PUBLIC SECTOR ECONOMICS FROM ISLAMIC PERSPECTIVE

By Monzer Kahf

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Introduction

Several issues are covered under the title of the present paper. These include the role and functions of the Islamic state in the economy; its economic objectives; responsibilities and policy instruments. Public finance is also covered under this title whereby a discussion of revenues, expenditures, budget, public debt and fiscal policy should be made; it also covers the economic public sector, i.e. the state owned economic enterprises and questions related to them, including issues of nationalization, public ownership, denationalization, privatization and management of Government-run economic enterprises. In the present paper, only a few of these issues will be discussed, namely :

1) The nature of the Islamic state and its functions;
2) Its economic objectives;
3) Instrument and policy tools available for fulfilling the economic objectives of the Islamic state;
4) Constraints on the economic activities of the Government; and
5) A brief outlines of the Islamic Government's fiscal system: revenues, expenditures, budget, deficit and its financing;
6) Islamic instruments for Government financing.

Page # 2 - 31 is in the diskette of Br. Rashid under ref. 91Doc.rh, which was done in microsof word program, because of Arabic & English mixed text.

Section V: Brief Outlines of the Islamic Fiscal System

A) Public Revenues

The Islamic fiscal system developed at an early time with its beginning going back to the time of Prophet (PBUH). The Prophet (PBUH) institutionalized the concept of public property, when he designated certain lands as property owned by the whole *ummah* from which a flow of revenue was derived for financing the expenditures of the Government.

The first such lands left for the *ummah* as a source of public revenues where the seven orchards bequested by Mukhairiq to the Prophet (PBUH) in the Madinah. Later, half of the land of Khaibar was turned into public property in the 7th year of Hijrah[28].

'Umar, the second Khalifah expanded this practice by establishing the rule that all conquered lands should be left as public property for the whole *ummah* while at the same time given to farmers against a rental payment that is called *al-kharaj*. Since then *al-kharaj* became the major source of public revenues of the Islamic state. As Abu Obaid defines it, *al-kharaj* is the rent of the land that is owned by the *ummah* as a *waqf* for its generations, it is used to finance the government activities.

In addition to *al-kharaj*, there used to be some minor sources of revenues including revenues of land owned and managed by Government enterprises, the estate of a person who dies without leaving any heirs and donations given to the public treasury.

Muslim *fuqaha* discussed the concept of public property and some of them (the Malikites) argued that minerals, whether solid or liquid, found on the surface of the ground or beneath it must also be considered public property. Contemporary Muslim *fuqaha*, including the late Sheikh Mohammed Abu Zahrah, believed that in contemporary context of industrial

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28 The other half of the land of Khaibar was distributed by the Prophet (PBUH) among the Muslim soldiers who contributed to its conquer.

development, and the great role mineral resources play in the economy of the whole *ummah*, the Malikites view must be most appropriate. Thus they conclude that minerals are an essential part of the wealth of the whole *ummah* and they are part of the public property. This makes minerals a major source of public revenues for a contemporary Islamic Government.

Additionally, Muslim scholars also discussed two other kinds of public revenues: taxation and public borrowing.

With regard to taxation, the general view of Muslim scholars is that taxation may be imposed in the Islamic states if other resources are not sufficient to sustain the needs for public expenditures. Furthermore, when taxation are imposed, the main conditions for their *shari'ah* legitimacy are the following:

1) Existence of genuine needs for public revenues.
2) Regular public revenues (mainly from public property) are not sufficient to fulfill those needs.
3) Elimination of all extravagant or wasteful uses of public revenues.
4) The decision to impose such taxation must be taken with due regard to the *Shura* political process as defined in *shari'ah*.

With regard to public borrowing, it is argued that the Islamic Government may borrow from its citizens and/or from others provided that borrowing is done only within the limits of the national ability for repayment and to fulfill basic needs of *ummah*. Imam Al Juwaini argued that borrowing may be the last resort, i.e. after exhausting the taxation capacity while Imam Al Mawardi considers taxation as the last resort, i.e. after public borrowing.

Before concluding this sub-section, a reference must be made to a source of public revenues that was often resorted to by the Prophet (PBUH): private voluntary donations to the Government. We have many narrations to the effect that the Prophet (PBUH) depended on this source of revenue for fulfilling many of the functions of the Islamic state, especially in its early days before the flow of war booties (which took place mainly after the 7th year of Hijrah). This source of public revenue almost disappeared afterward. However, in our contemporary time, we observe that Governments sometimes resort to voluntary donations, especially at times of crises or threats to national security as well as for community related projects, such as city beautification and municipal monumental projects.

Finally, we should remember that *zakah* and *awqaf* make important sources of public revenues but this kind of revenue is restricted to special use. *Zakah* can only be used for the eight categories mentioned in the Qur'an, while *awqaf* must used solely in the objectives dictated by the person who created the *waqf*. In spite of these limitations, both *zakah* and *awqaf* satisfy an important segment of public activities that would otherwise tax on the public revenues at large. Hence, they can be considered as part of public revenues of the Islamic Government even with the fact that use of their proceeds is limited.

B) Public Expenditures

One may argue that the first constitutional document which establishes a social welfare role of the Government was that issued by the Prophet (PBUH) upon His arrival in Madinah which is known as *al-sahifah*. This document dictates that the state is responsible for the provision of the basic needs of the poor. It establishes a collective responsibility upon all the believers together to provide for such needs. Since then the expenditures of the Islamic state expanded to include defence, administration of justice, law and order, welfare of the poor, fulfillment of basic religious obligations, e.g., prayer facilities, collective duties or *fard al-kifayah*, etc.

Umar established the public records of expenditures by borrowing what used to be called *al-dawawin* from ancient Persian state. *Al-dawawin* are records of public expenditures on the different aspects of the Government activities through which the Government was able to estimate its needs for public funds and to subject their use to financial and administrative control[29].

C) Budgeting

The concept of annual budget as a plan of action and appropriation of expenditures to each segment of the plan along with an estimation of potential revenues is a new one. However, matching the ends and means of the Government in terms of revenues and expenditures has always been done by the Islamic state since its inception at the time of the Prophet (PBUH). Therefore, although we do not have on record a report of the existence of an annual budget, we do have reports of annual estimation of certain kind of public revenues, especially, the major one *al-kharaj*, and of annual estimation of public expenditures as recorded in the *al-dawawin*. This goes back as far as the time of 'Umar, the second Khalifah.

D) Public Deficit and its Financing

Keeping in mind the Islamic approach to providing alternative means for the provision of social goods, especially by institutionalizing *awqaf* as an important provider of certain public goods[30] and permitting the provision of certain types of public goods to be done on profit and loss basis even with a third party guarantee and other incentives by the Islamic Government[31], a deficit may still occur in the budget and the Islamic *shari'ah* provides for means for filling the gap.

Basically, there are two types of financial instruments that can be used for financing budget deficit: non-debt instruments and debt-based instruments which are discussed in section

29 It is known that the Prophet (PBUH) initiated a process of estimation of public expenditures when he ordered that statistical information be collected in certain areas of the Islamic state. Additionally, the process of collection of *zakah* entails statistical information on the main resources of the country).

30 For instance, the whole education system has historically been financed by *awqaf* throughout the Muslim world from the Far East to Morocco and Muslim Spain.

31 For details see Monzer Kahf "Instrument of Meeting Budget Deficit in Islamic Economy", paper in process of publication in IRTI.

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Section 6: Debt and Non-debt Instruments for Government Financing

6.1 Non-debt Financing instruments

Non-debt public financing instruments are certificates issued with regard to *shari'ah* compatible forms of financing which allow the financier certain return and are at the same time negotiable, since negotiability is a desired feature in any financing instrument because it offers flexibility and reconciles the desire for income with that of liquidity and precaution. From *Shari'ah* point of view a certificate must represent (i.e., be a title of ownership of)[32] physical commodities or property in order to be sold at a price other than its face (purchase) price[33]. Consequently, from the point of view of the financier, all instruments discussed in this sub-section represent real or physical properties that generate income.

a) *Ijarah* instruments

Ijarah instruments[34] are certificates issued to the public as titles of ownership of real estates, machinery and equipment, airplanes, ships, or any other long-living assets. These fixed assets are rented to the government. Certificate holders receive their share of the rent.

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32 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 physical or constructive possession. Sale of commodities or property one owns and possesses may be done at any agreeable price. Selling of a debt is usually called *hawalah* [transfer]. In *hawalah*, only the face value of the debt is payable to the transferor. A debt, whether represented by a certificate or not may be in terms of money in terms of or any other physical commodity which can be described in a standard manner to the extend that its identification becomes undisputable. Finally, since an instruments or a certificate is itself just a piece of paper, what matters in all transactions is the commodity, property and/or debt it represents.

33 This is the general case. A special case is also addressed in *Shari'ah*, that is when an instrument represents a mixture of physical assets, usufruct rights, debt nd cash. The OIC *Fiqh* Academy ruled that if usufruct rights and physical assets make the majority of the total value of the mixture, the instrument may be sold at a market price. (OIC Fiqh Academy No. 5, of the Fourth Plenary Session, Jeddah, 1408H).

34 It will be shown later that all other sale-based certificates represent debts and are therefore not negotiable.

Certificate holders bear full responsibility of what happens 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 Islamic insurance and agency to the lessee or anybody else.

The issuing body declares in the prospectus, that holders may sell the property without any effect on the *ijarah* relationship between lessee and lessor. Therefore, these certificates are fully negotiable. Moreover, *ijarah* instruments are sold at market prices which obviously reflects the market valuation of the stream of income involved with each instrument. This stream of income includes present contractual rent, expected future rents, and the asset's value at the end of the *ijarah*.

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

- perpetual or renewable *ijarah* instruments, where capital consumption (amortization) or replacement allowance is introduced to preserve the value of the asset and replace it when needed;

- 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 are expected such as computer equipment, etc.;

- declining *ijarah* instruments, where the lessee desires to own the property after a period of time and assigns installments of the value of the property to be paid to the lessor along with the periodical payment of rent.

Ijarah instruments may be used to finance income producing projects such as an electricity plant as well as for projects which do not produce income such as mute infrastructure.

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

They can be used for construction of infrastructure, productive equipment or even for weaponry (except consumable ammunition), as long as the asset involved has a long life and can be identified for a rental relationship. They can represent one long living asset or a group of assets put together in one project or in several projects as long as they are covered by one *ijarah* contract. Subject to *Shari'ah* permissibility, even assets of different life spans may be combined together as long as the certificates are issued against physically existing assets, thus providing this instrument with the ability of having fixed or declining return.

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

It is important, however, to notice that *ijarah* certificates **must always represent well defined physical assets**; and whenever there are different portfolios, corresponding different certificates should be issued.

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

Finally, because of their above mentioned properties, *ijarah* certificates may be very convenient for external resource mobilization in addition to their internal fund raising potentials. Take for instance medium term *ijarah* instrument; it suits external resource mobilization in areas of rapid technological change. By the same token, declining *ijarah* is convenient in cases of long-living assets that the government likes to own in the future. Moreover, permanent, temporary and declining *ijarah* certificates offer international financiers desired degree of liquidity if an international market of *ijarah* certificates can be organized, while they preserve the independence of the host country in all relevant decision making . These advantages make *ijarah* certificates a good candidate for debt equity swap especially that it is up to the debtor country to identify physical assets that will be sold to creditors and leased back.

b) Profit and Loss sharing instruments

This principle of financing covers *sharikah* and *mudarabah* where losses are distributed in accordance with the shares of capital while profits are distributed as per agreement which may differ from the shares in capital. Noticeably, these two modes of financing are fit for profit making projects only. Therefore, unless combined with some other arrangement as will be shown later, they do not suit financing current expenditures deficit.

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

***Sharikah*-based instruments**

These instruments are similar to common stocks in almost all aspects provided they do not have any prohibited conditions. For instance, preferred stocks that guarantee a minimum return or less capital risk are prohibited[35].

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35 See the Resolutions of the 7th annual meeting of the OIC Islamic *Fiqh* Academy, Jeddah, Shawwal 1412H.

It should be noticed that *sharikah* mode of financing does not offer much of freedom for the public sector as it gives shareholders corresponding shares of management right. This implies that by selecting *sharikah* instruments as a means of project financing, the government surrenders management rights to shareholders. In this respect, *sharikah* financing is in fact a form of partial privatization of public projects which may be applied to new projects as well as to existing projects. Hence, *sharikah* may suit mixed corporations in which the public sector desires to benefit from the skills of private businessmen in decision making. In such a case private shareholders will provide both finance and management together. 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, e.g., open market operations. The government may preserve a majority right by holding a large chunk of the stocks.

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

Empirical experience of Islamic banks in the last fifteen years shows that the success of *mudarabah* in mobilizing deposits has been very satisfactory. This success, along with the limited ability of most Islamic banks to exercise this mode of financing on their assets side, may at least partially be attributed to the corporate form of the *mudarib* (Islamic bank) which reduces the moral hazards in addition to other factors related to trust in management, religious zeal which may be higher among Islamic banks' depositors than businessmen who are usually more pragmatic, etc.[36] 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.

[36] See references about studies of these factors in Saudi business and in Pakistan business cited in M. Fahim Khan, "PLS, Firm Behavior and Taxation", IRTI, unpublished, 1412H.

Mudarabah instruments

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

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

Additionally, *mudarabah* instruments may be issued by the users of funds themselves so you have *mudarabah* instruments of railway, airlines or communication companies.[37] 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 instruments making it possible to establish private or government institutions specialized in issuing *mudarabah* instruments to financiers and allocating mobilized funds to

[37] According to majority of *fuqaha'*, *mudarabah* can only be used in trade because *mudarabah* implies disposition of the principal itself in buying and selling (al Sharh of Kabirwith al Mughni, V 5, P192 and Monzer Kahf: Mufhum al Tamwil, P24). However, some *fuqaha'* approve the inclusion of certain services on the part of the *mudarib* such as sewing the cloth into dresses and weaving the threads into cloth (al Mughni, V 5, P118). Moreover, al Sarakhsi (al Mabsut, V 22, PP 72-73) argues that farming is permissible in *mudarabah*. farming includes renting land, cultivating it, and buying grain for seeds because "farming work is something merchants do for the purpose of getting a return". Also renting ships, animals, land, and other means of transportation, storage and cultivation is permissible (al Kasani, V 6, P 88). Al Kasani (V 6, PP 91-92) also permits providing the service of tinting by *al Mudarib*. All these, in addition to the fact that there is no text in Sunnah that prevents using *mudarabah* in industry, agriculture and services, have lead several contemporary scholars to argue that in today's world, *mudarabah* may be used in the provision of services such as communication and transportation as well as in other industries.

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* basis; to provide capital goods on *ijarah* basis, or to combine goods and services together and provide financing to the government on the basis of *istisna'*.[38]

These kinds of specialized institutions may work on the basis of *wakalah* [agency] with or without compensation for their services, or they may themselves be profit making similar to Islamic banks. But it should be noticed that there may be certain limitation on negotiability of *mudarabah* instruments which are exclusively used to finance *murabahah* transactions on the ground that these instruments may represent assets consisting mostly of debts and cash since according to rules of *Shari'ah* debts may only be transferred at their face value.[39]

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

Besides, the pool of funds raised through *mudarabah* instruments may be a closed one as in common stock companies with fixed principal, or it may be open, similar to that of open capital companies and to the pools of investment deposits in Islamic banks.[40]

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38 *Istisna*' contract is similar to manufacturing or construction on order, in which the supplier of manufactured or constructed goods may also provide financing, i.e., payment will be made at, or after, delivery. The nature of the contract, however, gives room for financing to be given by the orderer to the producer, i.e., in the opposite direction, too.

39 *Fiqh* Academy resolution No.5 in the Fourth Annual Meeting, Jeddah 1408H.

40 Bahrain introduced an act permitting the establishment of open-end-capital companies in which part of the capital may take the form of non-voting shares based on *mudarabah* principle. See

Transfer of ownership of these instruments may be made easy by records in the issuing institutions, endorsement on the certificates, or even by hand over of certificates if they were to bearers.[41]

Lastly, *mudarabah* instruments may be backed by a guarantee from the government if they are issued by corporations and/or institutions that have legal and financial independence from the government and the government does not own any share in them. Such a guarantee may cover certain kinds of risks especially non-commercial risks but it may also cover commercial risks with regard to capital alone as we have seen in section two above.

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

Mudarabah instruments provide a viable alternative to public debt for internal as well as external resource mobilization. The experience of Islamic banks indicates that savers in the Muslim countries are willing to take the risk *mudarabah* exposes them to if their funds are entrusted to qualified institutional intermediaries. It seems that there is no reason why profitable government enterprises do not enjoy the same advantage. By the same token if *mudarabah*

Sami Hamud, "*al Adawat al Maliyyah al Islamiyyah*" [Islamic financial instruments], paper presented at the seminar on the financial markets from Islamic point of view organized jointly by the OIC *Fiqh* Academy and IRTI, Rabat Nov. 1989.

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

deposits are used by intermediaries to finance government on the basis of *murabahah*, *ijarah* or *istisna'*, they also should have similar appeal to individual savers.

With regard to external resource mobilization, *mudarabah* instruments offer a combination of return and liquidity, which allow them to be a viable alternative to external borrowing especially from international capital markets. Noticeably, the host country keeps the management in its hands. Thus *mudarabah* instruments offer a tool that is worth considering in the debt/equity swap especially if a third party principal guarantee can be arranged at least for a transitory period in order to minimize the risk involved. This may allow *mudarabah* instruments to seriously compete with debt rescheduling.

It should also be noted that *musharakah* instruments share all the characteristics and potentialities of *mudarabah* instruments with the sole difference of participation in management.

c) Output sharing instruments

This may be applied when no valuation of capital is needed, in similarity with the *muzara'ah* relationship which does not require evaluation of the land. Hence, this principle requires that income generating property be handed over to a manager on the basis of sharing the output.

Forms of output sharing certificates may be suggested as follows:

> The government sells an existing income earning fixed asset such as a toll bridge or highway to certificate holders. The proceeds of sale are needed for another governmental project whatever it may be and the purchasers have nothing to do with this matter. Certificate holders may assign an agent or a managing partner, that may be a governmental bridge authority, to run the property on the basis of output sharing while all running expenses are born by the managing partner. Hence gross toll revenues of the bridge will be divided between the manager and

share holders according to the agreed upon percentage of output sharing. Of course, expenses are taken into consideration in determining this percentage.

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

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

With regard to negotiability, it should be noted that output sharing certificates represent property actually owned and legally possessed. Therefore, they can be sold at market prices. For new projects, there may be certain waiting period until cash funds are exchanged 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.[42]

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

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[42] OIC Islamic *Fiqh* Academy,Rulings and Recommendations, Ruling No. 5 of annual meeting No. 4, Jeddah 1408, pp. 66-67.

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

Like *mudarabah* instruments, output sharing certificates may represent projects in which allowance for amortization of capital may or may not be made. In the latter case, periodically distributed share of output represents both the principal and the return and the output sharing instruments would be declining. 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.

Lastly, output sharing instruments are also convenient for external resource mobilization especially that they have lesser moral hazards risks than *mudarabah* instruments because the reporting required in output sharing is only about gross rather than net revenue. Therefore, output-sharing instruments are more amenable to external debt swap than *mudarabah* and *sharikah* instruments.

6.2 Debt Based Instrument

All instruments mentioned in sub-section 6.1 are based on ownership. This makes their exchange at market prices permissible because this is one of the implications of the right of ownership. Although, these instruments are essentially structured for long-term financing, some of them, especially *mudarabah* instruments, may also serve short-term public financing.

On the other hand, ownership-based instruments may not fulfill all financing needs of the public sector and governments may prefer resorting to public borrowing under certain circumstances. For instance, seasonal needs to bridge the time 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. These and similar conditions make debt-based financing an alternative and a supplement to ownership-based financing especially that debt-based modes are more tuned to serve short term needs than long term financing.

However, it must be noted that whenever one moves from the idea of property ownership to the idea of debt, a severe blow to the liquidity of the instruments takes place because of two *Shari'ah* rules: (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 payment of price or delivery of sale's object must be done at the time of contract.

Consequently, all debt-based instruments of financing that public sector may issue cannot be negotiable. This eliminates the possibility of a secondary market with all its feedback effects on the first market itself. It will make it necessary that an alternative approach for liquidity must be sought. This alternative is redemption.

Redemption, in this context, means buying back the debt before its maturity by the debtor. It is done either at the debt's face value or at a discount. discount in debt redemption is called *wadi'ah*,[43] and there are certain *Shari'ah* conditions for its applications such as it should not be an explicit part of original contract which initiates the debt, nor an implicit condition well established as a regular custom by previous government practices.[44]

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43 *Wadi'ah* is a reduction in the amount of the debt given up by the creditor in exchange of early payment. The permissibility of it is based on the Saying of the Prophet (pbuh) which means "reduce the amount of debt and get it before maturity" which he said addressing some jews when they were leaving the country and they wanted to cash their debts before due dates. The fact is that if mark up is acceptable because of delay in payment also a reduction may be acceptable if a 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 must not be separated from real business exchanges to become a pure monetary phenomenon.

44 It must be noted that *wadi'ah* is approved by some ***Shari'ah*** scholars while others oppose it on the ground that it is a form of *riba.* For a discussion on the issue refer to Rafiq al Misri, Al Hasm al Zamani [time discount],Center for Research in Islamic economics, Jeddah. However, the OIC Islamic *Fiqh* Academy considers *wadi'ah* permissible provided it is not made a condition in the contract, and it is done as an arrangement between the debtor and creditor without the interference of a third party. See Resolutions of 7th Annual Meeting, Jeddah, Shawwal 1412. One may add that *wadi'ah* arrangement should not become prevalent to the extent that it

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

Voluntary public debts[45]

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 a form of *riba* whether they are called *riba* or not. this is on the basis of the famous *fiqhi* rule that a loan which may bring any benefit is a *riba* tinted loan. *Riba*-based fringe benefits are material benefits which may or may not be calculated at the time of lending. For instance, with regard to government borrowing, some may argue that such prohibited fringe benefits may include a tax reduction, relaxation of deadline condition of tax payment, providing facilities or concessions with regard to sale of debt-holder's products, etc.[46]

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

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becomes a regular custom adopted by the government because this makes it similar to being pre-contracted.

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

46 It may be noted that some scholars believe that a tax rebate or privilege to a public-debt holder may be permissible on the ground that this is not a fringe benefit to a loan but part of tax arrangements similar to variations in rates and taxability on the basis of different conditions of tax payers; especially that a tax is not obligatory from its origin.

the government for immediate payment. It may also be at present prices as a protection against expected future inflation.

A- SALE-BASED PUBLIC DEBT

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

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

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

Public-debt creation may take the form of simple deferred payment sale in which the government gives IOU's for future payment to suppliers of goods. By the same token, *istisna'* form of sale may be used for construction with payment taking the form of IOU's due at a point of time subsequent to the date of delivery of completed construction. Since these IOU's are transferable at the face price, they do not attract secondary market transactions. A provision may be made that they can be used for tax payment, etc. IOU's, which may be of different denominations and maturities, may be redeemed by the government before their due date. At the time of redemption, the government may seek a discount (*wadi'ah*) for early payment. *Murabahah* is a version of deferred payment sale in which the seller declares his/her cost and profit or added mark up.

Another form of *murabahah*-based public debt may copy the *murabahah* for the purchase orderer. It works as follows:

The government assign one of its bodies to work as an agent of the public in acquiring goods on order for the government. This government body may work on a voluntary basis if the government provides all its administrative expenses; or it may work against a given fee collected from *murabahah* bonds' holders.[47]

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 respective principals.

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

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

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

Salam certificates and *'istisna'* coupons

Indebtedness in *Salam* is in terms of physical goods rather than money. *Salam* offers a mode of financing public sector if the government is able to provide goods in the future for which it gets immediate payments. For example, government-owned enterprises or farms, which produce consumer goods, may sell part or all of their output on *salam* basis.[48]

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47 Alternatively, if the agent works as a *mudarib* for the public, funds would then be obtained on *mudarabah* basis as mentioned in Sub-Section 3.1.2 of this paper.

48 It is to be noted that in addition to normal conditions of a *bay'* contract, there are seven conditions in *salam*: 1) immediate payment of price; 2) postponement of delivery; 3) the commodity sold should be describable in absentia and it becomes a debt on the seller; 4) detailed

Salam certificates of indebtedness of small denominations of quantities of goods may thus be issued to purchasers. These certificates are not negotiable because according to *Shari'ah* one may not sell purchased goods before physical delivery. But they can be redeemed before maturity by canceling the contract if the parties agree. In this case, the purchaser gets his/her money back without any increment or reduction.

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

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

It should be remembered that in both *Salam* certificates and *istisna'* coupons, government acquires funds at present and bears indebtedness in terms of real goods. On the other hand, unlike ownership-based financing, the use of proceeds of these forms 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 unrelated to the production of sold goods, current budget deficit, balance of payment deficit and what not.

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

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specification of commodity; 5) determination of quantity; 6) ability of delivery; and 7) exchange of price and commodity should be permissible from the point of view of prohibition of *riba*. See for instance Abd al Halim Muhammad Umar, Al 'Itar al Shar'i wa al Muhasabi li Bay' al Salam, IRTI, 1992, and other *fiqh* books for details of these conditions.

is feasible for the issuing body.

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

Public utility warrants

Finally, a special kind of debt-based financing arrangement may be suggested to finance public sector utilities. This arrangement is a combination of a recurrent supply agreement [*istijrar]* combined with some of the features of *salam*. Provided *Shari'ah* permits a utility public-sector corporation may contract its consumers to sell 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 corporation that provides the concerned utility for which electricity, water, or telephone warrants may be issued and used for payment of these utilities at locations determined by warrant holders.[49] Warrants are not negotiable and theirs proceeds may be used at the debtor's own discretion. They may be redeemed before receiving the services at face value by mutual agreement, and at partial face value in proportion to the residual of the service unreceived.

***Ijarah* bonds**

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49 It is worth mentioning that these utility warrants represent a financing arrangement between the producer and the consumer of utilities and can be used by public-sector providers of utilities as well as private sector as long as the relationship is between the producer/seller and the consumer. But if the relation is made three way in which the provider/seller is different from the user of finance, it becomes similar to *bay' al inah* which is prohibited by the majority of *fuqaha'*.

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

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

B - LOAN BASED FINANCING

Two kinds of public loan bonds may be mentioned: 1) foreign currency bonds which invoke the incentive of protection of one's wealth against devaluation and, to a certain extent, inflation (at least in many developing countries where domestic rate of inflation is higher than inflation abroad); and 2) bonds issued on the basis of appealing to patriotic and religious sentiments of private citizens.

Foreign currency bonds

These bonds are issued against foreign currency loans to the government. They may be used when local currency is expected to 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, as it is presumed that this foreign currency is more stable than domestic currency. Thus, foreign-currency bonds give protection against devaluation of domestic currency and against inflation.

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

Benevolent bonds

It may be possible sometimes to find a reasonable response to the appeal for lending the government by invoking the sentiments of loving one's country and protecting and promoting the religious values and principles it stands for. After all, the Islamic system has a strong built-in mechanism to promote voluntary contributions by tying them to good deed and to appeasing to God and saving for one's hereafter. If the Qur'an calls on people to sacrifice their lives for helping the *ummah*, why not also sacrificing one's wealth especially if it is sought only on a borrowing 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 to refund. Forced loans may be sorted according to sources of funds as: loans from individuals and non banking corporations, loans from commercial banks and loans from the central bank. *Shari'ah* permissibility of payment of certain return on public loans has been raised in some quarters[50], and a debate was carried over about the return of treasury bonds and other government saving schemes[51].

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50 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.

51 Like the debate raised in Cairo in 1989/1990 on investment certificates which contraused the

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

To answer these points it should be noticed that *riba* is a matter of inter-personal transactions, i.e., whenever there are no transactions between different entities the prohibition of *riba* does not apply. Thus if giving or taking (principal and any increment) is merely an internal arrangement within the same financial entity, the question of *riba* does not arise. Hence, the issue that there is no *riba* between a slave and his master falls in its right place because the master owns the slave's wealth.[52]

In the same context, some argue that a father has a free hand on the wealth of his son and therefore *riba* prohibition does not apply between them. *riba* does not apply between a father and his son since the father can take (give) any thing from (to) the wealth of his children.[53] Here again, the argument is based on the assumption that a father has a free hand on his son's wealth[54], not on the relaxation of the *riba* prohibition.

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publication of many newspapers' articles and several books.

52 Since the master owns his/her slave along with any property the slave might own.

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

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

Consequently, since individuals are legally and financially independent of the government, 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* prohibition must also apply between this entity and other governmental entities, but if the government and all corporations it owns represent one single legal entity, the use of any fixed rate in calculation, evaluation, or allocation of funds within the finance of this single entity is not *riba.*[55]

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

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

Additionally, such 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 inflicted damage. Obviously, this is not the case in interest-based public debt. Consequently, inflation can't be used as a pretext for violating the rule of *riba* prohibition. The

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55 Sami Homoud, in Tatwir al A'mal al Masrafyyah, pp 200-205, emphasized the separation of legal entity (*al thimmah al malyyah*) in the prohibition of *riba* between a master and his/her slave, especially that according to Ibn Hasm such separation is what justifies the conclusion of contracts between these parties; otherwise contracts become redundant. However, it may also be argued that what matter is ownership only, so that as long as the owner of different corporation is one, *riba* prohibition does not apply.

OIC Islamic Fiqh Academy issued an opinion on this subject stating that charging the debtor to compensate for inflation-caused damage to creditor is not compatible with *Shari'ah*.[56]

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

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56 Decision No. 4 of Session No. 5 of the Islamic Fiqh Academy.