NON-TAX PRIVATE SECTOR FINANCING OF GOVERNMENT IN ISLAM

INTRODUCTION

Government borrowing is as ancient practice. There are many circumstances that create a gap in the public finance of any state and requires quick borrowing. Besides public borrowing may be an easy solution which is more popular than raising taxes or cutting down on government programs.

The present paper looks at public borrowing from a special angle. Accepting for a moment, the postulate many Muslim writers make that the religion of Islam is a total way of life, and that it has its own economic system, the paper investigates the methods and means the Islamic system provides for bridging the budget gap.

In Section One, I will study the Islamic approach to the provision of public goods. Section Two will give a brief description of the Islamic principles of financing. Section Three will discuss the Instrument of financing the Government' budget from the private sector without resorting to taxes. Finally, Section Four summarizes the results of the paper.

I - PROVISION OF PUBLIC GOODS IN THE ISLAMIC ECONOMIC SYSTEM

Government borrowing have several reasons. In the past, Governments used to borrow for meeting certain necessitates such as mars of natural catastrophes. The contemporary phenomenon of public borrowing in many Muslim countries is not always caused by conditions of necessity. M.U. Chapra cites four major areas of excessive public spending that are behind resorting to borrowing in most Muslim countries: high defense expenditures, price subsidies, inefficient and large public sector and corruption and wasteful spending.[1] One may even argue that if these malaises are cured, there may still be needs for public borrowing in an Islamic or non-Islamic economy.

Social Goods -- Islamic Perspective.

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

Additionally, political elements interfere in deciding whether goods are going to be provided by the public sector. Certain rival and excludable goods may be provided by the public sector by virtue of political choice. The most obvious example is public concerts and education[2]. A close look into the public finance of

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.[1] Chapra, M. Umer ,Islam and the Economic Challenge ,Islamic Foundation, Leicester, UK 1992, pp. 290-294.

[2] Education may be considered a mixed good because the benefit of adding one educated

the early Islamic state, especially during the life of the Prophet Mohammad when revenues were tight, may indicate that the main services provided by his government were: defense, judiciary and running the administrative affairs of the state. Therefore, public borrowing made by the Prophet in cash or in kind may be assumed to be for payment of these kinds of services. On the other hand drinking water, Mosque construction, feeding the poor, freeing slaves and some defense and foreign guests expenses were provided by philanthropic action in response to calls by the head of state. When public revenues became abundant during the reign of the Prophet's Second Successor, Umar, the government not only ceased asking for voluntary contributions, but provided rival goods, such as, food stuff to private consumers.

Furthermore, the historical experience of Muslim society indicates that the role of philanthropy in providing public goods might have been instrumental. For instance, until the introduction of Western system of education in the Muslim countries, education had always been provided free to its users by the Islamic Awqaf. In fact, whenever certain rulers wanted to support education, the help itself would be channelled through Awqaf. Good examples are the Ayyubites and Mamluks Awqaf on schools in Palestine[3].

Alternatives to Public Provision of Social Goods:

It can be argued that for each feasible level of public revenue, there is a level of provision of public goods which does not cause any budget deficit. Accordingly, stretching the provision of social goods beyond government available resources creates a budget deficit. Consequently, providing social goods by agents which do not require the use of public funds lessens the financial burden of the budget and may therefore be considered alternative of public borrowing[4]. Non-government

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person to one's colleagues may be impossible to internalize. One may also argue that a conversation with an educated person may be made a rival good and all its cost may be internalized through a 900 charge call number.

[3] Islamic Research Center for History, Culture and Arts (IRCICA ,(The Muslim Pious Foundations (Awqaf) and Real Estates in Palestine, Istanbul 1982.

[4] Islam does not allow the provision of certain social goods by private or voluntary agents. Law enforcement is an example. Additionally, certain social goods cannot be made subject to market conditions on moral grounds, such as, giving religious opinions or visiting a mosque.

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

Voluntary provision of public goods:

Provision of public goods by voluntary agents is as old as human societies. In the Muslim society, this goes back to the time of the Prophet Muhammad. Upon his arrival in Madinah, a mosque was built by voluntary labor and material. Defense activities started on a voluntary basis. The faithful used to volunteer both labor and weapons. Lights in the mosque and food to the poor were also provided on voluntary basis. Drinking water used to be sold by owner of a well and the Prophet called on Muslims to buy the well and give water free. The Institution of Philanthropic *waqf* (non-profit trust) was established. The early properties of philanthropic *waqf* consist of agricultural land, wells, etc. These were used to provide support for the poor and free drinking water for inhabitants of Madinah[5]. As time went by, *waqf* Institution became the main provider of education, health care and mosques construction and maintenance and a major contributor to building and maintaining border defense posts and providing financial aid to the poor.

Voluntary organizations have achievement incentives because of the bondage that links their workers to the organization's objectives. At the same time, they have accessibility to free (voluntary) labor while they avoid the bureaucratic structure of government[6]. The provision of public goods by non-profit organizations has now-a-days a wide spread application, especially in the area of education, health care and water supply[7]. Nevertheless, non-profit organization may become victims of corruption and exploitative management.

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[5] Hasan Abdallah al Amin, ed ,*Idarat wa Tathmir Mumtalakat al Awqaf*,(Management and Development of Waqf Properties), IRTI, Jeddah 1989.

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

[7] Gabriel Roth ,The Private Provision of Public Services, EDI of World Bank, Oxford University Press, 1987, pp. 11-12.

Profit-Motivated Provision of Public Goods

On the other hand, whenever market mechanism can be activated, efficiency usually increases. Therefore, if the concept of smaller government leads to inducing the private sector to provide goods that should otherwise, be provided by debt - financed public sector, efficiency and consequently social welfare may increase. Education, health care, water supply, communication, electricity, garbage collection, etc. are examples of goods where almost all cost of production can be internalized[8]. These traditional public goods can now be produced and provided by the private sector.

From Islamic point of view, the following two important points deserve attention: First, the scope of private provision of public goods is flexible and it depends on two factors: (1) Islam prevents a small number of goods from being produced on market basis. These include spaces in a place of worship, exercise of political rights and implementation of law and order. Beyond these, most goods and services may be privatized. For instance, you may go to Court to have a judgement on a dispute or you may agree with the other party to buy the services of a private judge[9]. (2) Sources of public revenues affect their uses. This means that if the government has revenues characterized with flexible usage such as return from public property, it can allocate them to any public goods. On the other hand, if the government does not have such use-flexible revenues and it has to tax citizens for revenues, then necessary public goods, such as public administration, law enforcement and defense must be provided. Second, like other religions, Islam provides individuals with moral and spiritual incentives to undertake social work and produce public goods on voluntary basis. In Islam, this is further supported by

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

[9] The ***Qur'an*** refers to private judges in family disputes (4:35). These judges may be paid for their services.

the concept of individual responsibility of social duties (*fard al kifayah*). Additionally, Islam permits the government to provide government guarantee as a third party for encouraging investors in socially desired sectors.

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

The Islamic Shari'ah does not allow the partner/entrepreneur to guarantee the principal or any profit to the partner/ financier in all forms of partnership. However, it has been argued that if such a guarantee is granted by a third party, it may become permissible. Third-party guarantee is therefore a pledge given by a person, who is not part of the partnership, to the financier assuring him/her that if the investment 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.[10] The government may offer this guarantee to private investors in order to encourage them to offer funds for projects that would otherwise be financed from public sources. Consequently, this guarantee saves on the use of public funds and may be treated as an alternative to budget deficit. The use of tax-payers' money to provide this guarantee has its pros and cons the discussion of which is outside the limits of this paper. However, the reality remains that governments have done it and will continue doing it for one reason or another.

[10] Islam's permissibility of third-party guarantee is beyond doubt. It was approved by the Religious Committee of the Ministry of Religious Affairs in Jordan, 1977. A published opinion of the Islamic *Fiqh* Academy of the Organization of Islamic Conference states :

> "There is nothing in *Shari'ah*, which prevents the inclusion of a statement in the prospectus of the *Mudarabah* certificates about a promise made by a third party, totally unrelated to the two parties of the contract, in terms of legal personality or financial status, to donate a specific sum, without any counter benefit, to meet losses in a given project, provided that such commitment is independent of the partnership contract". (The OIC Islamic *Fiqh* Academy, Resolutions and Recommendations, for the years 1406H-1409H/1985-1989, Resolution No.5 of its fourth session held in Jeddah, Saudi Arabia, 18-23/5/1408H equivalent to 06-11/2/1988, p. 62.)

II - PRINCIPLES OF FINANCING IN ISLAM

Public Borrowing

During the time of the Prophet Muhammad in Madinah, incidents of public borrowing happened a few times![11]. There are also known cases of borrowing by Muslim governments during the Abbasites[12] and the Ottomans, and obviously by modern Muslim states since the middle of the nineteenth century. Ottoman's and Egypt's borrowing in the nineteenth century were mainly external, from foreign governments and bankers. Early borrowing, i.e. the Prophet's and the Abbasites' did not result in issuing any debt instruments. Although it may be understandable that Abbasite Ministers of Treasury who made the borrowing must have issued some "IOU's" to lenders. Historical sources mention that transactions of the government treasury (*bait al mal)*, at that time, were recorded and documented. However, there are no reports available on negotiability of such "IOUs" if they ever existed. Additionally public borrowing was known to the classical writers of Islamic Jurisprudence (*fiqh)*. For instance, Al Mawardi (Circa 1058 CE, P 215) talked about resorting to borrowing for payments of dues on the treasury and argued that successive rulers are bound to pay such loans back.

The Prophet' borrowing was all interest-free. Later on, interest may have been the basis for at least some of the Abbasites' public loans.[13]

The Qur'an, Islamic holy book, prohibits interest *(riba)* in terms stronger than any terms used in any other prohibition. The alternative mentioned in the *Qur'an* for *riba*-based financing is sale (Verse II: 275),[14]. The traditions of the

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[11] Τηε Προπηετ Μυηαμμαδ διεδ ιν 632 Χ.Ε. Ηε μιγρατεδ το Μαδιναη ιν Ωεστερν Αραβιαν Πενι νσυλα ανδ εσταβλισηεδ τηε φιρστ Ισλαμιχ στατε ιν 622 Χ.Ε. Μ.Ν. Σιδδιθι χιτεσ σεϖεν χασεσ οφ β ορροωινγ βψ τηε Προπηετ. Ιν τωο χασεσ, 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 νεεδ σ φυλφιλλμεντ φορ χερταιν χιτιζενσ. Μ.Ν. Σιδδιθι, ∀Πυβλιχ βορροωινγ ιν εαρλψ Ισλαμιχ ηιστορ ψ.∀ παπερ πρεσεντεδ ατ τηε τηιρδ Ιντερνατιοναλ Χονφερενχε ον ισλαμιχ Εχονομιχσ, Κυαλα Λυμ πυρ, ϑαν 29–31 1991 φορτηχομινγ ιν τηε χονφερενχε προχεεδινγσ, ππ. 4–14.

[12] <u>Ιβιδ.,</u> ππ. 19–23

[13] Ιβιδ.

[14] ςερσεσ ΙΙ: 276 ανδ 280 αλσο μεντιον χηαριτψ ανδ γραντινγ τιμε το τηε δεβτορ φρεε οφ χηαργε , βυτ σινχε βοτη οφ τηεσε αλτερνατιϖεσ αρε χηαριταβλε ιν νατυρε τηεψ δο νοτ μακε αλτερνατιϖ

Prophet Mohammad confirm this and add the principles of Profit and loss sharing and output sharing as additional alternatives.

Sale -base Financing

Financing is done when payment is deferred. The sale principle of financing lies in the provision of physical factors of production, intermediate inputs or consumption goods and services against deferred payment. The object of financing may be goods or services, which may be used for production or consumption. 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.[15] Financing may take the form of sale or lease with few differences in their respective legal conditions. Sale, as a financing mode, includes deferred payment sale, order purchase with deferred payment *(istisna`)* and deferred delivery sale *(salam)*. Deferred payment sale is usually practiced as sale at mark up to the purchase orderer (*murabahah)*. Leasing financing is practiced in the form of leasing to the purchase ordered too.

Unlike interest-based financing, *murabahah* and leasing do not create a situation in which the return to financier is known in advance,[16] because the seller-cum financier (or lessor-cum-financier) carries certain risks involved in purchasing, owning and selling or leasing the object of sale or lease.[17] Moreover, in the case of lease the object of the contract remains in the financier's ownership for the duration of the contract. Like interest-based financing sale financing creates debtor/ creditor

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ε το ιντερεστ–βασεδ φινανχινγ ον τηε γρουνδ τηατ τηε φινανχιερ δοεσ νοτ εξπεχτ ματεριαλ ρετυρ ν ουτ οφ τηεμ.

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Μονζερ Καηφ ανδ Ταριθυλλαη Κηαν, Πρινχιπλεσ οφ Ισλαμιχ Φινανχινγ: Α Συρϖεψ, Ισλ αμιχ Ρεσεαρχη ανδ Τραινινγ Ινστιτυτε (IPTI) οφ τηε Ισλαμιχ Δεϖελοπμεντ Βανκ, ϑεδδαη, 1993.

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Μ. Φαηιμ Κηαν, Χομπαρατιϖε Εχονομιχσ οφ σομε Ισλαμιχ Φινανχινγ Τεχηνιθυεσ, IPTI, 1992, ππ. 6–7.

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Τηεσε ρισκσ αρε υσυαλλψ μεντιονεδ ιν Ισλαμιχ φυρισπρυδενχε ρεφερενχεσ. Τηεψ ινχλυ δε τηε ρισκ οφ τηε χονтραχτ δισχοϖερεδ το ηαϖε βεεν ϖοιδ, τηε ρισκ οφ δισχοϖερινγ αν υνδετεχτ εδ δεφεχτ, ετχ.

relationship between the two parties. On the other hand, unlike interest-based financing, sale- based financing is committed to a complete or perfect correspondence with the physical or real market and it involves the financier in commodity-based relationships in strictest sense of the term rather than pure financing.

Profit-and-Loss sharing principle

Profit-and-loss sharing may take the form of partnership (*sharikah)* or commendam partnership (*mudarabah)*. The Islamic principle of profit-and-loss sharing implies that profit may be distributed between partners as per agreement which may differ from their shares in capital, but losses have always to be distributed in accordance with capital shares. *Mudarabah* is a special case of *sharikah* in which the capital share of the managing partner is zero, therefore he/she does not share in the loss.[18] Partnership requires the financier to share both capital and management i.e., to contribute to the decision making process. *Mudarabah* requires financier to provide capital and remain away from managerial decisions. *Mudarabah's* inability to allow the banker to participate in the decisions of the management and to exercise effective control 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.

Output sharing principle

This principle of financing is derived from crop sharing which is an ancient practice in agriculture approved in Islam and re-organized in accordance with the Islamic law. In this arrangement, output (rather than profit) is shared. One party provides land and trees while the other party provides labor. Seeds, fertilizers, pesticides and machinery may be provided by either partner. Output-sharing financing requires the financier to own durable productive assets which are given to the manager who takes charge of managerial decisions against certain percentage of gross output. The issue of expenses on other inputs seem to be of lesser importance according to Islamic law since, as in corp sharing, either party may pay for them provided this is considered in determination of shares of output distribution.

[18] Μ. Φαηιμ Κηαν, ιβιδ., ππ. 2–9.

In Practice, output sharing did not make a serious headway among the modes used by Islamic banks today as it requires the financier to own land and equipment for a long period.

III - INSTRUMENTS PUBLIC BORROWING IN ISLAMIC SYSTEM

This section will discuss instruments of public borrowing in the Islamic state which are based on the Islamic principles of financing. From the discussion of Section Two, it is noticed that as the financier in profit-and-loss-sharing and output-sharing agreements is a partner not a creditor to the working partner, and as a lessor in leasing agreements is an owner of leased assets not a creditor to the lessee, the application of these principles of financing does not create public debt. Modes of financing derived from these principles are - in fact - alternatives to public debt. Government guarantee of private investors in public goods production is also another alternative. On the other hand, sale-based financing creates debt and instruments derived from sale-based financing are instruments of public debt. Moreover, since Islamic Shari'ah does not prohibit interest-free borrowing by the public sector, instruments and modes of public borrowing which fulfil the Islamic law's conditions should also be included in the category of public-debt creating instruments.

3.1 Ownership-based Financing instruments

Ownership-based financing instruments are certificates which allow the financier certain return and are at the same time negotiable, i.e., can be traded at a secondary market. From Islamic point of view, a certificate must represent (i.e., be a title of ownership of) physical commodities or property in order to be sold at a price other than its face (purchase) price. Consequently, from the point of view of the financier, all instruments discussed in this sub-section represent real or physical income-generating properties.

Lease instruments

This is the only form of negotiable instruments of financing based on sale principle: *ijarah* [leasing] instrument. The way a leasing instrument works within an Islamic system is as follows: Certificates are issued to the public as titles of ownership of real estates, machinery and equipment, airplanes, ships, or any other long living assets. These fixed assets are leased to the government. Certificate holders receive their share of the return in proportion of their holdings to total certificates. As owners, certificate holders bear full responsibility of what happen to their property and they are required to keep it in shape suitable for deriving its usufruct by the lessee. Arrangement to take charge of these responsibilities may 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 lease relationship between lessee and lessor. Moreover, lease instruments are sold at market prices which obviously reflects the market valuation of the stream of income involved with each instrument.

A variety of condition may be included in lease instruments. Lease instruments may be perpetual or renewable, whereby capital consumption (amortization) or replacement allowance is introduced to preserve the value of the asset and replenish it when needed. They may be temporary in which no amortization allowance is made and the instrument gradually looses its value at regular intervals. This kind of instruments may fit for investments where fast changes in technology are expected such as computer equipment, etc. They may also be declining leasing instruments, where the lessee desires to own the property after a period of time and assigns installments of the value of the property to be paid to the lessor along with the rent.

Lease instruments may be used to finance income producing projects such as an electricity plant as well as for projects which do not produce income such as mute infrastructure. Fixed assets and installation of either a commercial or military airport may be financed by leasing certificates. These certificates may also be used to bridge the gap in current budget such as leasing public office furniture instead of buying it. They can also be used in developmental financing such as school buildings, laboratory equipment or machinery for a government economic enterprise. They can be used for infrastructure construction, productive equipment or for defense (except consumable material), as long as the assets involved have long live and can be identified for a rental relationship. Certificate may be issued to represent one long living asset or a group of assets put together in one project or in several projects (diversification) as long as they are covered by one leasing contract. Assets of different life spans may be combined together, thus providing this instrument with the ability of having fixed or declining return.

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

Lastly, the nature of leasing financing does not change the provider of public goods. When resorting to this form of financing, the government keeps the decision making on the provision of goods it supplies in its own hand. Therefore, leasing financing can be applied irrespective of the public choice regarding who provides public goods. The issue of privatization, or size of government does not arise.

Sharikah-and-Mudarabah-based instruments

These instruments are similar to common stocks in almost all aspects provided they do not have any prohibited conditions such as preferential or guaranteed return.[19] *Sharikah* mode of financing does not offer much of freedom for the public sector as it gives shareholders equal shares of management right. By selecting *sharikah* instruments for financing projects the government surrenders management rights to shareholders. In this respect, *sharikah* financing is in fact a form of privatization of public projects which may be applied to new projects as well as to existing projects. *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 managerial skills along with finance. The benefit to the government is that it gets its project established and entrusted to skillful management while keeping certain control over it. *Sharikah* instruments are negotiable and the government may increase (decrease) its stake in the corporation through the secondary market. The government may preserve a majority right by holding a large chunk of the stocks. On the other hand, *mudarabah* makes a good mode of finance for income earning public sector projects as it limits the role of the financier to providing money and receiving (+ or -) return, while the management of the project is retained in the hands of the government.

The practical experience of Islamic banks in the last fifteen years indicates that the success of *mudarabah* in mobilizing deposits is very satisfactory. This success, along with the limited ability of most Islamic banks to exercise this mode

[19] Σεε τηε Ρεσολυτιονσ οφ τηε 7τη αννυαλ μεετινγ οφ τηε OIX Ισλαμιχ *Φιθη* Αχαδεμψ, ϑεδδαη, Μαψ 1992.

of financing on their assets side, may partially be attributed to the corporate form of the managing partner (bank) which reduces the moral hazards in addition to other factors related to trust in management and religious zeal which may be higher among depositors than businessmen who are usually more pragmatic, etc.[20] Consequently, *mudarabah* has a good chance to succeed in mobilizing resources for public sector income earning projects provided the government takes practical steps to offer managerial skills which nourish confidence among prospective financiers. *Mudarabah* instruments are also equity shares. They entitle shareholders, who are exposed to losses not to exceed the entire value of their shares, to receive shares of profit as stipulated in the prospectus. They may be offered for a specific investment or project (or a group of projects) under the management of one managing partner provided that this project (group of projects) may be identified accounting-wise in such a way that a profit and loss account may be made for it (them) distinct from other projects the managing partner might be running.

These kinds of instruments may be issued for short, medium or long term investment. They may be issued by the government itself, local executive branches, municipalities, government economic enterprises, etc. They can be sold at market prices because they are fully negotiable. They may be issued by the users of funds themselves so you have *mudarabah* instruments of railway, airlines or communication corporations etc. They may be issued by an intermediary managing agency which 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 instruments which makes it possible to establish private or government institutions specialized in issuing *mudarabah* and/or *sharikah* instruments to financiers and allocating mobilized funds to government income generating enterprises. Moreover, specialized institutions may be established to raise funds on *murabahah* basis and use them to supply goods for deferred payment to the government; or to combine goods and services together and provide financing to the government on the basis of contracting works against deferred payment (*istisna`*).[21] *Mudarabah* and *sharikah* instruments may be perpetual or for a definite period. They may also be decreasing if the prospectus allocates certain proportion of the managing partner's share of profit to buy up the shares of financier. They may also

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[20] Ιν ∀ΠΛΣ, Φιρμ Βεηαϖιορ ανδ Ταξατιον∀, IPTI, 1992, Μ. Φαηιμ Κηαν, χιτεσ εξαμπλεσ οφ Πα κισταντι ανδ Σαυδι βυσινεσσ αττιτυδε τοωαρδσ *Μυδαραβαη.*

[21] *Ιστισναэ* μανυφαχτυρινγ ορ χονστρυχτιον ον ορδερ, ιν ωηιχη τηε συππλιερ οφ μανυφαχτυριν γ ορ χονστρυχτιον μαψ αλσο προϖιδε φινανχινγ, ι.ε., παψμεντ ωιλλ βε μαδε ατ, ορ σομε τιμε αφτε ρ, δελιϖερψ. Τηε νατυρε οφ τηε χοντραχτ, ηοωεϖερ, γιϖεσ ροομ φορ φινανχινγ το βε γιϖεν βψ τηε ορδερερ το τηε προδυχερ, ι.ε., ιν τηε οπποσιτε διρεχτιον, τοο.

have decreasing value if assets exploited have no end-of-productive-life value such as an oil well or a fixed term franchise. Besides, the pool of funds raised through *mudarabah* and/or *sharikah* instruments may make a closed pool as in common stock companies with fixed principal, or they may make an open pool similar to that of open capital companies and to the pools of investment deposits in Islamic banks.[22]

Transfer of ownership of these instruments may be made easy by records in the issuing institutions, endorsement on the certificates, or even by change of hands of certificates if they were to bearers.[23] Lastly, these instruments may be backed by a guarantee from the government if they are issued by corporations and/or institutions having legal and financial independence from the government. Such a guarantee may cover certain kinds of risks especially non-commercial risks but it may also cover commercial risks as we have seen earlier in this paper.

Output-sharing instruments

This principle permits sharing the output provided no valuation of capital is needed, because valuation is subject to value judgement. Hence, this principle requires that income generating property is handed over to a manager on the basis of sharing the output. Output-sharing certificates take the following form: follows: The government sells an existing income earning fixed asset such as a toll bridge or highway to certificate holders. The proceeds of sale are needed for another governmental project whatever it may be and the purchasers have nothing to do with this matter. Certificate holders may assign a governmental bridge authority (or any other body they may choose) to run the property on the basis of output sharing while all running expenses are born by the Managing authority. Of course, expenses are taken into consideration in determining the rate of output sharing. Alternatively, a private contractor may issue shares and invite investors to construct a toll bridge which will be managed by the governmental bridge authority on the

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[22]Βαηραιν ιντροδυχεδ αν αχτ περμιττινγ τηε εσταβλισημεντ οφ οπεν–ενδ–χαπιταλ χομπανιεσ ι
ν ωηιχη παρτ οφ τηε χαπιταλ μαψ τακε τηε φορμ οφ νον–ϖοτινγ σηαρεσ βασεδ ον *μυδαραβαη* πρι
νχιπλε. Σεε Σαμι Ηαμουδ, ∀*αλ Αδαωατ αλ Μαλιψψαη αλ Ισλαμιψψαη*∀ [Ισλαμιχ φινανχιαλ ινστ
ρυμεντσ], παπερ πρεσεντεδ ατ τηε σεμιναρ ον τηε φινανχιαλ μαρκετσ φρομ Ισλαμιχ ποιντ οφ ϖιεω
οργανιζεδ φοιντλψ βψ τηε ΟΙΧ *Φιθη* Αχαδεμψ ανδ ΙΡΤΙ, Ραβατ Νοϖ. 1989.

[23]Α ωορκσηοπ οργανιζεδ ιν Βαηραιν, Νοϖ. 25–28, 1991, βψ Τηε ΟΙΧ Ισλαμιχ *Φιθη* Αχαδεμψ, ΙΡ
ΤΙ ανδ Ισλαμιχ Βανκ οφ Βαηραιν ρεχομμενδεδ τηατ ιτ ισ περμισσιβλε ιν ***Σηαριэαη*** το ισσυε βεαρ
ερ σηαρεσ. Τηισ ωασ αππροϖεδ βψ τηε πλεναρψ 7τη αννυαλ μεετινγ οφ ΙΦΑ, ϑεδδαη, Μαψ 1992.

basis of output sharing between the Government and the contractor. The bridge authority may also assume the role of the construction contractor as deputed by shareholders.

Certificates may be offered for an existing or a new project with or without a gestation period. But in new projects, there will be two forms of relationships, at two consecutive stages, between the bridge authority and certificate holders. In stage one, the authority shall be an agent of certificate holders in constructing the bridge. It may be paid certain fees for services provided or it may act voluntarily until the construction is complete. In stage two, i.e., once the property is ready for income generation, the authority becomes a managing partner as in corp sharing.

Since output-sharing certificates represent property actually owned and legally possessed, they can be sold at market prices. For new projects, there may be certain waiting period until cash funds are substituted for physical property and/or construction material since the *Fiqh* Academy of the OIC ruled that sale of such instruments at a price other than the purchase price is only permissible after at least majority of property becomes physical commodities and assets instead of cash.[24]

Output sharing certificates, like common stocks, do not necessarily have any embodied process of redemption or amortization as they represent full ownership of fixed assets. They also expose holders to risks resulting from natural calamities as well as commercial risk such as diversion of traffic away from the bridge. A vast variety of output sharing certificates may be issued to accommodate a multiplicity of output yielding public projects which need financing especially in infrastructure and transportation sectors. Like *mudarabah* and *sharikah* instruments, output sharing certificates may represent projects in which allowance for amortization of capital may or may not be made. In the latter case, periodically distributed share of output represents both a portion of the principal and a return. This approach may be suitable for projects based on exploiting a franchise or when there is a condition of transfer of ownership of the project or its assets to the public sector after certain period.

Characteristics of Ownership-based public financing instruments

[24]ΟΙΧ Ισλαμιχ *Φιθη* Αχαδεμψ,Ρυλινγσ ανδ Ρεχομμενδατιονσ, Ρυλινγ No. 5 οφ αννυαλ μεετινγ N ο. 4, ϑεδδαη 1988, ππ. 66–67.

1. The most important implications of ownership-based instruments are the following: a) These instruments are fully negotiable at market prices because their sale means the sale of the property they represent. They can be issued to a specific name or to holder. b) In principle, there is no need for repayment (by government) of the principal of these instruments, unless this is so specified in the conditions of financing agreement (as in diminishing leasing, *sharikah* or *mudarabah*). Therefore, the whole issue of inter-generational equity does not arise. c) Ownership by the public of government projects is in a way a form of privatization. But we noticed that except in *sharikah*, the government retains the management of projects financed by these instruments. This means that the provision of the output of these projects is kept public, not private. Therefore, this is only a special form of privatization, not similar to what is usually meant by the term. In a different research,[25] I called this form a "democratization" of public projects. d) Except in diminishing leasing, the government has to pay the market price if it wants to regain ownership of projects financed by these instruments. In diminishing leasing the paid price is contractually determined.

2. These financing instruments are neutral as far as the size of government is concerned. In other words, these instruments can be used by a government which opts to provide larger variety of goods, or by a government which chooses to contain its role to the provision of goods on which the principle of exclusiveness does not operate through the play of the market forces.

3. The need for future taxes and/or fresh borrowing to pay for public financing through these instruments can be tackled from two angles: first, whether a financed project produces a surplus sufficient to pay for its finance services (principal plus return). Efficient income generating projects may be able to pay for these services. Therefore, in this case, future taxes may not be inevitable. On the other hand, projects that do not produce income may call for future taxation to pay for their financing services. Second, what forms of financing is applied in the project. In interest- based public debt, future taxation-cum-borrowing is required to pay for the debt services. In all financing instruments discussed in this sub-section, the financing agreement may be formulated in a way that does not require future taxation because there would be no need to pay back the principal financed. In other words, even with leasing instruments used to finance non-income generating assets,

[25] Μονζερ Καηφ, Φινανχιαλ Ρεϖενυεσ οφ τηε Εαρλψ Ισλαμιχ Στατε, IPTI, 1992.

the government is not necessarily required to pay back the principal since it may keep renting the leased assets for ever.

4. Ownership instruments financing are always related to specific projects and usages. In case of leasing, this implies that the government can only use the rented fixed assets and in the case of other instruments the government is bound to undertake specified revenue generating projects. This is in contrast with interest based public borrowing which does not necessarily involve such one to one correspondence with acquisition of physical assets or construction of income producing projects. On the one hand, this linkage with physical assets and the profit incentive in such projects reduce the moral hazards on the part of public officers because of added (private) control element, and on the other hand, they increase efficiency because public projects would have to compete with private sector's projects for financing.

5. *Sharikah*, *mudarabah* and output sharing instruments only apply to income generating projects. On the other hand, leasing may be utilized for any kind of public projects regardless of being mute or income generating. Therefore, of the above mentioned instruments leasing financing is the most flexible.

6. These instruments can be used for external and internal resource mobilization.

3.2 Debt Based Public Financing

Governments may prefer resorting to public borrowing under certain circumstances. For instance, seasonal needs to bridge the timing gap between revenue collection and expenditure disbursement, inability to formulate certain financing needs under any of the ownership instruments because of certain legalities or failure of these instruments to attract investors. Thus, debt-based financing remains an 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 the Islamic system, whenever we move from the idea of ownership to the idea of debt, we loose on the side of liquidity because of two Islamic Shari'ah conditions: (1) debts may only be exchanged at face value regardless of date of maturity, and (2) debts may not be exchanged for debts, i. e., in a permissible or lawful exchange either price or commodity must be present if the other is deferred.

Consequently, none of the debt-based modes of financing can be negotiable. This eliminates the possibility of a secondary market with all negative effects on the first market itself, and makes it necessary that an alternative approach for liquidation must be sought. The alternative which is permissible in Islamic law is redemption. Redemption, in this context, means buying back the debt before its maturity by the debtor. It may be done either at the debt's face value or at a discount. The Islamic law requires certain conditions for redemption, the most important among them is that it should not be part of the original contract which created the debt.[26]

Lastly, debt may be acquired from the public voluntarily or by use of legal authority of the government or coercion. With regard to sources of the loans, they may be internal or external. The focus of this paper is on the voluntary public debt in Islam.

If voluntary public debt is to succeed, it must have certain built-in attractions in order to appeal for the self interest drive of individuals. Islamic Shari'ah prohibits attaching any fringe benefits to loans and considers any such benefits as a form of interest. Prohibited fringe benefits may include tax reduction, relaxation of deadline conditions of tax payment, providing facilities in sale of certain public goods, etc. Consequently, attractions for public debt must be carefully designed in order to fulfil the conditions of Islamic law. Attractive features of public debt may be in the form of appealing to the sense of patriotism and religious piety or in the form of profit incentive incorporated in exchange relationships. This profit incentive may take the form of mark up on goods sold to the government for deferred payment, mark down on future goods and services sold by the government for immediate payment, or protection against inflation.

A- SALE-BASED PUBLIC DEBT

Mark up may be applied through *murabahah* or through *'istisna'*. Mark down may be applied by means of *salam*, *'istisna'* or leasing. Hence, we have four kinds of sale-based financing modes which can be used by the public sector:

[26]Ιτ μυστ βε νοτεδ τηατ τηισ δισχουντ ισ αππροϖεδ βψ σομε Μυσλιμ σχηολαρσ ωηιλε οτηερσ οπποσε ιτ ον τηε γρουνδ τηατ ιτ ισ α φορμ οφ ιντερεστ. Φορ α δισχυσσιον ον τηε ισσυε ρεφερ το Ρ αφιθ αλ Μισρι, Αλ Ηασμ αλ Ζαμανι [τιμε∋σ δισχουντ],Χεντερ φορ Ρεσεαρχη ιν Ισλαμιχ εχονομιχ σ, ϑεδδαη. Ηοωεϖερ, τηε ΟΙΧ Ισλαμιχ *Φιθη* Αχαδεμψ χονσιδερσ τηισ δισχουντ περμισσιβλε υνδε ρ χερταιν χονδιτιονσ. Σεε Ρεσολυτιονσ οφ 7τη Αννυαλ Μεετινγ, ϑεδδαη, Μαψ 1992.

murabahah, *'istisna'*, *salam* and leasing.

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

The concept of mark up comes from raising the price of goods if payment is made at a subsequent date in recognition of a financing compensation. Public-debt creation may take the form of simple deferred payment sale in which the government gives IOU's for future payment to suppliers of goods. By the same token *'istisna'* form of sale may be used for construction with payment taking the form of IOU's due at a point of time subsequent to the date of delivery of completed construction. Since these IOU's are transferable at the face price, they do not attract secondary market transactions. A provision may be made that they can be used for tax payment, etc. Debt certificates, which may be of different denominations and maturities, may be redeemed by the government before their due date and at the time of redemption the government may seek a discount for early payment.

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

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

Salam offers a mode of financing the public sector if government is able to provide future goods for which funds are obtained presently. For example, government owned enterprises or farms, which produce consumer goods, may sell part or all of their output on *salam* basis. *Salam* coupons of indebtedness of small denominations of quantities of goods may thus be issued to purchasers. These coupons are not negotiable because according to Islamic law one may not sell purchased goods before physical delivery. But they can be redeemed before maturity by canceling the contract if the parties agree and the purchaser may get his/her money back without any increment.

'Istisna'-based public debt is similar to *salam* with only one difference related to the nature of goods. In *'istisna',* the object of sale is not necessarily identical or standardized commodities. Rather, it includes construction or manufacturing works with certain specification. These works may cover both material and labor such as houses, cars, etc. In *'istisna'*-based financing of the public sector, the government sells future housing units with specifications and delivery date, put clearly forward in the prospectus at the price of say $100 for each one thousandth of a unit. Whoever buys one thousand coupons will get a house. These housing coupons are also not negotiable but they can be redeemed before maturity by canceling the *'istisna'* contract.

The use of proceeds of this form of financing is not tied or restricted to specific goods or projects. Consequently, proceeds of *salam* and *'istisna'* may be used to finance another project, current budget deficit, balance of payment deficit and what not. Moreover, *salam* and *'istisna'* coupons may be issued by federal, regional or local branches of government as long as the delivery of object (contracted goods or construction) is feasible for the issuing body. The incentive to hold these debts may be a mark down on current prices or alternatively, if prices are expected to increase because of expected or persistent inflation, pricing at the present level provides an incentive in the form of protection against inflation.

Public utility warrants

This is a special kind of debt-based financing which applies to public utilities. This arrangement is a version 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 marked-down price against advance payment. 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.

Lease instruments

Lease debt may take the form of securities representing a commitment by the government to provide certain service to the holder or his family at a future date. It is a contract to sell a service for advance payment. Services object of this contract may be provided after a number of years such as university education for children or housing usufruct, or they may be provided only after a short span of time such as garbage collection during 4th month of the current year. Like *salam* and *'istisna'* public debt, leasing securities are not negotiable. They may be priced at a mark down or at present a price lower than expected price at time of delivery. They can be issued by central government, a university or a local branch of government as long as issuing agency can provide contracted service in the future. They may be redeemed before maturity for the paid price. Their proceeds need not be tied to any specific use, i.e., seller of services may use proceeds at own wish and discretion, e.g., to finance current budget deficit.

B - Loan-based financing

There is one kind of public loan which may embody certain permissible fringe benefit. This is foreign currency loan. It invokes the incentive of protection of one's wealth against devaluation and to a certain extent inflation abroad).

Foreign currency bonds may be issued against foreign currency debt on 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. They are issued when foreign currency is more stable than domestic currency. Thus, these bonds award protection against devaluation of domestic currency and against domestic inflation, but the prohibition of yield and negotiability makes them unattractive. However, they may be demanded by individuals who have no investment opportunities of their foreign liquid assets which may happen in case of restrictions on holding foreign assets.

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

Characteristics of public debt modes

1. While mark-up modes, voluntary and involuntary public borrowing create indebtedness in money terms, mark-down modes create in-kind

indebtedness.

2. Mark-up and mark down-modes are tightly related to the exchange/production of goods and services. In mark-up modes, *(murabahah* and *'istisna')* public borrowing occurs only in order to supply the government with goods and services it wants to use for its current and/or developmental activities, regardless of whether financed projects generate income or not. In mark-down modes, government prepares to produce goods and services as payment of its in-kind debt. Islamic law requires that those forms of financing cannot be concluded if the debtor is not able to supply contracted goods and services.

   The link with commodities supplied and produced puts a tab on public debt which prevents the government from expanding it. Thus mark-up and mark-down public debts avoid one of the major drawbacks of interest-based debt.[27]

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

4. Debts, whether in-cash or in-kind, have to be paid when due. Therefore, all modes of Islamically acceptable forms of public debt pose the challenge of repayment of debts in the future, especially if the goods and supplies obtained in mark-up modes and/or proceeds of other modes are not used for income generating projects. This means that future generations have to be either taxed or asked for fresh flow of loans to repay outstanding debits. Obviously, this calls for a thorough examination of the impact of such modes on inter-generational equity.

[27]Αλ–Θαρι, Μοηαμμαδ Αλι, ∀Πετρολευμ βονδσ ασ αν αλτερνατιϖε το τρεασυρψ βονδσ∀, υνπ υβλισηεδ παπερ, ΧΡΙΕ, Κινγ Αβδυλαζιζ Υνιϖερσιτψ, ϑεδδαη, 1412Η.

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

6. The government may provide any form of guarantee or collateral. Such a guarantee may be given by the same body which uses the financing or by another governmental body which may be legally and financially independent from the debtor.

7. Modes of public debt can be applied to external as well as internal financing. Consequently government may obtain foreign institutional financing on the basis of *murabahah*, *salam*, *'istisna'* and benevolent foreign borrowing. It can also mobilize foreign financing from individual, citizens and others, on the basis of mark-down modes and foreign currency bonds.

IV - CONCLUSIONS AND SUMMARY

The Islamic system foresees, public goods to be provided by government, voluntary sector, and/or private sector. The Islamic system encourages the provision of public goods by non-profit organization and by the private sector and offers moral enhancement as well as material incentives for that. Whenever it is possible Islam, in general, prefers small government over big government as it assigns as fewer goods as possible for provision by the government. Nevertheless, under all circumstances there will remain certain public goods that are to be provided by the public sector. This may be either because of the nature of these goods, Islamic law's requirement, or political choice of the nation.

Since interest is prohibited, the Islamic economic system provides two kinds of instruments that mobilize non tax resources from the private sector. Funds may be raised on the basis of financier's ownership of assets made available to the government or on the basis of debt creation. Without going in the details mentioned in the text about the characteristics of each public financing instrument and mode of public debt, three important points are worth to conclude with:

1- A future liability arises always from public debts. Hence, unless the government generates sufficient future resources to pay back the debt, taxes and/or expansion of borrowing become inevitable. From the point of view of financing instruments this requires certain details: while ownership-based instruments do not call for redemption as they do not create liability on the public sector, in-kind public debt calls for future production of contracted goods and services. This requires financing. Therefore, unless the production capacity of the public sector is expanded sufficiently, fulfillment of contractual obligations becomes difficult. Default of government in this regard may result in compensatory damages, etc.

2- Public debt cannot be rescheduled because interest is prohibited.

3- There are non-tax public revenue sources which should be explored.

4- Sale of public property is, for instance an important source of public revenue that may be tapped to meet budget deficit and pay back public debt.

Privatization is another source of revenue through which third world countries may generate financial resources to pay back outstanding public debts and cater to their future financial needs.

5- The modes and instruments discussed in this paper serve as a vehicle for resource mobilization from the private sector within the country as well as from external sources.

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