ZAKAH AND PROHIBITION OF RIBA IN THE ISLAMIC ECONOMIC SYSTEM

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Z A K A H

Zakah is a special annual contribution-cum-worship. It is levied on the total personal net worth of an individual Muslim. It is to be collected by the state and spent for specific purposes, primarily the several types of social insurance. Ordinarily, government expenditures should not be met by *Zakah* funds. *Zakah* is due on almost on all types of wealth and income including savings added during the year as long as the beginning-of-the-year stock is above the exempted minimum. It is assessed on net worth at a fixed percentage which varies according to the type of wealth or income. *Zakah* covers agricultural products, industry, money and finance, commerce and mining and no exemption is given to non productive assets.

Besides being the third pillar of religion which provides it with a spiritual backing and support, the above mentioned characteristics give *Zakah* a pivotal role in the Islamic macro economic system. It is assessed on the net worth, whether this net worth is used in productive activities, kept idle, or even spent for luxuries[3]. *Zakah* influences (a) the non-productive means of production, (b) the allocation of productive wealth among alternative uses, (c) the allocation of income between expenditure and saving, (d) the allocation of savings between productive uses and durable luxury goods, and (e) the long-run redistribution of wealth.

Before proceeding to analyze each of these effects, a few important observations are worth mentioning :

(i) while bullion, money (paper, coins and bank deposits), and debts on others are included in the zakatable net worth, agricultural land is not;

(ii) public property is not subject to *Zakah* since it is exclusively designed to serve the public interests of the whole community including its social welfare objectives;

(iii) the fixed percentage has been set by the Prophet, peace be on him, at 2.5 per cent (or some equivalent in case of cattle) for all kinds of net worth, except the flow of agricultural products where the percentage is 5 or 10 per cent depending on whether the land is irrigated by rain or by hand (we must keep in mind that there is no *Zakah* on land), and *Zakah* on extraction industry where the rate is 20% of the output;

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3 A small number of jurists exempt some types of luxuries such as women's jewelry whereas other gold and silver ornament and decoration objects are unanimously Zakatable.

(iv) the percentage of *Zakah* is independent of income, which may be positive or negative, as long as the net worth at the end of the year is above the minimum exempted level;

(v) *Zakah* is to be given to a person who deserves it, say a poor so that he/she becomes the owner of it, and

(vi) the payment of *Zakah* is obligatory on net worth and not on total wealth, i.e, debts due to other parties are deductible so are losses incurred during the year; and

(vii) the fiscal year of *Zakah* in lunar not solar. Therefore, to convert to solar, a proportional increase in its rates is necessary.

a) *Effect of* Zakah *on the allocation of productive wealth:*

The marginal profitability of capital (MPK) for the private sector should not normally go below the effective percentage required to keep net worth non-decreasing. This percentage is 2.564[4] This is clarified in Figure 1. The equilibrium level of capital invested by the private sector is at K_e with MPK equalling Z. At this level of capital any capital increment does not bring sufficient return to justify its addition to the stock of capital and a better form of investment must be opted if the owner of capital would like to keep his/her principal not declining. In other words, those industries whose MPK is below Z do not represent a good choice to investors. Rational investors prefer to seek other industries whose MPK is still above Z.

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4 Let this effective percentage be Z, then:

$$(1 + Z) - 0.025\ (1+Z) = 1$$
$$0.975\ Z = 0.025$$
$$Z = 0.025/0.975 = 0.02564$$

What will happen if MPK went below Z in certain industries ? First of all, new investment funds fly away to other industries where the MPK is still above the effectrive rate of *Zakah*, Z. The increase of investment in those industries reduces their MPK to Z. This process may continue as long as MPK is above zero because all points at which MPK > 0 promise investors higher net worth should they decide to invest instead of leaving their funds idle. Assuming every other thing is constant including technology which affects capital profitability, if such conditions continue investment would continue until MPK becomes equal to zero in all industries. At this point, *Zakah* burden on newly invested funds becomes equal to its burden on idle funds. This does not justify any *Zakah* inducement to investors. Consequently, the choice available to income earners at this point becomes between consumption and saving as they would be indifferent with regard to investing their savings or leaving them idle.

On the other hand, when MPK is equal to zero, the APK remains positive. This means that already existing stock of capital is still profitable. APK may take a value Z depending on its slope at the point of MPK = zero. If APK is equal to, or less than, Z there will be no incentive to replace obsolete or used up capital because any such replacement would not bring the owner the satisfaction of maintaining his/her wealth intact. This emphasizes that gross investment is more relevant to the present analysis than net investment. The same conclusion can be obtained by studying the different effects of a tax on income and a tax on net worth which is closer to *Zakah*.

The previous analysis does not apply to the public sector which is exempted from *Zakah*. This allows it to invest at MPK lower than the private sector's MPK and to apply conventional marginal analysis. This allows the public sector to consider zero as the minimum level of profitability.

Public sector is therefore encouraged to invest in less profitable projects not only through the traditional argument that government is not a profit-seeker, but also the by fact that it is exempted from paying Zakah.

In the preceding discussion I used the term "profitability of capital", which is very different from the conventional efficiency of capital; the former refers to the share of capital in the 'monetarized production' which will be schematized in section V of this chapter. This share plus the share of the working partner constitute the rate of return on capital in conventional analysis. In this chapter the latter is called the rate of profitability of the firm.

b) Effect of Zakah on Idle Wealth:

The characteristics of Zakah mentioned above and the fact that exempted minimum level is very small (equivalent of 12 British gold sovereigns)[5] imply that whoever keeps his/their wealth idle instead of investing it would lose one-fourth of his/their wealth in less than twelve years.[6] Hence the Prophet (Pbuh) urged his community to invest the wealth of orphans and he justified his recommendation by the argument that Zakah would eat up or consume wealth if it is not productively invested.[7] This point has claimed the attention of many Muslim writers from the late 1940's till now. M.S.A. Irshad comments "Le monde n'apas connu d'autre systeme

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5 As estimated by Muhammad Abu-Zahra in his article on Riba published in Al-Mu'tamar al-Thani li-Majma' l-Buhuth l-Islamiyah, Papers and Proceedings, Cairo, May 1965. This equals US$ 400-500 at 1988 prices of gold.

6 In a simple equation the residual after payment of Zakah is equal to original principal K times $(1-Z)^n$ where n is the number of years. By solving this equation one gets the following:

% of Loss	No. of Years
one-tenth	less than 5
one-fourth	less than 12
one-half	less than 28
three-fourths	less than 55
90%	less than 100

The time path of non-productive wealth is asymptotically convergent to the minimum level as shown below:

7 Majma' al-Buhuth al-Islamiyah, ibid., p. 159.

economique lequel a dissout le probleme de l'argent accumule' qui demeur sterile et refuse le bien etre qu'il peut fournire a la Societe.[8] Abdul Mannan considers Zakah as the uncompromising penalty for hoarding because "it checks the tendency to hoard idle cash resources and provides a powerful stimulus for investing these idle stocks".[9]

One may add that Zakah penalizes not only "l'argent sterile" or "idle cash resources" but all idled means of production as well if one adopts a more liberal yet genuine position with regards to zakatability of fixed assets. In this manner Zakah deals with "waiting and unused resources" and tries to put them back into economic activity either in terms of means production as an increased capacity or in terms of transferring them for consumption purposes as an increase in demand for consumption goods. In both cases society benefits from them a lot more than if they mere left idle.

The low minimum exempted level is of special significance in the drive toward productive investment inculcated in Zakah. In brief, the obligation of Zakah helps to incorporate every bit of wealth into productive activity by penalizing all forms waiting material resources.

c. The effect of Zakah on the allocation of income:

This effect can be easily traced. Let us take an overly simplified example. Suppose that the APK in a given firm is 10%. This means that Zakah due on the firm's owners is 2.75% of its capital, i.e. 2.5% X 1.1 because Zakah is levied on the principal and its return together. Consequently, a saving ratio of 27.5% out of the income of the firms owners is needed to maintain a non-decreasing wealth. The selfish drive of maintaining one's wealth either increasing or at least non-decreasing requires that every individual should merge, at any practical level, the decision of income allocation with that of savings utilization, because the passing of

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8 Mo'tamar al- 'Alam al-Islami, op. cit., p. 68. The quote means "the world never knew of any other economic system which solves the problem of funds that remain idle and refuse to contribute to the welfare of society".

9 M.A. Mannan, op. cit., pp. 220-221.

any time interval between these two decisions is, in fact, penalized on a proportional basis. Therefore, the opportunity to invest becomes a direct element in income allocation decision.

An example will help clarify the merging effect of Zakah on saving and investment decisions: one may abstain from consumption today in order to increase one's wealth. To increase net wealth at the end of the year, one should expect an increase in one's gross wealth (before Zakah) equalling at least Z plus one's preference of today over tomorrow.[10] Avoidance of savings erosion by Zakah does not mean seeking higher rate of interest simply because interest cannot, by law, exceed zero. To avoid a reduction in net wealth, income earners would think of investment opportunities at the time of allocating their income between consumption and saving. At the same time, they try to minimize the time span between saving and investment. On the aggregate level, this effect is increased further by a low exemption criterion.

A low Zakatability criterion means that most income earners are subject to Zakah. This makes the decision as to whether to save and invest the concern of almost every wage earner in the society. As Shaikh Mahmud Ahmad puts it: "Islam suggests two alternative channels to which surplus wealth should be directed, either spending that wealth on comforts of live or investing it in productive activity."[11]

The previous analysis emphasizes the economic effects of Zakah on the Zakah payer. This can be summed up as an: a) upward shift in the saving function of the individual, 2) further upward shift when aggregating, and, 3) a tighter relation between saving and investment decisions.

We will now take a look at the effects of Zakah on its recipient. We will use this occasion to recall that Zakah is a function of local government, as this term is understood in the

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10 If prices are expected to be constant. Anticipated inflation would increase current saving, reduce time span between saving and investment and tilt investment towards inflation-protective assets.

11 Shaikh Mahmud Ahmad, op. cit., p. 88.

United States, as long as the local government is able to spend it in the eight categories of expenditures specified in the Holy Qur'an, (9:60), whose order of hierarchy is some what flexible and subject to the norms and standards of the society and its representative administration.

Four of the eight categories, on which Zakah can be spent relate to socio-economic insurance and welfare of recipients. These are: poor, needy, travellers and those who are in debt.[12] A fifth category is sufficiently general, to include every activity which can be classified as good or beneficial to the society by the Islamic criteria. The sixth category is intended to improve the morals and behavior of individuals who are weak or have aggressive tendencies, and the seventh is a translation into action of the understanding and practice of personal freedom, that is, to spend for the ransoming of captives or the manumission of slaves. The eighth category is the financing of the activities of the Zakah administration and its employees.

Spending Zakah is not limited to short-term provision of recipients' necessities. Most Islamic writers make special emphasis on enriching the poor and needy by providing them with means of production and circulating capital, skills, training and employment, in order to raise their earned income, together with the necessary short-term consumer goods, transport, residential facilities, etc.

There is no special injunction concerning the form of distribution of Zakah funds. Zakah may be distributed in the form of cash, claims on consumer goods such as food stamps, or real goods and services.

The only limit which one can see is that imposed by the minimum exempted level. The general rule is that "one who pays Zakah is not eligible to receive it". The minimum exempted level is conceived in terms of a stock of wealth remaining over a period of one year. It has little to do with the size of income flow or with transaction demand for means of payments (as

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[12] The last category is especially significant in relation to providing confidence for economic transactions. This will be discussed later.

comprehended from Baumol analysis),[13] which is exhausted by the end of the income period. It is the stock of wealth, remaining unchanged over a period of one full year, in excess of what is commonly accepted by the society as non-luxurious durable consumer goods. In other words, all non-luxurious durables[14] used by a household are excluded from the definition of net worth as far as the imposition of Zakah is concerned. The minimum exempted level of net worth as defined above is what is usually referred to as Nisab. Any of the first four recipient categories looses eligibility to receive Zakah if he/she possesses Nisab during a full continuous year, no matter how high one's income may be. In other words, in order to qualify to receive Zakah, one should have spent whatever one has above Nisab. Then any shortage of one's income below the minimum standard of living is paid by the Fund of Zakah. Finally, payments from the Zakah funds are not limited by the amount equivalent to Nisab. The poor may be given as much as needed to satisfy his/her needs and/or to be furnished with ability to earn income sufficient to pay for future needs.

The previous discussion leads to the conclusion that Zakah does not decrease the aggregate demand and may even increase it, depending on the shape of the consumption function we adopt and on the allocation of the Zakah funds. This conclusion is supported by requiring that funds should be distributed during the collection year and no leftover is allowed.

The allocation of the aggregate demand created by Zakah, between investment and consumption goods, is left to the executive authority to manage according the actual economic conditions at the time and the goals of the economic policy.[15]

d. Effects of Zakah on allocation of savings betwen investment and durable luxury goods:

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13 See D.E.W. Laidler, The Demand for Money: Theories and Evidence, Scranton, Pa.: International Textbook Company, 1969.

14 This is socially and culturally determined.

15 See economic policy late in this part.

As we have seen Zakah is not imposed on non-luxury durable goods. However, when savings are converted into luxurious durables, they are considered idle and become subject to Zakah accordingly. What constitutes luxury is socially and culturally determined. Additionally, Islam does not approve some uses of wealth which may be approved by other communities. For example, the use of precious metals for household decoration and utensils is prohibited as mentioned in several sayings of the Prophet (Pbuh).

Moreover, hoarding is also prohibited. The Qur'an reads:

"And there are those who bury gold and silver and do not spend it in the way of Allah. Announce to them a most grievous penalty on the Day when heat will be produced out of that (wealth) in the fire of Hell, and with it will be branded their foreheads, their flanks and their backs.-- 'This is the (treasure) which you buried for yourselves. Taste, then of the (treasures) you buried'"

e. Effects on long-term distribution of wealth and income:

Zakah affects the long-term distribution of wealth and income in the direction of equalitarian conditions. Business on any micro level is subject to losses and gains. Since Zakah is levied on the net worth which exceeds the exempted minimum without any consideration of business losses, it can be mathematically proved that, at any given moment, those who are presently affluent will not be able to maintain the same level of wealth over a long period of time as long as the probability of losing is not negligible. This depends on the rates of expected profit and expected loss, the probability of the occurrence of losses, and the constant rate of Zakah. The positive effect on the redistribution of wealth is significant. This will be evident if we recall two characteristics of Zakah. First, the funds are to be distributed among the deserving categories, i.e., not kept in the Zakah Fund.[16] Second, the amount given to each poor person is

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[16] Some writers have argued that the Zakah Fund is allowed to initiate productive project, keeping their ownership in its possession and providing employment and then income to the poor and the needy. What these writers have missed, I think, is that such a process will undoubtedly result in the Zakah Funds owning all the means of production in the long run,

not limited by Nisab i.e., the recipient may be given an amount which meets his/her needs according to the current standard of living of the community, with the intention of improving the poor's capacity for earning so that he/she can move out of the Zakah recipient's group. This shows that Zakah tends toward egalitarian distribution of wealth, and that, as a result of Zakah, wealth always keeps circulating.[17] This characterizes the dynamics of the Islamic economy and is deeply rooted in the Islamic conception of social welfare.

The short-term distribution of income is more apparent. It is simply accomplished whenever the distribution of Zakah is achieved by means of cash, consumption goods or capital goods.

Finally the principal difference between Zakah and taxes is that Zakah is an integral part of the Islamic system, while taxation is merely a devise for public revenues and policy. All taxes are left in the hands of policy makers, whose authority is very limited as far as Zakah is concerned.

Additionally, the inducements underlying Zakah and taxes are not the same. Zakah is supported by the moral and religious incentive which is made strong to the extent that Zakah is considered the third pillar of Islam, so that it is just as clear and binding an obligation on Muslims as is the obligation of prayer. At the same time, Zakah is also enforced by law. Other taxes are usually supported by the latter only, without the existence of any religious motivation or injunction.

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which is by no means the intention of Islamic system. It will also result in the elimination of that part of the Zakah money itself which is levied on the wealth of the Zakah Fund. This of course does not imply that the Zakah Fund should be kept from helping the poor to get the benefit of large-scale production on the basis of the worker-shareholder principle.

[17] The egalitarian effect of Zakah is supported by Islamic inheritance system which fragments large estates and bequeathes.

Prohibition of Riba

Riba, as understood from the Qur'an, is any payment imposed in excess of the principal of a loan.[18] It also includes, as a corollary, the excess in quantity in a barter exchange of the same commodity, e. g., 12 for 10 pounds of wheat. It is immaterial whether excess can be justified by quality differential or not.[19] *Riba* is unequivocally prohibited in the Qur'an and *Sunnah*. There is no dispute whatsoever about this in the Islamic literature, ancient or modern. This implies that two types of transactions are excluded from the Islamic system: first, interest on loans, and second, barter exchange of the same commodity of different qualities. In this section we will consider the first type only.

Before undertaking an economic analysis of the interest-free economy of Islam, we should look into a definitional gap of *Riba* that exists between radical and modern writers. The dispute is focused upon two points: whether there is any difference between consumption and production loans with regard to the prohibition of interest, and whether the rate of interest makes an effect on the prohibition. These two points are merely a reflection of a basic question which is, Shall Muslims accept the *status quo* (i. e. banking with interest) which prevails in Muslim countries today, or is this *status quo* as a whole, un-Islamic, requiring replacement by an Islamic system. In these discussions outside observers can easily trace the political affiliation of different writers, especially on issues related to nationalisation of commercial banks or the government benefits from post office saving deposits.

Some writers argue that prohibition of interest is restricted to the interest on consumption

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18 Muhammad Abu-Zahrah. Buhuthun fi-al Riba. Beirut: Dar al-Buhuth al-Islamiyah, 1970, pp. 28-30.

19 Sayed Qutb. Tafsir 'Ayat al-Riba. Beirut: Dar al-Buhuth al-Islamiyah, no date. pp 22-23. Some writers have argued for the inclusion of this increment in exchange into the definition of *Riba.*

loans and does not apply to production loans on the basis that the former constitutes an exploitation of the needy and contradicts the spirit of Islam. On the other hand, it is argued that lending for production represents a form of cooperation between lender and borrower to increase the utility of wealth and they both should share that increase and that interest payment is the share of lender. It is also argued in productive loans, the lender, (i. e., the saver), is economically a weaker party in the contract and the borrower is economically stronger. This is in contrast to the case of consumption loans to the needy.[20]

In rejecting this view M. A. al-'Arabi argues that it is more likely what has been forbidden in the Qur'an is really interest on production loans, since this was the pillar of trade in Makkah at the time of the Prophet, (pbuh).[21] Moreover, the prohibition of interest is part of an economic system based on the fundamental teachings of Islam rather than simply a moral injunction which happens not to fit in with the situation in Muslim countries today, which itself is inherited from the colonial era.[22] Other writers on the subject have rejected this position based on the fact that Islam is a system for organizing human life in all its aspects. They argue that interest on production loan disturbs the internal harmony of the Islamic economic system, which can only function in a consistent manner without interest.

The argument concerning the distinction between interest and usury in the late Middle Ages in Europe had its impact on some writers. They use it to distinguish between *Riba* and interest. They claim that *Riba* is usury while interest is not regarded as *Riba* as long as its rate is not usuriously high. This claim does not deserve serious attention because it contradicts the text of the Qur'an itself. The Qur'an categorically mentions that at the due date of a loan, the lender is

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[20] Abdul-Rasul; op. cit., pp. 81-88.

[21] Muhammad 'Abdullah al-'Arabi: *Al-Nizam al-Iqtisadi*, Cairo: Ma'had al-Dirasat al-Islamiyah, 1967, pp. 4-8.

[22] Muhammd Abu-Zahrah, *Tahrim al-Riba Tanzim Iqtisadi*, Kuwait: Maktabat al-Manar, no date, pp. 58-59.

only permitted to receive his/her principal without any addition.[23] Actually, the distinction between *Riba* and interest does not have any theoretical base. It is merely a pragmatic attempt to colour as 'Islamic' un-Islamic situations existing today in many Muslim countries.

Interest, Rent and Capital

Earlier in this study, an attempt was made to clarify the Islamic concept of capital by showing the difference between capital as the material goods used in producing other goods and services, which is a real phenomenon, and loan as a monetary phenomenon. The 'rent of the machine'[24] denotes the price of capital, while interest constitutes a duty imposed on the borrower. This distinction implies a difference between the capital market, which is a long-term market, and the monetary market, which may be long or short-term. A confusion arises here because of the conventional use of the term 'capital' in a broad sense, for we always hear of short-term and long-term capital movements to describe monetary movements.

It is true that money buys goods, whether producer's or consumer's (conversely goods by money), but it is also true that it buys labour and land as well. If we allow ourselves to identify rent on capital with interest on borrowed money because money buys machines, we should, by the same analogy, identify interest with wage of labour and rent of land. Claiming that other factors of production have their own units of measurement, namely, man hour and acre, while capital does not, is no way out because we can also use machine as a unit of capital.

Moreover, it is also true that money is productive in the sense that the introduction of money in a barter economy reduces the ratio of inventories of both final output and factors of

[23] The Qur'an, Verse 2:279.

[24] 'Rent' is not intended here to convey the meaning of purely economic rent extracted by the more efficient units because the reward on the last machine, assumed to be the less efficient, which is equal to its marginal productivity under the set of conditions of perfect competition, determines the rental price per machine. What is meant by 'rent' in this section is the rental price itself rather thatn the economic rent.

production at any level of economic activity of the producer. This in turn increases the efficiency of a given collection of factors of production. Therefore while its basic function is to facilitate the exchange of the goods and factors of production, money is productive because it increases the productivity of all producers in the economy. Thus money affects the production function but does not enter into it as a factor of production, making it similar in this respect to technology.

In the Islamic literature, one can hardly find any distinction between hoarding and saving. Both are considered as one and the same thing. Additionally, it is hard to distinguish between income saved and concealed under the ground and income saved and hidden in a bank's vault as long as it is not put into a production process. The mere act of saving and depositing in a bank is an economically-negative action. Therefore, it should be penalized, not rewarded, and this is actually the case in the Islamic economic system. From economic point of view, injecting these savings into a production process as new capital, is the real productive action. This action should be rewarded, and so it is in Islam. The action of transforming savings into investment may be done either by savers or by other businessmean with or without financial intermediaries such as Islamic Banks. When investment is done by other than owner of savings, it takes the form of a legal contract called *Qirad* or *Mudarabah*. The two terms are substitutes[25]. The reward of *Qirad* will be called 'profishare' in this study.[26]

It is essential to be clear about the distinction between interest and profishare. The mere act of saving goes without any reward if we adopt the idea of profishare and is rewarded if interest is accepted. Saving is therefore distinguished from the act of committing savings into factors of production whose reward in Islamic economy is profishare.

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25 Hereafter, I will use the first term because some writers use the second as a translation of the term "speculation". This usage can save us from confusion in the literature.

26 "Profishare" is coined from "share of profit".

In other words, interest is earned by savers and profishare is earned by owners of monetary resources which are transformed to productive assets provided the latter produces a real net value added. While interest allows saving and investment to be separated from each other and made at two different stages, profishare links them together by the very fact of not allowing savings alone to earn any reward. To reinforce this effect, savings are not only deprived from interest (prohibition of *Riba*) but also penalized by the imposition of *Zakah.*

Qirad

Qirad is a sort of partnership between owners of monetary assets and businessmen. It is an Islamic mechanism for injecting monetary assets in production activity by transforming them into real factors of production by a joint effort of the owner of these assets, who is known as *Rabb al Mal*, and the entrepreneur. The reward of the first party, profishare, is calculated as a predetermined percentage of the total profit of the project; the remainder of this total - call it profit - is the reward of the entrepreneur. The crucial difference between profishare and interest charged on business loans is that the latter is a fixed burden on the firm, while the former is a share of the net return of the project which fluctuates with the fluctuations of the real results of the activities of the firm. Hence, as a partner, the *Rabb al Mal* has a direct interest and real concern in the activity of the firm, although he/she does not participate in the daily decision making. The *Rabb al Mal* is interested in the profitability of the firm because his/her profishare is a positive function of this profitability. Therefore, *Rabb al Mal* always seeks maximum efficiency of the firm. On the other hand, all the concern of an interest-earner lies in his/her own income, which does not depend in any way on the degree of efficiency with which it is used. Thus the goal of the *rabb al Mal* is consistent with the goal of the entrepreneur, while there is no internal consistency between the objective of the interest-earner and that of the entrepreneur.

Moreover, in allocating financing between different projects *Rabb al Mal* would be interested in the most efficient and most qualified entrepreneur as well as the most profitable project while the interest earner would focus on the best guarantees and security of principal and interest income.

Additionally, profishare is a long-term phenomenon in which the preference for liquid assets is almost negligible, whereas interest is both a short and long-term phenomenon. Economic thought has not yet provided an acceptable theory for explaining interest and its term structure, although there is undoubtedly some interaction between short-term and long-term rates of interest. The short-term fluctuations in interest exercise pressure on long-term investment by means of this duality in the nature of interest. Herein lies the substance ofthe Keynesian argument of the effect of interest rate on investment. For profishare, there are no short-term changes in the reward of *Rabb al Mal*. The ex-post results of firms and real profishare are declared at the end of each production period. Any difference between expected and actual returns may influence future investment through its effect on the expected rate of return. One source of long-term fluctuation is thereby eliminated, namely, variation in short-term interest rate. This suggests that liquidity preference and short-term changes in business activity have lesser influence on investment in Islamic economy than in an interest-based economy.

Theoretically, *Qirad* has a dual basis; namely, the principle of constancy of ownership and the principle of cooperation. The principle of constancy of ownership implies that the *Rabb al Mal* has full claim over his/her monetary assets, new assets exchanged for them and the increment stemming from the growth of these assets brought about by labor applied to them by the entrepreneur. The principle of co-operation implies that since the two parties, have shared the elements that create the project, capital and labor, and the interests in it, they must also share its fruits in the full sense of the word 'share'. The true meaning of sharing cannot be realized by assigning a fixed return to one party regardless of what is left tothe other. Sharing requires that realized net return be equitably distributed between the *Rabb al Mal* and the entrepreneur.

On the other hand, the theoretical difference between profishare and rent of machine is that in the former the *Rabb al Mal* is committed to a project as a whole unit, while in the latter the machine owner is committed to the machine. The machine owner is an independent entrepreneur working on the same basis as producers of raw materials and other inputs. Thus, the real difference between the *Rabb al Mal* and the leased machine owner lies in the degree of commitment to the project at hand.

Qirad is thus an Islamic alternative of interest in bringing together the entrepreneur and the owner of monetary assets. It is the solution which co-ordinates the interests of the two parties and fits the objectives of the Islamic system.

Money and Monetary Authority

To introduce this topic, let us consider the second type of Riba which prohibits the exchange of a commodity for a different quantity of the same.[27] While rejecting this sort of barter exchange, the Prophet (pbuh) did not deny the possibility of differences in quality. However, it is evident from those sayings of his which allow such an exchange only if it is split into two transactions, carried out with money in between, that qualitative differences are valued.[28] Consequently, the prohibition of the exchange kind of riba implies that differences in quality are difficult to estimate without the use of a common denominator such as money.

Barter may inject an element of injustice in transactions, and the 'demoralizing' effect it creates probably led to its rejection by the Prophet (pbuh). In stating that this kind of exchange would be permissible if it is carried out with the help of money as a medium of exchange, the Prophet was in part laying down an economic system on a monetary rather than barter basis.[29]

The issuance of money has attracted the attention of most writers in the field of Islamic

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[27] According to Islamic jurisprudence, such a transaction is forbidden even though there might be differences in the quality.

[28] Zaidan Abul-Makarim. *Mathhab Ibn Abbas fi al-Riba*, Cairo: Dar al-Ittihad al-Arabi lit-Tiba'ah, 1972, pp.49-50.

[29] Abul-Makarim, *ibid*, could not see this meaning in the Prophet's saying (pbuh) therefore, he unjustifiably rejected it.

economics during the last twenty-five years. It is considered as an element of political sovereignty of the state. That the state should be the only authority which can issue money is not disputed in both ancient and contemporary Islamic writings. This privilege cannot be conferred to any private party or a franchise under any circumstances. The issuance of currency and the creation of demand deposits must both be included in this authority.[30] Commercial banks are able to create demand deposits only because of public confidence in the system and general strength and stability of the economy. This implies that this activity should be managed by the government and not by any private party because its justification are not owned or created by commercial banks. By credit creation, Banks really sell what they do not own.[31] Moreover, there is an important principle in Islamic jurisprudence which implies that whenever the interests of too many people are involved the government should take charge in order to promote and protect these interests vis a vis private interests. When certain undertakings cannot be left to the public to do them on their own either because of its nature or because of the investment requirements involved, such projects should be taken up by the government only. This principle is mentioned in one of the saying of the of the Prophet (pbuh).[32]

Since the creation of money affects all member of the society it must not be left to private parties. Therefore, commercial banks should not be permitted to create money. This activity must be monopolized by the government. Additionally, in an Islamic society issuance of money, whether in form of currency or demand deposits cannot be a function of the interest rate simply because interest is banned by law. Both currency and credit become direct tools of economic policy, and neither of them is to be determined by any private interest.

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[30] Isa Abduh, *Bunuk Bila Fawa'id* Volume I. Beirut: Dar al-Fath, 1970, pp.35-6.

[31] Monzer Kahf. "Contemporary Challenges to Islamic Economists", paper presented at the first National Conference of the Association of Muslim Social Scientists, Chicago, June 2-5, 1972, p.6.

[32] Al-Mubarak: *op. cit*. p. 104.

Functions of Money

In Islamic economic literature, money is discussed as a medium of transaction, i.e., a means of payments, a standard for evaluating goods and services, a measure of future values, and a store of value. Money is c;ear;y distinguished from goods. Consequently, the Patinkin's argument concerning money may be criticized on two grounds: first, his assertion that "money buys goods but goods do not buy money", i. e. money is not a "full tool" of exchange in the economy; and second in his model, he has considered money the (n + 1) good, which implies that money is a good like other goods. Hence his model includes cross transactions between goods and goods on the same ground as between money and goods.

In a monetary economy there is two-way traffic between goods on one hand and money on the other, but there are no cross transactions between goods themselves. In other words, goods are exchanged for money and money for goods but goods are not exchanged for goods.

The immediate result of the use of money as a measure of pricing is the effect of its quantity on transactions. This has been of concern in Islamic literature both ancient and modern. The effects on price instablity of quantity of money arise from three sources. First, the creation of new money, mainly inside money (Bank's current acounts) by the banking system. This increases the quantity of money in the economy and cause an upward shift in prices. The role of the banking sector in creating credit is restricted under the Islamic economic system by relating both kinds of money (inside and outside monies) to the government and by eliminating interest whicht is an essential motive for the multiplication of inside money. The unstabilizing effect of changes in demand deposits is one of the main arguments given to defend the proposition of 100 % reserve requirement in the free market system as well as in the Islamic economic system. However, in both systems the government's economic policy itself may be the most important source of changes in the supply of inside and outside money.

Second, the withholding of money (saving-cum-hoarding) by not using it in investment exersice a downward pressure on economic activity. Imbalance between saving and investment is a major reason of economic fluctuations. Through the price signal, these fluctuations reduces demand for consumtion. If investment does not sufficiently increase to close the gap in aggregate demand either prices or aggregate supply must go down. In Islamic economy. saving without using one's savings in investment is considered sinful and economically bad practice. It is not rewarded as no interest is allowed. On the contrary, it is penalized as *Zakah* is levied.

The third source of price fluctuations lies in the inability of money supply to cope with the growth in economic activityduring booms.[33] In all economic systems (Islamic, free market and mixed), government policy is supposed to maintain balance between supply of and demand for money. In other words, main purpose of the economic policy derived from government management of both outside and inside money is to maintain consistency between money supply and economic activities.

It is worth noticing that some Islamic writers have overemphasized the role of money as a tool for facilitating transactions and have overlooked its use as a provision for the future or a store of nature. Holding certain reserves for unforseen future is referred to in several sayings of the Prophet (pbuh) such as those that urge people to make provision for one year. The use of money as a store of value is also implicit in the idea of *Nisab*. *Nisab* implies a *Zakah* exemption of money holdings that are less than *Nisab*. Granting this exemption is a privilege for holding small amounts of money for a year or more.

Moreover, the yearly condition of zakatability also provides an implicit recognition of the role of money as a store of value. This condition exempts from *zakah* any amount of money that remains in the hands of its owner for less than one full year. In this connection Abu Sa'ud has taken an extreme and unjustified position in claiming that money should be taxed periodically at short intervals so that it maintains a periodically decreasing value.[34] Periodical tax on money does not only affect money held above **Nisab** but also that part which is below it. It also hits money held for transactions purposes, especially that Abu Sa'ud suggests a monthly tax by means of a monthly stamp or coupon. Moreover, this approach involves injustice because it does

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33 Abu-Sa'ud, *op. cit*, p. 20.

34 *Ibid*., pp. 37-48.

not take into account the change of hands during the period and leaves the burden of th stamp on the last holder. It also creates fluctuations in transactions between the beginning and the end of the stamping period. In addition, Abu Sa'ud's proposal discriminates beween monetary and non-monetary assets, whereas *Zakah* rules do not make such a discrimination, as we have seen earlier in this study.

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