it, possible distortions it may bring about in

[45]OIC *Fiqh* Academy,Rulings and Recommendations, Ruling No. 5 in Session No. 4, Jeddah 1408, pp. 66-67.

the capital market and its negative effect on efficiency. This is of course in addition to the condition of complete independence of the guarantor with regard to legal and financial identity.

2.2- Public debt modes and certificates

All instruments mentioned in sub-section one 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.

On the other hand, ownership based instruments may not fulfill all the financing needs of the public sector and the government may prefer resorting to debt based financing in general and to borrowing in specific under certain circumstances. For instance, seasonal needs to close 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 debts a severe blow to the degree of liquidity 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 at least either price or commodity must be present if the other is delayed.

Consequently, whatever debt based modes of financing the public sector may have available shall not be, practically, negotiable. This eliminates the possibility of a secondary

market with all its effect on the first market itself and makes it necessary that an alternative approach for liquidation must be sought. This alternative is redemption.

redemption is 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*,[46] and there are certain *Shari'ah* conditions for its applications such as it should not be part of original contract which initiates the debt.[47]

Loans may be acquired from the public voluntarily or by use of legal power of the state. With regard to lenders, they may be internal or external.

A- Voluntary public debts[48]

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[46]*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 in the amount of debt and get it before maturity" which he said addressing the jews in Khaybar 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 also 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.

[47]It must be noted that *wadi'ah* is approved by some 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 ...... and ....papers at fiqh academy.......

[48]Some basic ideas of this sub-section derive from M. Fahim Khan and Monzer Kahf, "Financing government deficit through borrowing from the private sector,"

While forced borrowing is obtained by coercion, voluntary public debts must have certain built in attractions in order to appeal for the self interest drive of individuals. It must be noticed, however, that *Shari'ah* prohibits attaching any fringe benefits to a loan and considers any such benefits an expression of *riba* whether it takes the name of *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. Furthermore, *riba* based fringe benefits of lending are material benefits which may or may not be calculated at the time of lending or may not even subject to quantification. For instance, they include a tax reduction, relaxation of deadline conditions of tax payment, providing facilities in sale of debt holder products, etc.

Consequently, attractions for public debt must be carefully formulated in order to be tailored within the limits of *Shari'ah.* Hence, they may take the form of appealing to the sense of patriotism and piety. Alternatively they may take the form of material incentives which may be in terms of mark up on goods delivered to the government for deferred payment, mark down on future goods and services sold by the government for immediate payment, or protection against inflation.

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. Hence, we have three kinds of sale based financing modes which can be used by the public sector: *murabahah* based financing, *salam* and *istisna'* financing and *ijarah* financing. The following few paragraphs will briefly describe these three modes of public debt.

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presented at the sixth annual meeting of experts of Islamic banks held in Bahrain, May 1990.

***Murabahah* based public debt**

Public debt creation may take the form of simple *murabahah* in which the government delivers IOY's to suppliers of goods purchased. By the same token *istisna'* form of sale may be used for construction with payment taking the form of IOY'a due at a point of time subsequent to the date of delivery of complete construction. Since these IOY's are transferable at the face price, they do not attract a secondary market transaction. a provision may be made that they can be used for tax payment, etc. IOY's, which may be of different denominations, may be redeemed by the government before maturity and at the time of redemption the government may seek a discount (*wadi'ah*) for early payment.

Another form of *murabahah* public debt may quote the *murabahah* for the purchase orderer and it may work as follows:

> The government assign 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 purchaser (the government) for the amount of the contract, the agent will distribute these bonds to the contributors of funds in proportion of their principal

Murabahah bonds are not transferable to other owners except at the face value of the debt. 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 the stream of supply of goods to the government.

***Salam* and *istisna'* based public debt**

Salam is the kind of sale where the price is paid at the time of contract and delivery is postponed to a future clearly determined date. The goods object of the contract should be standardized and indisputably identifiable. Indebtedness in *Salam* is in terms of physical goods and not money. It offers a mode of financing for the public sector if the government is able to provide future goods for which funds are obtained presently. For example, government owned enterprises which produce consumer goods or farms 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 any thing one purchases before physical delivery. But they can redeemed before maturity by canceling the contract and if the parties agree and the purchaser may get his\her money back without any increase or decrease.

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

In *istisna'* based financing of the public sector, the government sells say future housing units with specifications put clearly forward in the prospectus with determined delivery date, etc., at the price of say 100 *dinar* for each one thousandth of the unit. coupons in each issue will have unified price for one thousandth of the housing unit, but a new issue of coupons may offer a different price. Whoever buys one thousand coupons of a given issue or their equivalent 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, while the government acquires funds at present its indebtedness is in terms of real goods. On the other hand, unlike ownership based financing, the use of proceeds of this form financing is not tied or restricted to the goods and construction object of the sale.

Moreover, *salam* certificates and *istisna'* coupons may be issued by any federal, regional or local bodies 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 their pricing at the present level provides an incentive in the form of protection against inflation.

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 draw on (*istijrar*) agreement combined with some of the features of *salam.* 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 the warrant holders. Warrants are not negotiable and theirs proceeds may be used at the debtor's own discretion.

***Ijarah* based public debt**

These 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 it may be provided only after a short span of time such as garbage collection during the 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 or any local branch as long as it can provide the contracted service. Bonds may be redeemed before maturity for the paid price and 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.

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 a lot higher than inflation abroad) and bonds issued on the appeal to patriotic 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 loose value in terms of foreign exchange. The incentive they provide is the guarantee of payment in the foreign currency in which bonds are issued and it is presumed that this foreign currency is more stable. Thus, these bonds award protection against devaluation of domestic currency.

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 prohibit any return or benefit attached to the transaction. However, they are not transferrable unless at face price. Therefore, there is no incentive for their negotiability. They will demanded by

individuals who have no investment opportunities of the foreign currency they hold which
arises especially when there are restrictions on foreign currencies. They do, however, grant sensible protection against domestic inflation.

Three other versions of this kind of bonds are worth mention although they are prone to criticism from *Shari'ah* point of view. Firstly, foreign currency bonds may be sold for domestic currency at the time of issuance and paid in foreign currency when due, secondly, delivery of loan may be at the nominal foreign currency and its payment at domestic currency and thirdly it may be effected in domestic currency at both ends.

Although such arrangements may be done at the current rate of exchange in each step, an objection may arise that a loan should be written in the same denomination used actually in its delivery and is payable back in terms of the very same denomination, otherwise it may hide a *riba* based lending and becomes therefore prohibited.

Public debt on patriotic ground

It may be possible sometimes to find a reasonable response to the appeal for lending the government by invoking the sentiments 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 binding 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 they are sought only on lending basis?

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 funds, forced loans may be sorted as: loans from individuals and non banking corporations, loans from commercial banks and loans from the central bank. Since the literature is full of deliberations about procedures, forms,and pros and cons of these three kinds of public loans, the present paper will avoid repetition and will concentrate on two points which have certain peculiarities and are specifically discussed in Islamic economics. These points are: 1)- The implication of the concept of social justice; 2)- Demand deposits and seignorage as a basis for justifying imposing loans.

Implications of social justice on involuntary public borrowing

It has been argued earlier in this paper that loans, when permissible, should only be taken from the rich and not from the poor[49]. Therefore, any kind of coercive public borrowing, whether taken from individuals and corporations, commercial banks or the central bank, must be carefully evaluated form the point of view of social justice on the basis of whether it affects individuals in proportion to their richness or not, keeping in mind that richness in Islam is measured in both wealth and income together not only by a stock or flow measurement.

Consequently, if borrowing from the central bank creates an inflationary pressure adverse to the poor or which influences the equal 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.

[49]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 prevent such misdeed. See Al Ghiyathi, op. cit., p. ....

Moreover, if the government decides to impose forced loans on individuals, such loans should not be implemented by means of say deductions from government employees because they make up a large mass from whom collection is easy and almost cost free. Rather such loans should be obtained from individuals in a progressive manner according to their wealth and income whereby, unless for important and overwhelmingly acceptable reasons, all the equal must be treated equally.

Demand deposits, seignorage and forced 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 the partial reserves-cum-multiplier affairs. This gives rise to the seignorage rights regarding this kind of created credit,[50] and both of 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.

Several ideas are put forward by Muslim economists in order to bring justice in this regard.[51] some suggests that commercial banks in the Islamic system should be asked to maintain 100% reserves of all their demand deposits;[52] Others recommend

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

[51]The consideration of justice in 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.

[52]See for instance, Mabid al Jarihi.......... and Monzer Kahf, The Islamic Economy, The MSA of the Us and Canada, Indianapolis, Indiana USA, 1978.

that banks may be permitted to harvest this benefit but they should be taxed accordingly;[53] some others yet suggests that derivative deposits should be used for a.) broadening the base of borrowers from commercial banks to include fulfilling some of the welfare objectives of the Islamic state in supporting the poor and needy and promoting their productive capacity; and b.) whatever is left of created credit should be considered similar to *mudarabah* deposits in the hands of commercial banks the return of which is to be collected by the government and spent on welfare programs for the poor and needy.[54]

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 the money supply by the banking system.

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 and therefore, the same principles of financing which guide individual behavior from Islamic point of view also guide the behavior of the public sector. That is

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[53]Munawar Iqbal, "Fiscal Reform in Muslim Countries with Special Reference to Pakistan" Paper presented at IRTI 1991.

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

to say that all branches of government and all economic and services public enterprises are required in *Shari'ah* to observe the same principles of financing which are applicable to the private sector.

The paper then proceeded to discussing the conditions of public borrowing after arguing that consideration of inter-generational justice are crucial to the issue of public borrowing. It rationalized that according to *Shari'ah* the essential conditions for involuntary public borrowing are establishment of a real need for it along with approval of people or their *shura* representatives. For voluntary borrowing as well as for non loan based financing incentives are needed to induce funds suppliers to make them available to the public sector.

In section two, I examined the different kinds of alternatives of borrowing which may be available to the government as Islamically permissible instruments and modes of finance. We have firstly financing instruments which preserve ownership in the hands of financier. These include the *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.

Secondly, we have financing instruments which are based on creditor\ debtor kind of relationship. These include *murabahah* based public debt on one hand and *salam, istisna'* and *ijarah* based public debt. The paper noted that while the *murabahah* creates a cash kind of public debt, the other three tools result in an in-kind type of public debt.

Without going in the details mentioned in the text of the paper about the characteristics of each suggested instrument and\or mode of alternatives-cum-instruments and modes of public debt, two important points are worth be used as concluding remarks. these are: First, the modes and instruments which may be utilized for internally financing the public sector can also be used for external financing.

Tariqullah Khan and myself, in a different paper discussed the principles of external financing
for the public sector.It may be worthwhile to add here that from the point of view of external security of the Muslim country ani its economy a distinction may have to be done on the basis of sources of external borrowing which brings into the discussion the issue of Muslim - non Muslim economic relationships. This is an area which may be suggested for future studies.

Second, a thorough *fiqhi* investigation 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 the area which itself may bring new ideas and result in developing other modes and instruments.

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