A SURVEY OF ISSUES AND A PROGRAMME FOR RESEARCH IN MONETARY AND FISCAL ECONOMICS OF ISLAM

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August 1981

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FOREWORD

The Muslim world is passing through a period of creative tension. The old socio-economic order, structured during the colonial period, has begun to crumble as it is unable to meet the demands of the new situation characterised by independence and urge to establish a society based on the ideals and values of Islam and capable of ensuring self-sustained growth, socio-economic justice and a place of honour and respectability in the comity of nations. Current tension is the natural product of yawning incongruity between the ideal and the existing reality. But this tension is creative as it is spurring the Muslims to resolve the conflict by searching for new solutions and by exploring the possibilities of developing new infrastructures in keeping with their ideals and values and capable of meeting the needs of a modern society. This conflict, and consequently this search for new creative solutions, is greatest in an area of gross and flagrant confrontation between Islam and the modern economy. Islam forbids *riba* categorically, while *riba* constitutes the centre-piece of a *riba* based financial and fiscal system.

There was a time when a section of modernist writers engaged itself in the fruitless exercise of demonstrating that 'interest and *riba* are two different things', 'that *riba* relates to consumption loans and not to commercial and production

loans' or that '*riba* is usury which is different from present day bank interest'. On the basis of these and similar premises they surmised that one should differentiate between the two and as such the Muslims too should accept bank interest as genuine. After a protracted debate the issue is now settled and there is near-consensus among Muslim economists as well as the religious thinkers that Islam prohibits interest in all its forms and that there is no genuine economic or religious justification for differentiating one form of interest from the other.

Islam is opposed to the principle of a fixed pre-determined return on capital, whether used for consumption or productive purposes and whatever be the rate of this pre-determined return, nominal or exorbitant. Islam emphasises that economic cooperation between different agents of production should take place on the principle of risk-sharing, and not on fixed and pre-assured reward for one party and total risk bearing by the other. Islam's critique of interest is a direct demand of its concept of justice and its total condemnation of exploitation in all its forms. This does not mean that there is not to be a price for capital or that zero rate of interest should mean no return to capital. It only means that as far as those consumption loans are concerned which are given to accommodate one another, they should be based on brotherhood, and philanthropy or mutuality and reciprocity and not on any variant of Shylockism. All other loans which are motivated by economic considerations should be on the basis of a joint venture where all parties should equitably share the risk as well as the reward. This provides an alternative basis for the organization of financial and economic relationships and institutions.

The Muslim economists, bankers and policy-makers are presently engaged in the challenging task of developing models of banking and financial institutions which operate on *riba*-free basis. Some tangible progress has been made in

expounding the objectives, characteristics, mechanisms and policy instruments of these *riba*-free institutions. Enough work has been done on the philosophy of the new system, now the economists and bankers are concentrating on developing operational models of the new system. It would be unfair to suggest that all the knotty questions have been answered, but it would also be unrealistic to ignore the valuable work that has been done at the theoretical and practical levels — a work that has paved the way for transition towards the new system.

An important question with which all of us are trying to grapple is: What is the transition path? Some policy-makers are suggesting an over-cautious view with the result that the peripheral changes they are making are unable to initiate the processes of change necessary to transform the system. There should be no doubt that Islam aims at a total transformation of the system. The capitalistic institutions and the whole network of relationships sustained by a set of capitalistic values and motives will have to go. Marginal changes in the system cannot deliver the goods, nor can they fulfil the demands of the Islamic faith and ideals. We have to boldly discard the view that the system can be changed by a few mark-ups and mark downs! The change has to be much more fundamental. It seems that some of the policy makers either lack the vision of total change or are consciously or unconsciously too steeped in the prevailing system that they lack the courage to embark upon a bold but well-thought out programme to change the system in clearly defined phases.

The Muslim economists are of the view that the Islamic economic system, and its sub-system, the Islamic monetary system, is unique, with its own ideals, values, principles, institutions, and set of incentives. It is neither capitalistic nor socialistic. The economic *status quo* of Pakistan and the Muslim world is anti-thetical to the Islamic model and any effort to perpetuate the *status quo* even if in the name of

some 'Islamic reform' is not only destined to fail but would be a betrayal of the ideals of Islam. Abolition of interest is going to be a revolutionary step, as it would entail a new approach to economic enterprise and financial cooperation, resulting in the rise of new institutions and emergence of new relationships strengthened by a new set of motives and values. The final change would be radical, yet it would be achieved gradually. Nonetheless, every dose of reforms has to be large and effective enough to produce some significant change in the desired direction. This is the right strategy for Islamization, otherwise infinitesimally small changes on the periphery are not going to transform the system, nor would the strategy of waiting for the ideal day when total reform can be introduced, is going to lead the country towards any change. Both of these are recipes for the perpetuation of the *status quo* and do not constitute lead to a real agenda for reform.

With these few ideas I have great pleasure in introducing the present study by two of my esteemed young friends and colleagues, Dr. Munawar Iqbal and Dr. Muhammad Fahim Khan. The present study is based on the Seminar on Monetary and Fiscal Economics of Islam held in Islamabad in January 1981 and sponsored jointly by the Planning and Development Division, Government of Pakistan, and the King Abdul Aziz University, Jeddah. This seminar represents a landmark in Muslim economists' search for an Islamic monetary and fiscal system. Dr. Munawar Iqbal and Dr. Fahim Khan, who acted as rapportteurs for the Seminar, have worked hard to dig into the papers and discussions of the Seminar and come out with an illuminating report on the major issues and themes discussed, ideas and insights shared, new contributions made and unresolved questions posed during the Seminar. This study not only brings the substantive contribution of the seminar into sharp focus but is a valuable contribution in its own right as it surveys the whole area of monetary and fiscal economics of Islam, spells

out in a systematic way the answers that Muslim economists have offered to some of the tricky questions, and also identifies some of the major issues on which further thinking and research are needed. I congratulate them on their valuable contribution to this challenging area of Islamic economics. I am sure this study would be of great help to all those who want to understand the present state of the art in simple and candid terms without sacrificing professional rigour. It would also be helpful to all those who want to work in this field, as this study would be of great assistance to them in formulating their research problems so as to address themselves to unresolved issues and avoid repeating what others have said. This is a great service they have rendered to future researchers and this makes the present study indispensable reading for anyone interested in Islamic economics.

We are grateful to the International Centre for Research in Islamic Economics, King Abdul Aziz University, Jeddah, and particularly to its Director, Dr. Ghazi Madani, its Deputy Director, Dr. M. M. Reddadi for sponsoring this study and to Dr. Mohammad Omar Zubair, Dr. Ziauddin Ahmed, Dr. Syed Nawab Haider Naqvi, Dr. Anas Zarqa, Dr. Nejatullah Siddiqi, Dr. M. A. Mannan for their valuable comments and suggestions on an earlier draft of this survey. My thanks are also due to my colleagues in the Institute of Policy Studies for producing this study.

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5 Ramadhan 1401
9th July, 1981

Chapter 1

INTRODUCTION

Monetary and Fiscal Economics is one of the major areas of interest in Islamic economics. If we review the literature on Islamic economics, it is in this area where most of the contributions lie. The emphasis is not misplaced in view of the fact that the abolition of *riba* and the imposition of *Zakah* are the corner-stones of the Islamic economic system. It is certainly true that these two institutions are not the end of Islamic economic reform which is a lengthy and very broad-based process, but there are certain things which serve as catalysts. In the field of economics, the abolition of *riba* and the imposition of *Zakah* are the two most obvious candidates for that role in the long and arduous task of changing the chemistry of the economy of Muslim countries in accordance with the dictates of *Shariah*. Both of these have a clear basis in the text of the Qur'an and hence they have to be implemented without any reservations.

Unfortunately, however, over the past few centuries the degeneration of Muslim societies, the colonial rule, the rise of modern capitalism in the West and its invasion on Muslim countries have undermined the very basis of the Islamic

system. *Zakah* has been replaced by colonial tax-systems and the rate of interest has assumed the position of a foundation stone in all market economies. Western economists like Irving Fisher and Samualson have raised the rate of interest to the status of a divine law and have given it an all-embracing position in the economy.

The recent Islamic resurgence has again brought these institutions into sharp focus. At the same time the serious economic crisis that the capitalist countries experienced during 1930s and again in 1970s have rubbed the glamour off that system. The communist model also failed to improve the lot of countries even at the cost of individual freedom. It is being increasingly realized that the alternative economic system of Islam can not only solve the problems of Muslim countries, but may also set an example for non-Muslim countries to follow.

This is a big challenge to the Muslim economists. We have to ward off the slumber that we have been in for so many centuries and rise to the needs of the occasion. It must be emphasized that Islamic economic system is not capitalism minus interest plus *Zakah,* nor is it a socialistic system after making a few corrections here and there. It has its own distinct and unique features and the Muslim economists must probe into those. That process is already underway. Besides a number of seminars and symposia at national level in many countries, one conference and two seminars have been held at international level to investigate various aspects of the Islamic economic system. The two seminars, Mecca '78 and Islamabad '81, have been addressed to the important question of monetary and fiscal economics of Islam, and have helped in crystalizing ideas on a large number of issues. It is not possible to reach a consensus on all issues but on a number of them the thinking is now well articulated. The areas where further research and dialogue are needed have come to fore and are being actively explored.

In the present monograph we have made an attempt to give a glimpse of the important issues in the field of monetary and fiscal policy. The motivation for writing this monograph came from the Islamabad Seminar which generated a lot of interest in academic as well as government circles. We felt that at this stage it will be highly useful to present a systematic documentation of the important issues in this area in a "digestible" form. This is the objective that we have attempted to achieve in this monograph.

Even though the major input comes from the Islamabad Seminar, an effort has been made to provide a general interpretative survey of the important issues in the field of monetary and fiscal economics of Islam. Since almost all important issues did come up in the Islamabad Seminar, either in papers or in discussions, the papers and views presented in this seminar have been used as the basic framework. In each of the following chapters a synoptic summary on various subjects is presented. The major issues have been picked up from the papers and the discussion thereupon and various opinions on the issues have been assorted and documented. In the interest of a clear presentation and conciseness, the various points of views have not been ascribed to the names in the text (that is being done in the proceedings of the seminar. The names of authors and major discussants also appear in the list given in Annexure 1). The issues on which some degree of consensus was reached as well as the controversies arising out of the discussions have been identified. An effort has been made to bring into sharp focus, issues which require further research and discussions.

The next chapter deals with the monetary structure and policy in an Islamic framework. The functions of money and banking, the institutional structure, the objectives and the instruments of monetary policy are among the issues which form the subject-matter of this chapter. In Chapter 3 the

experience of interest-free banking has been reviewed. A strategy for the implementation of the new system has been proposed and the performance of the existing Islamic banks in various countries has been assessed. Chapter 4 deals with the fiscal policy in an Islamic economy. The scope of fiscal policy in general and of a taxation policy in particular has been investigated. The objectives of Islamic fiscal policy have been highlighted and the mechanism for their achievement laid out. In Chapter 5 the various aspects of the economics of profit-sharing have been analysed. The questions of the stability of the economy under profit-sharing and of the allocation of resources under the new system have been examined. The rationale and the practical approach to project evaluation in an Islamic economy has been spelled out. Profit-sharing as a tool for income distribution has also been discussed. Chapter 6 provides a summary while Chapter 7 highlights the areas in which further research is required.

Chapter 2

MONETARY STRUCTURE AND POLICY IN AN ISLAMIC ECONOMY

2.1 FUNCTIONS OF MONEY AND BANKING

Money is an integral part of any modern economy. Modern economies could never achieve the present level of development without money. The invention of money performed the same function for economic development as the invention of 'wheel' did for industrial development. The importance of money derives from its being a medium of exchange. Modern industrial economies, with all their complexities and interdependencies cannot function without a medium of exchange. The money serves as a medium of exchange at an instant of time as well as over time which gives rise to its store of value function. Thus, the individual is enabled to save from his present income in order to consume in the future. But money as a store of value has certain disadvantages. It earns no direct income and its purchasing power may be eroded as prices increase. Wealth (or accumulated savings) can also be held in the form of real estate, stocks and bonds, etc. which earn something for the owners and whose value tend to move more nearly in line with changes in the price level. Why would anyone want to

hold money then? One thing is easily understandable. People would want to hold money because it is more liquid and they need liquidity to carry out day to day transactions and to meet unforeseen contingencies. This is what is known as the demand for active cash balances. But above and beyond this, there is some demand for speculative cash balances or the demand for idle cash balances. While there is no controversy about active balances, there are a few people who have doubts about the permissibility of holding speculative balances in an Islamic framework. These doubts stem from the fact that Islam prohibits hoarding and most forms of speculation. However, a large majority of Muslim economists feel that speculative demand for money is permissible. The confusion perhaps arises because of a misnomer. The speculative demand for money is not necessarily hoarding or speculation. A more appropriate term is "asset demand" for money. The question is that of relative rates of return on different assets, of which money is only one. If people want to keep their savings in liquid form to take advantage of expected changes in relative prices of assets, this is quite permissible.

So much for the functions of money. Now we come to the functions of the financial system as a whole. In a market economy the financial system has to perform two fundamental functions: (i) to provide "adequate" liquidity to the system so that the production and exchange are smoothly effected; and (ii) to mobilize investible resources and to allocate them to the investors. In the present system these functions are performed from a lender's vantage point. Resources are handed down by their owners to the investors through lending organizations which use nominal interest rate as an allocative device to ration resources to different investors. The modern banking system also creates money which is lent to government, consumers and business, etc. The basic feature common to both these activities is that money balances are lent on the basis of being repaid in fixed mone-

tary sums with an agreed interest return. In such a system solvency of the borrowers becomes primary while the "productivity" of investment undertaken by them is considered secondary. On the contrary in an interest-free system, as will be seen later, productivity will become more important.

Let us now review briefly how the two basic functions listed above are performed in an Islamic economy. We will take them in turn.

2.2 SOURCES OF MONETARY EXPANSION

The first function of the monetary system is to provide for the transactions needs of the community, especially in a growing economy. It has to ensure that monetary growth is "adequate" and not "excessive" or "deficient". It is, therefore, necessary to watch and control the sources of monetary expansion.

There are three sources of monetary expansion: (i) fiat money creation, (ii) credit money, and (iii) balance-of-payments surplus. Let us review these in the light of the absence of rate of interest.

(a) Fiat Money Creation

The central bank creates money in two cases. Firstly, when the government borrows directly from it, and, secondly, when the central bank decides to carry out an "expansionary" open-market operation. In the first case government borrows to finance a deficit in the budget and in the second case the central bank attempts to stabilize the economy through open-market operations.

In the first case, the central bank creates and lends nominal money to the government against interest-bearing securities. In an Islamic economy, there cannot be any

interest-bearing asset, which means that it has to be done on the basis of some interest-free asset. Operationally, there is no problem in devising such an asset. More important is the question that how far deficit financing can be permitted. There is nothing good or bad in deficit financing *per se* but from a pragmatic point of view, most economists would agree that fiscal deficits can be and have been an important source of excessive monetary expansion. It is politically easier for the government to borrow from the central bank than raising taxes and less costly than borrowing from the public. It, therefore, becomes very popular with the governments, leading to accelerated increase in money supply and inflationary spiral. This destabilizing tendency of fiscal deficits underscores the need for a realistic and non-inflationary fiscal policy in Muslim countries. This does not rule out fiscal deficits but imposes the constraint that deficits be allowed only to the extent necessary to achieve broad-based well-being within the framework of stable prices.[1] The government may, nevertheless, have genuine needs for which it has to borrow and arrangements must be made to enable the government to do so in a non-inflationary manner. The institutional arrangements proposed in the subsequent sections provide for some provisions.

(b) Credit Money

In the present system, commercial banks' deposits constitute a significant part of money supply. These deposits may be divided into two parts. Firstly, 'primary deposits' which provide the banking system with the base money, and, secondly, 'derivative deposits' which in a fractional reserve system represent money created by commercial banks in the process of credit extension. The derivative deposits lead to an increase in money supply in the same manner as currency issued by the government or the central bank. This raises the

[1] For an argument why stable prices are so important to the Islamic system, see p. 20.

important question that since money creation is a social prerogative, should the banks be permitted to create credit in an Islamic economy or should the central bank enforce a 100 per cent reserve requirement. Among Muslim economists there are two schools of thought on this question. The first school favours 100 per cent reserve requirement on three grounds. Firstly, fractional reserves cause the monetary system to suffer from an "inherent instability" because any switch from 'high powered money' to 'deposit money' and vice versa, changes the supply of money. With 100 per cent reserves, such a switch will change only the composition of money, leaving its total supply constant. Secondly, changes in the money supply arising from deposit creation or resulting from substituting deposits and cash make it more costly to maintain the existing stock of real balances or to add to it. Finally, there is an equity aspect to credit creation. Some people argue that it is inequitable to permit the commercial banks to create credit because the beneficiaries of this process are the banks themselves and the borrowers who are mostly big businessmen and industrialists and who pay a little interest to the banks and earn huge profits from these borrowed funds. From an equity point of view, the benefits of the process of money creation should accrue to the whole society which can be best achieved through 100 per cent reserve system.

The other school while recognizing these problems, proposes to solve them within the framework of fractional reserve system. If there are suitable checks and balances, they argue, the process of money creation will not be unstable. As far the equity consideration, they maintain that it is not true that the beneficiaries of credit creation are only banks and the big industrialists and businessmen. If feedback effects are taken into account, then the benefits are much more widespread. More importantly, the fact that at present the direct beneficiaries of credit creation are big industrialists is not a natural or necessary outcome of the

system of fractional reserves. Measures can be adopted to ensure that the allocation of the derivative deposits is such that the benefits are more equitably distributed.

This is a subject where further research is required to establish whether a fractional or a 100 per cent reserve system will serve the needs of an Islamic economy in a better way. There is agreement among Muslim economists that both the stability of the value of money and equitable distribution of income and wealth are of fundamental importance to Islamic economic system. Therefore, if fractional reserve system is permitted, there must be checks *both* on the *creation* of credit by commercial banks and on its *allocation*. Some of the measures proposed in this regard will be discussed in Section 2.5.2.

(c) Balance-of-Payments Surplus

The balance-of-payments surplus is another source of money expansion but it is not very important in case of Muslim countries because most Muslim countries are experiencing balance-of-payments deficits and in the few that do have a surplus, the surplus does not originate in the private sector. Hence it does not lead to an automatic expansion in money supply. It does so only if the government spends its surplus domestically and the private sector balance-of-payments deficit does not offset this adequately. If such country's government spending is regulated in accordance with the capacity of the economy to generate supplies, there should be no inflation resulting from this balance-of-payments surplus.

2.3 FINANCIAL INSTRUMENTS

The second major function that the monetary and financial system has to perform is, as mentioned before, to mobilize investible resources and to allocate them to the

investors. In the present system this is done by the financial intermediaries on the basis of fixed rate of interest. In an interest-free economy this will be done under a profit-sharing system. The financial market can offer the following alternatives to the savers [6] :

(i) Demand Deposits

These are similar to the chequing accounts usually held in commercial banks. They carry no rate of return, but give their holders the right to write cheques against them.

(ii) Profit-Sharing Accounts

The banks can open PS accounts, wherein the deposits will be received on the basis of profit-sharing. The profit will be determined ex-post and shared between the depositors and the bank according to an agreed formula.

(iii) Corporate Stocks

A saver can buy stocks directly and become a stock holder. This affords him direct participation in the management of the company to the extent of his capital.

(iv) Commercial Bank Certificates

Member banks can offer four kinds of certificates:

(a) Specific Investment Certificates (SIC)

These certificates would carry the name of an enterprise in which the value of the certificate would be invested. They would be exactly like stocks held by a member bank for a particular customer. The advantages of holding stocks through a bank include the use of the bank expertise as well as its block-vote as a representative of more than one stock

holders. Small stock holders would in particular benefit from these advantages.

(b) General Investment Certificates (GIC)

A GIC value would enter the general pool of member bank investment. Its holder would be entitled to an average rate of profit on all operations of the member bank. It is the closest thing to holding a stock in the bank itself. In addition to the expertise and the block-vote power, the GIC provides a greater degree of diversification. This could mean lower risk for savers. GICs can be issued for different terms of maturity. They can vary between 60 days to 5 or even 10 years depending on the range of bank operations. They can be made marketable, which would make them relatively liquid.

(c) Profit-Sharing Certificates (PSC)

A profit-sharing certificate involves investing certain sum of money into short-term operations. Its maturity can vary from 60 days to one year. It offers diversification among short-term placements. All these characteristics would make it specially marketable and relatively attractive to savers who desire to stay closer to the higher edge of the liquidity spectrum.

(d) Leasing Certificates (LC)

A leasing certificate is similar to a SIC, except that it is a form of declining equity. Lease payments include profit plus capital depreciation. If both parts are refunded, net of bank costs, the holder recoups part of his capital as the term of the lease gets closer to maturity. It is possible to design LCs which entitle holders to only dividends during the lease time. Meanwhile, capital repayments would be reinvested in other lease contracts.

(v) Central Deposit Certificates (CDC)

A CDC gives its holder a share in the central bank deposits. The central bank will invest these with all member banks. This makes it the most diversified investment in the economy. Since it involves two layers of financial intermediation, namely member banks and the central bank, it would be the safest instrument available.

2.4 INSTITUTIONAL STRUCTURE

Every system has its unique requirements with respect to an institutional structure which will ensure a smooth functioning of the system. What would be the institutional structure of monetary and financial system in an interest-free economy is a natural question. Before we discuss the essential features of the Islamic system, it is useful to point out that it is not the institutions as such which distinguish the Islamic system from the present system. It is rather the functions and the way they are performed which will make the Islamic system distinct.

The organizational structure of Islamic monetary system is quite similar to the existing system but the mode of operation of various institutions is quite different. Let us briefly review this structure.

(a) The Central Bank

Central bank is the institution entrusted with the management of the supply of money which involves the issue of fiat money as well as the control of commercial banks.

The central bank should determine annually the desired growth in money supply in the light of national economic goals. This desired amount of money can be provided in one of two ways. In one scheme [6], the central bank would

open investment accounts in its member banks, in which it would deposit whatever money it creates and from which it would withdraw whatever money it retires. Under the other scheme [2], the central bank would make part of the M_o that it creates available to the government as an interest-free loan and the rest to commercial banks and specialized credit institutions as *Mudarabah* deposits. More will be said on this in Section 2.5.2.

(b) Member Banks

The member banks in the Islamic system are not the traditional commercial banks. In addition to providing regular banking services they will also undertake direct investment. Perhaps a more appropriate term for such institutions could be "business banks". The banking services will include the usual services provided by commercial banks like chequing accounts, selling foreign exchange, issuing letters of credit, etc. The new feature will be their greater emphasis on investment activities. These can be of various kinds such as:

(i) Direct Investment

This allows the bank to hold shares in enterprises and participate in their administration. Considering their expertise, banks can increase the degree of business success in their communities.

(ii) Profit-Sharing Ventures

This category of investment provides short-term placement of funds to finance business needs for liquid capital for the duration of the production cycle. It is also a good outlet for funds to be employed in commercial activities. The profit of the business or commercial venture will be divided

between the bank and the business according to an agreed formula.

(iii) Leasing Activities

A bank can purchase industrial equipment, buildings, means of transport, etc., and lease them to users for periodical instalments. Leasing contracts provide a means to serve customers in a way that is flexible enough to cater to their varying needs and they provide the bank with a way to invest in an equity which transfers itself into liquid cash gradually over a certain period of time.

(iv) Central Deposit Certificate (CDC)

This is an instrument whereby the central bank can borrow the savings of public on a profit-sharing basis and invest as central deposits with member banks. This will be a good instrument for risk-averters because it will involve very low degree of financial risk, since it carries a title to a very diversified portfolio. The rate of return on the CDCs will approach the average rate of profit on investment for the whole economy.

(c) The Treasury

This will have three branches: the distributive, the allocative, and the market-correction branch. The distributive branch will be responsible for the collection as well as the distribution of *Zakah.* The allocative branch will take charge of the mineral resources and will provide public goods like health services, education and defence, etc. The market-correction branch will handle monopolies, externalities and market disorders.

In addition to the above institutions there are three other

institutions which are necessary for an Islamic economy. These are:

(d) Consumer Loan Institutions

Because of the elimination of interest from the Islamic system, the provision of consumer loans[1] will require special institutions. Some people propose that the member banks can be made to perform that function by making a regulation that each bank would devote a small percentage of its resources to interest-free lending. Others believe that this is not desirable, firstly, because it will affect the profits of banks and since banks run on *Mudarabah* basis, it will adversely affect the flow of funds to the banks. Secondly, only the people having business links with the banks will most likely get the loans. However, the people needing these loans will in most cases be those who have little business relations with the banks. It will, therefore, be advisable to create specialized institutions for such loans. The funds for these institutions can be contributed by the government from *Zakah* proceeds under/ or by voluntary loans/contributions by public. Some sort of institutional mechanism can be evolved to provide deposit insurance for voluntary loans. This is an area where further work is required.

(e) Stock Market

This again is not unique to the Islamic system but it is too important to be neglected. Since, *Mudarabah* will be the predominant mode of investment, an extensive, efficient and 'stable' stock market is very important. The stock markets in the capitalist world suffer from erratic fluctuations and low rates of dividend which make them less attractive than

[1]Consumer loans can be of two kinds: (i) consumer durables, and (ii) pure consumption loans. Here we are talking of pure consumption loans. The first kind of loans can be provided by either commercial banks or specialized institutions on the basis of hire-purchase leasing or participatory financing. House Building Finance Corporation in Pakistan is one example.

no-risk, fixed return bonds. This state of affairs is not acceptable in an Islamic economy where equity financing has to be encouraged. It would be necessary to ensure that entrepreneurs are able to raise sufficient equity capital without undue difficulty and that investors are able to sell their stocks and shares whenever they need liquidity. One of the first essentials for this purpose would be to reduce fluctuations and to bring about a rational behaviour in stock prices. The elimination of *Riba* would be extremely helpful in this regard but in addition it would be important to take other measures to eliminate speculation in order to minimize fluctuations in stock prices.

(f) Investment Cooperatives

Besides *Mudarabah, Shirkah* will be the other important mode of investment in an Islamic economy. In modern world, a personal type of approach to *Shirkah* will have very limited scope. It will, therefore, be necessary to establish investment cooperatives wherein people can share both in capital financing and management.

2.5 MONETARY POLICY

In order to ensure smooth functioning of the monetary system the monetary authorities usually have to monitor the whole system. Not only that. It is also commonly believed that money is not simply a veil. Monetary sector has important links with and influences upon the real sector of the economy. Thus monetary policy is an important instrument of public policy in a modern economy. This is also true of an Islamic economy but because of fundamental differences in its goals and the prohibition of interest in Islam, the objectives as well as the tools of monetary policy will be different. Many authors [2, 6] have addressed themselves to these matters. In the next two sub-sections, we will review, respectively, the objectives and the tools of monetary policy in an Islamic framework.

2.5.1 Objectives of Monetary Policy

Monetary policy in an Islamic economy should try to accomplish the goals that Islam stands for in the socio-economic sector. Some of the most important goals may be briefly stated to be: (1) economic well-being with full employment and optimum rate of economic growth; (2) socio-economic justice and equitable distribution of income and wealth; and (3) stability in the value of money. It may be noticed that the socio-economic justice and equitable distribution of income and wealth is a goal which is of paramount importance to the monetary policy only in an Islamic framework. Moreover, while the first and the third goal stated above may appear to be the same on surface, there are in essence fundamental differences arising from the difference in the roots of the two systems. Islamic economic system is a morally-based system while capitalism is a secularist and morally-neutral system. The ensuing discussion should help make these points clearer.

1. Economic Well-being with Full Employment and High Rate of Growth

The natural outcome of man being the vicegerent of God is that he must lead a life that befits his status. Muslim jurists have unanimously held the view that welfare of the people and relief of their hardships is the basic objective of *Shariah.* This view would, in the economic field, necessitate economic well-being through satisfaction of all basic human needs, removal of all sources of hardship and discomfort, and improvement in the quality of life, morally as well as materially. Hence full and efficient employment of human and material resources would be an indispensable goal of the Islamic system.

While a high rate of economic growth should be the natural outcome of policies leading to full and efficient

employment of human and material resources, high rate of growth is by itself of no prime importance. This is because the requirement to attain material prosperity within the framework of Islamic values requires that it should not be attained through the production of inessential or morally questionable goods and services and should not lead to excessive and overly rapid use of God-given resources at the expense of future generations who are equal owners of these resources. Hence in an Islamic economy, the emphasis will change from volume to the composition and justice orientation of growth.

2. *Socio-Economic Justice and Equitable Distribution of Income and Wealth*

The goals of socio-economic justice and equitable distribution of income and wealth are an integral part of the moral philosophy of Islam and are based on its unflinching commitment to human brotherhood. The recent capitalist retreat to socio-economic justice and equitable distribution of income is, on the contrary, the outcome of group pressures. Accordingly, the system as a whole, particularly its money and banking arrangements, is not geared to these goals and glaring disparities of income and wealth continue to be generated. Nevertheless, because of the influence of socialism and political pressures, some of these inequalities are being partly reduced by taxation and transfers. In contrast with this, Islam tries to eliminate the causes of gross inequalities at source and also uses *Zakah,* taxation, and transfers as additional measures to reduce inequalities even further to bring about a distribution of income which is in conformity with its concept of human brotherhood. Hence it is essential that even the money and banking system and the monetary policy are so designed that they are finely interwoven into the fabric of Islamic values and contribute positively to the reduction of inequalities.

3. *Stability in the Value of Money*

Stability in the value of money is not only an important goal of monetary policy but it is rather fundamental to the structure of Islamic economic system. Islam stresses fairness and justice in all human dealings. Inflation involves an element of injustice to the *riba*-free lender and is, therefore, repugnant to Islamic system.

The erosion of the real value of *Qard-Hasanah*, a loan extended without interest or profit-sharing, is a very important problem which has to be solved. One of the suggestions to solve this problem is indexation. The issue will be discussed at some length in Chapter 3. Here it would suffice to say that the idea does not get general support. The ideal solution therefore, remains price stability. However, the practical difficulties in achieving this ideal, especially in the present day world where most of the inflation is imported, makes it imperative to find some practical solution for insulating the economy from external inflation as well as keeping the domestic prices stable.

While inflation is in conflict with Islamic values, prolonged recession and unemployment are also unacceptable because they bring misery to certain sectors of the population and also act counter to the goal of broad-based economic well-being. Hence it should be considered obligatory for the Islamic state to eliminate or minimise the economic fluctuations and to stabilise the value of money by cutting at the roots of inflation as well as recession.

Before leaving this subject, there is one question which must be answered. By having multiple objectives, are we not over-burdening the monetary policy? There are some people who think that if we assign too many objectives to monetary policy we will be violating the Tinbergen and Mundell Principles which require matching of policy objectives with

policy tools. If we fail to do that, we may not be able to achieve anything. They suggest that monetary policy should aim at stability in the value of money and leave the rest to other policy tools.

There is some weight in this opinion as the objectives listed above may not always be compatible with one another. However, the Mundell Principle is too text-book type to be strictly adhered to. It is desirable to have multiple objectives in view all the time. However, these must be thought of as objectives of public policy and then use different policy tools including the monetary policy to collectively achieve these objectives. In this regard it will be desirable to 'rank' these objectives from the point of view of effectiveness of various policy tools. The objective of stability of the value of money will no doubt be the one most amenable to monetary policy but it can also make a positive contribution to the achievement of other objectives. For example, we must recognize that the banking system has been one of the major sources of inequalities of income and concentration of wealth. The capitalist banking system provides a small group of families control over vast resources mobilized through primary deposits. If we want to achieve an equitable distribution of income and wealth, monetary policy must be geared to that end. Similarly, monetary policy in an Islamic economy will be able to contribute to the growth objective as well. As pointed out earlier, one of the fundamental features of banking structure would be that it would be productivity-based. Through central bank the government can encourage investment in certain regions or sectors as may be needed. Thus it will be able to affect not only the volume but also the composition of the growth in output.

Even for stabilization, Islamic monetary policy is more effective. As pointed out earlier, inflation is not acceptable in an Islamic economy. Not only because of its undesirable

effects on the economy but rather it is repugnant to the system itself because it violates justice which is the centre pillar of Islamic system. Also, in times of recession when the capitalistic monetary policy is very weak, the Islamic monetary policy will not be so. The current weakness of the monetary policy as an anti-recessionary device may be attributed to (a) interest inelasticity of investments, and (b) passive role played by the financial institutions. But, in an Islamic economy, interest is no longer a cost to the entrepreneur and the risk borne by the entrepreneur in times of recession is much less under the *Mudarabah* system than in the capitalist order. Thus, entrepreneurs in an Islamic economy will play a more dynamic role even in times of recession than their counterparts in the capitalist system. Moreover, the financial institutions in an Islamic framework play a more active role than do their counterparts elsewhere. As we all know the financial institutions in an Islamic economy are envisaged to take on an entrepreneurial role by being a partner in *Mudarabah* investments, quite unlike the present-day financial institutions which merely provide funds for investment. It is in this sense that the Islamic financial institutions can be expected to lead the business community and actively influence the business outlook by injecting confidence and stimulating investments by accepting lower share in profits in times of economic downturn.

2.5.2 Tools of Monetary Policy

In an Islamic economy interest has to be abolished. This rules out two important instruments of monetary policy of the capitalist economy; discount rate and open market operations in interest-bearing government securities. However, this should not be taken as a disadvantage. Muslim economists have suggested alternative instruments for monetary policy which will not only help regulate money supply in accordance with real money demand but will also help fulfil government needs for meeting its "genuine"

deficits and achieve the other socio-economic goals of the Islamic society. Monetary policy in an Islamic economy may consist of the following elements.

(a) Target Growth in M and M_o

The central bank should determine annually the desired growth in money supply (M) in the light of national economic goals including stability in the value of money. This target growth in M should be reviewed periodically in the light of the performance of the economy and the trend of prices. This desired amount of money can be provided in one of two ways: one school of thought among Muslim economists, which does not permit credit creation by commercial banks [6], proposes that the bank should open investment accounts in its member banks, in which it will deposit whatever money it creates and from which it will withdraw whatever money it retires. Such deposits are termed as central deposits (CD). The member banks will invest those deposits in the real sector and will share the profit with the central bank.

The other school which allows fractional reserves [2] proposes that the central bank should make the total M_o created by it available partly to the government and partly to the commercial banks and the specialized financial institutions. The proportion of M_o diverted by the central bank to each of these three sectors should, like the total size of M_o, be determined by economic conditions, goals of the Islamic economy, and the dictates of monetary policy. The part of M_o made available to the government should be an interest-free loan to enable the government finance its social welfare projects. The justification for this is that since the creation of M_o by the central bank results from the exercise by the central bank of the power to create money, which is a social prerogative, the resources derived from this power should be used, in the social-welfare-oriented value system of Islam,

only for accomplishing the goals of the Islamic society. The part of M_o made available to the commercial banks should be treated as *Mudarabah* advances and the profit realized from the "derived" deposits related to these advances should be made available the government to finance projects designed to eliminate poverty and reduce income inequalities. The part of M_o made available to specialised credit institutions should also be a *Mudarabah* advance and be used mainly for financing the productive activity of self-employed persons, farmers, cottage industries and other businesses which though viable and socially necessary, are unable to obtain funds from commercial banks.

(b) Public Share of Demand Deposits

A certain proportion of commercial banks' demand deposits upto a maximum of, say, 25 per cent, should be diverted to the government to enable it to finance socially beneficial projects in which profit-sharing is not feasible or desirable. This will be in addition to the amount diverted to the government by the central bank for expanding the monetary base (M_o). The rationale behind this proposal is, firstly, that the commercial banks act as agents of the public for mobilizing the society's idle resources; secondly, the banks do not pay any return on demand deposits; and, thirdly, the public does not bear any risk on these deposits which will be fully insured. Hence it would be fair to expect that the society's idle resources thus mobilized should be used for social benefit except to the extent to which the society permits the commercial banks to use them for private benefit in the larger social interest.

The percentage of demand deposits to be handed over to the government can be varied in accordance with the business conditions. This will provide the government with another counter-cyclical tool.

(c) Statutory Reserve Requirement[1]

In addition to the requirements of diverting a certain proportion of their demand deposits to the government, commercial banks should be required to hold a certain proportion of their deposit liabilities with the central bank as statutory reserves. This statutory reserve requirement may be varied by the central bank in accordance with the dictates of monetary policy. Some people hold that statutory reserve requirement should apply only to demand deposits. The rationale behind this proposal is that the *Mudarabah* deposits would constitute a part of bank equity in an Islamic economy and since there is no statutory reserve requirement against other forms of equity, there is no reason why *Mudarabah* deposits should be subject to such a requirement. This should not adversely affect the control of money supply which must be accomplished through control of high-powered money at source as indicated earlier.

(d) Value-Oriented Allocation of Credit

Since bank credit comes out of funds belonging to the public, it should be so allocated that it helps realize general social welfare. The criteria for its allocation, as for other God-given resources, should be first the realization of the goals of the Islamic society and then the optimization of private profit. This could be attained by ensuring that: (i) credit allocation leads to an optimum production and distribution of goods and services needed by a greater majority of society, and (ii) the benefit of credit creation goes to an optimum number of businesses in society.

The approach should be, firstly, to make it clear to the commercial banks what sectors and areas of the economy are to be promoted through commercial bank financing and

[1] If 100 per cent reserve requirement is adopted, then this tool would become rudundant.

what goals are to be realized, and, secondly, to adopt the institutional measures necessary for this purpose. However, an effort should be made not to tie the commercial banks with an elaborate network of controls.

The reason normally given by the commercial banks for diverting a very small proportion of their funds to small- and medium-size businesses is the greater risk and expense involved in such financing. It would, therefore, be desirable to reduce the risk and expense of such financing for banks. The risk may be reduced by introducing a loan guarantee scheme under-written partly by the government and partly by the central bank. The additional expense incurred by the commercial banks in financing small businesses should be partly or wholly offset by the government depending on the nature of the case and objectives to be served. The cost to the government exchequer arising from the above two schemes is well justified in the larger interest of the goals of the Islamic economy.

(e) Central Deposit Certificate (CDC)

The central bank can create an instrument which can be termed "central deposit certificate". The nature and functions of CDCs have already been discussed in Section 2.3.

Chapter 3

INTEREST-FREE BANKING IN PRACTICE

3.1 INTRODUCTION

To evolve an interest-free system is one of the biggest challenges facing the Muslim *Ummah* now. The following three basic issues arise when the question of the practical elimination of interest from the economy is discussed:

(a) What are the alternate foundations on which the banking and financial system of an interest-free economy will be based?

(b) What should be the strategy for the introduction of this system?

(c) How far this system will actually be successful in the hostile interest-bearing financial system of the outside world?

Pakistan has done a pioneering work on the first two questions. With the help of a Panel of economists, bankers, and religious scholars a comprehensive report has been prepared on the two issues [11].

At practical level, however, there are many questions that still need to be answered as complete interest-free banking system does not exist in any economy. In some countries, interest-free banking has been introduced at individual level. These attempts, working in hostile interest-bearing atmosphere, can provide a considerable insight into the practicability of the interest-free system. A report on the working of these interest-free banks operating in various parts of the world was also presented in the Seminar [9].

Discussion on these two reports resulted into detailed answers to above questions. In the following sections, brief summary is given.

3.2 ALTERNATIVE INSTITUTIONS FOR NON-INTEREST FINANCING OF INVESTMENT

Profit-sharing emerged as an instrument in the Islamic framework that not only can replace interest viably but is also close to the ideals of Islamic economic system. The main rationale for prohibition of interest in the case of loan for production purposes stems from the concept of justice between man and man which is the corner-stone of the Islamic philosophy of social life. Uncertainty is inherent in a business enterprize irrespective of the time and space dimensions. The operating results of the enterprise cannot be foreseen and the occurrence of profit or loss and their magnitudes cannot be fully determined in advance. It is, therefore, a sheer injustice if the party providing money capital is guaranteed a fixed and predetermined return while the party providing enterprise is made to bear the uncertainty all alone. The basis of cooperation between capital and enterprise which Islam cherishes is equitable sharing of the risks and gains between them. A real and permanent substitute, therefore, could be only a system based on profit-sharing for productive funds and *Qard-Hasanah,* i.e. funding without additional charge over and

above the principal amount for non-productive loans.

The whole system, however, cannot be changed to profit-sharing overnight. In the transitional period the system may be supplemented by some other alternative instruments. A number of instruments have been proposed in this regard.

(i) Indexation of Deposits and Advances by the rate of Inflation
(ii) Service Charge
(iii) Investment Auctioning
(iv) Mark-up/Hire-purchase/Leasing
(v) *Murabaha* and *Bai Muajjal*
(vi) Time-Multiple Counter Loans
(vii) Financing on the basis of Normal Rate of Return

There is a near consensus that there is no logic behind looking for alternatives to profit-sharing because whatever alternatives can be suggested, they will never be repository of the rationale that profit-sharing will provide. The first two instruments, i.e. Indexation and Service Charge, specifically did not get support as a lot of considerations were required to be kept in mind before these instruments could be used as an alternative to interest. Particularly for service charge it will have to be ensured that it covers only the administrative expenses of advancing the funds. The difficulties in the assessment of administrative expenses would require it to be very judicious and restrictive. The other instruments obtain only reluctant support for their application keeping in view the lack of proper infrastructural and moral values required for the successful implementation of the profit-sharing system. This support, however, is categorically conditional in that these instruments will be applied only in the transitional period during which mechanism for the working of the profit-sharing system will be rapidly built up as these instruments are likely to become very close to

interest. Let us briefly discuss each one of the above mentioned instruments.

(i) Indexation

Indexation means that the nominal value of deposits and advances will be increased every year by the same rate at which the general price level increases in the economy. The suggestion has given rise to a lot of discussion and debate. Although considerable work and thinking is taking place on the issue, Islamic scholars have serious reservations about the permissibility of this concept in Islam. One school of thought holds that, by preserving the real value of *Qard-Hasanah,* indexation fulfils the Islamic imperative of socio-economic justice and is, therefore, desirable. Also without indexation there is a disincentive for the interest-free lender to extend a loan and thus sufficient amount of finances for the needs of poor people may not be forthcoming in an Islamic economy. The other school of thought points out that besides administrative difficulties indexation has some other draw-backs which make it an undesirable option. They maintain that even though it is proposed with the innocent objective of doing justice to the *riba*-free lender, it has the potential of inflicting gross injustice to the borrower. Indexation principle will prove to be exploitative for sectors where price increase fall short of general price increase in the economy. They also point out that in deciding about the fairness to the lender, it should be considered what alternatives he has. If the alternative is to keep the money in cash or demand deposits then *Qard-Hasanah* will not involve any injustice to the *riba*-free lender. On top of that the *riba*-free lender is assured of a spiritual reward which must not be ignored. Above all, indexation has so far been rejected by the *Fuqaha* which rules out indexation as a general idea. Unless it is cleared by *Fuqaha* it cannot be considered as an alternative instrument. It must, however, be pointed out that Islam does permit the lender to extend loan in kind and get

back the same quantity. So if you have suitable commodity to serve as a *numeraire,* it may be a possible way to protect the genuine needs of some people. But the question is very complex and must be researched upon in much greater detail.

(ii) Service Charge

A service charge means simply an amount to cover the administrative cost of providing loans. In this system, the borrowers will be paying a small amount over and above the principal amount whereas depositors will not receive any additional amount. A large number of depositors of the bank are small savers whereas the beneficiaries, i.e. those who borrow money from the bank, are generally the big businessmen. Thus, under the interest-free system with service charge, the strong and affluent will be the gainers and this will further aggravate the economic inequalities in the society. Furthermore, the system of service charge will provide no incentive to the banks (or the depositors) and the banks will cease to play their role as mobilizers of savings.

(iii) Investment Auctioning

Under this system, the complete requirements of a project (machinery, building, etc.) will be auctioned by the banks to the prospective investors. The highest bidder will get the finances for the project. In this way the scarce capital is assumed to be priced adequately and hence efficiently allocated. Although this method of financing can be considered to be same as transferring assets by sale on deferred payments basis, the general opinion is that the essence remains the same as of interest. Investment auctioning is also likely to lead to more concentration of wealth because this means nothing but the auction of the investment funds and in an auction on competitive basis only big industrialists will get most of the funds. In an Islamic economy we have to provide equal opportunities to small businessmen also.

(iv) Mark-up/Hire-Purchase/Leasing Schemes

These schemes, where the banks will purchase goods and resell them to the borrowers at an agreed upon a certain margin of profit, are also considered to be very close to interest, because these schemes do not provide equitable risk sharing between the entrepreneur and the financiers and can also be misused by unscrupulous users. Its use, if allowed, will have to be very judicious and limited.

(v) *Murabaha* and *Bai-Muajjal* (or Sale on Deferred Payment Basis)

Murabaha may be defined as a sale in which the margin of profit is mutually agreed between buyer and the seller. The payment of sale price is inclusive of that profit. The payment may be immediate or deferred. Although this is considered to be in conformity with *Shariah,* considerable reservations are expressed about adopting it as a regular financial instrument. Its wide and indiscriminate use is likely to be dangerous in that it can open a back door for dealing on the basis of interest.

(vi) Time-Multiple Counter Loans

This scheme means that a borrower, for example, can get an interest-free loan of Rs. 5000 for a year if he deposits interest-free Rs. 1000 for 5 years in the bank, i.e. Rs. 5000 x 1 year = Rs. 1000 x 5 years. Though apparently the scheme is very simple, the fact that this is based on the concept of a conditional loan makes it unacceptable in an Islamic framework.

(vii) Financing on the Basis of Normal Rate of Return

Under this method, the government could announce

every year a normal rate of return to be expected in different sectors of the economy. The banks may provide finance on the assurance that the entrepreneur will pay at least a profit determined on the basis of normal rate of return. If the actual profit comes out to be greater than the normal rate of return, the difference will be voluntarily paid by the entrepreneur, and if he makes a profit less than the normal rate of return or a loss, the entrepreneur would have to prove the same to the satisfaction of the bank/financier, and in that case the bank/financier will accept to share a lower profit (or to bear the loss). The scheme as such does not entail substantial objection. Some serious apprehensions are, however, expressed upon the methods of determining normal rate of return and the mechanics required for an effective use of the scheme. One of the major apprehensions, for example, was that this may ultimately lead to a fixed return on capital because the entrepreneurs would not like to show higher profit to avoid more payments to banks and also they would not like to show a profit less than normal return in order to escape querry.

All the above instruments are considered to be leaving a back door open for interest. Keeping in view practical problems in introducing the system of profit-sharing and the institution of *Qard-Hasanah,* the above instruments (with the exception of service charge and indexation) are to be used as supplementary measures during the transitional period only in inescapable cases where the profit-sharing cannot genuinely be applied.

While looking for viable alternative instruments, it is repeatedly emphasized, that we should keep in mind that we want to change from a system in which all the risks were borne by entrepreneur to a system where the risk will be shared between the entrepreneur and financier. Any instrument other than profit-sharing does not contain this spirit.

In connection with profit-sharing, there is an unambiguous unanimity that whereas profits can be shared in a proportion different from the proportion in the capital investment, the losses will be shared strictly in the proportion in which the parties have contributed to the total capital investment of the enterprise. Nothing in *Fiqh* can be found that can permit sharing loss in proportion different from the proportion in the capital investment. It is also unambiguously provided in *Fiqh* that one who does not invest any capital does not bear any loss and that loss is to be shared strictly in proportion of capital invested.

3.3 STRATEGY FOR IMPLEMENTATION OF THE NEW SYSTEM

The fact can hardly be over-emphasized that the objective that we want to achieve is very different from the socio-economic realities with which we deal today. Therefore, the total change cannot come in one big leap. Hence, a peace-meal approach may be needed. This approach, however, should be such that each step leads to the next step. We must not stop midway and we must not bring about change simply for the sake of change, ignoring the substance. Every step should take us away from the old model and bring us nearer to the new model.

For the successful implementation of the new system the introduction of the system will require to be supplemented by the following.

(a) Sincere implementation and practice of Islamic values and principles.

(b) Bringing about the required structural and institutional changes fundamental to the introduction and smooth working of the new system.

Islamic economic system is an integral part of the Islamic order. Any effort to establish the Islamic economic order or any part of it, say monetary or fiscal system, will require simultaneous efforts to restructure the entire society and to transform the whole social *milieu* to make it consistent with Islamic values and principles. For example, with the establishment of an Islamic banking and financial system, the Islamic values regarding financial transactions will need to be implemented not only to create a social atmosphere for the required cooperation between borrower and lender but also to eliminate or reduce such financial transactions which have been a product of only the current interest-based banking system.

Apart from introducing the Islamic values, the nature and functions of the existing institutions, e.g. central bank, commercial banks, financial intermediaries and treasury, will have to be changed in various directions. Also to cater to the needs of the new system, some new institutions will also have to be formed. Some of the required changes have already been discussed in Chapter 2. Some additional observations are given below:—

a. Reducing Wasteful Spending and Conspicuous Consumption in Public and Private Sectors

Conspicuous consumption and wasteful spending will have to be reduced drastically in all spheres of life because the new system does not have any room to provide bank financing for such needs. Particular attention needs to be given to reduce the wasteful spending of government. Unless this is done, elimination of interest from the economy will be difficult because the finances now available to the government in the form of interest-based borrowings will no more be available. To check wasteful spending of the government, judicious limits will have to be imposed on deficit financing.

(b) Integrating Fiscal Policies with the Requirements of the Interest-Free Banking

The tax-structure of interest-based economies will remain no more consistent with the structure required for the interest-free economy. Some existing taxes will have to be eliminated or modified and some new taxes might have to be imposed. The whole fiscal system will have to be reviewed to find out any inconsistencies that will adversely affect the efficiency of interest-free system. Also the interest rate in the interest-based economies serves as an instrument to regulate the creation of credit and supply of money. In Islamic economy, this instrument will not be available and fiscal tools will have to be used to reinforce the monetary policy. Some of these tools will be discussed in Chapter 4.

(c) Rationalizing the Short-Term Demand for Credit

One of the main functions of the present day commercial banking is the short-term financing. In an interest-free economy, this will have to be rationalized. There is nothing sacrosanct about the short-term credit. A large part of the current demand for short-term credit in business sector is only a by-product of the interest-based system which encourages the businessmen to meet financial requirements from borrowing rather than by raising equity. Short-term credit in the present financial system generally reflects a lack of working capital. A change will have to be brought about in the business practices so that they may provide sufficient equity. There will, however, continue to exist genuine short-term needs. Institutional arrangements will have to be made to meet these needs of the business.

(d) Reforms in the Auditing System

Reforms in the existing system may be required. Special auditors need to be established to evaluate the profits of a firm for the purpose of determining the share of banks or lenders only. The evaluations of these auditors can be made strictly confidential for the purpose of income tax, if necessary.

Before, closing the discussion on the strategy of implementation of an Interest-Free Banking System, another question that comes to some minds is how far it is appropriate to eliminate interest from banking and financial institutions before changing the whole economic system. There is a view, that we should not eliminate interest unless other things are also changed. Particular reference is made to the profiteering motives in the capitalistic societies. It is argued that first the motive of profiteering should be eliminated from the society and then comes the turn of eliminating interest. It is also sometimes mentioned that the private ownership and control of means of production should be eliminated before freeing the society from interest. These views fail to get any real support from the Muslim economists. The general consensus is that it is not reasonable to say that just because elimination of *Riba* is not the whole of Islam, we should, therefore, wait until we are able to practise all aspects of Islam in one jump. This is just the opposite of the logic of history. No example exists in history where the complete system has been put in practice in one step. This is true that by eliminating interest, the system will not become perfectly Islamic but this is something that we must do as it is a major requirement of Islamic economic system. Side by side of eliminating interest we should, however, go for adopting other aspects of Islam. This is how all the system of the world have developed. It should not be ignored that a change from the interest-based system to an interest-free system will itself bring significant changes in the

society. Existing institutions will change their character. New institutions will emerge. Attitude of people and firms will change. Eliminating interest from the society and bringing about changes in structural, institutional and moral set-up of the society are the two processes to be initiated simultaneously.

It is true that profiteering is not acceptable to Islam but it should not be ignored that Islam allows genuine normal profits arising out of business and productive activities. In an Islamic economic system, there will be profits but they will not be exploitative. There is nothing wrong in private firms attempting to seek profit but that should not necessarily lead to exorbitant profits or exploitation. In a competitive economy, a profit-maximizing firm will get only a normal profit. Profiteering results from the market structure and a host of other factors. Obviously, in an Islamic economy, steps would be taken to eliminate such factors which lead to abnormal profit. The point is that there is no reason to blow up too much the profit maximization motives in capitalist economies in order to deemphasize the importance of elimination of interest from the economy.

3.4 PERFORMANCE OF EXISTING ISLAMIC BANKS IN THE WORLD

Even though doubts are expressed in certain quarters about the successful operation of the interest-free banking system in the modern environment, a glance on more than 13 banks,[1] now operating on Islamic principles in various parts of the world, can remove these doubts to a considerable extent. These Islamic banks working in Khartoum, Dubai, Kuwait, Bahrain, Sharjah, Amman, Cairo, Luxumbourg, Geneva and Karachi are not only following Islamic principles of interest-free banking but are also doing business successfully with their counterparts in the interest-based world

[1]The names of these banks are given in Appendix 1 to this Chapter.

around them as they are individual Islamic banks in countries where the overall banking system is interest-based. Working in an hostile environment, the success story of these banks should provide enough encouragement to the bankers/economists in the countries like Pakistan where the whole system is being planned to be converted into an interest-free system.

All these Islamic banks operate on interest-free basis. On the deposit side they share the banks' profit with the depositors. On the liability side they operate in the form of *Mudarabah* and *Shirkah* (equity participation). For short-term investments, particularly in commodity operations, they prefer *Murabaha* or *Bai-Salam.* They are in a continuous process of research to find out alternative non-interest-bearing instruments. *Mudarabah* and *Muqardah* bonds and Islamic securities are some of the examples of the instruments devised by Islamic banks. To those who think *Mudarabah* is an out-dated form of business in the modern world, these instruments of Islamic banks can serve as eye-openers.

All these Islamic banks showed remarkable performance and growth in their operations within a short period of their inception. Some of the banks did show in their initial period relatively slower growth in deposits and performance as compared to that of interest-based banks of their countries but, keeping in view, the difficult circumstances in which they have to operate, there does not arise any reason for dissatisfaction. Obviously these banks are recently established and they are passing through a trial period during which they have to compete with the long established modern banks. Furthermore, these banks working in individual capacity do not receive any help or financial assistance from the central bank of their country. In difficult times, e.g. in situation of liquidity shortage, the resources available to other banks from central banks or from money market are not available to the Islamic banks.

Despite all these difficulties, many of the Islamic banks have been able to show profit level not being achieved by the interest-based banks which shows that there is no reason to be sceptic about the performance of Islamic banks.

The real success of these Islamic banks, however, will not be judged by the profits earned by them. Their real success would be how far these banks have been able to contribute to the realization of Islamic goal of social justice. The experience of these banks need to be studied in detail particularly the profile of the beneficiaries of these banks compared to those of interest-based banks if we want to draw conclusions on the role of Islamic banks in an Islamic economy.

The Islamic banks have not been found to be working in isolation in the sense that they were not interacting with the rest of the world. Most of these banks are doing business with the modern financial and business institutions on Islamic principles not only in their own country but also in the international trade and financial transactions. There are indications that the way of working of these banks are attracting even the interest-based banks/institutions of non-Muslim countries.

The performance of the Islamic banks and their interaction with the other system around them on Islamic principles give a cause of satisfaction and sheds all fears about the practicability of the Islamic banking.

LIST OF THE ISLAMIC BANKS AND INVESTMENT COMPANIES

1. Baitul Tamweel Al Kuwaitee,
   P.O. Box 24989
   Kuwait.

2. Dubai Islamic Bank
   Deira, Dubai
   United Arab Emirates.

3. Faisal Islamic Bank of Egypt
   1113, Karnish El Nile Street
   Ittehad Al Ishtraki Building
   Cairo
   Egypt.

4. Faisal Islamic Bank of Jordan
   P.O. Box 5418
   Amman
   Jordan.

5. Faisal Islamic Bank of Sudan
   P.O. Box 2415
   Khartoum
   Sudan.

6. Islamic Banking System
   31, Palace de Paris
   Luxumbourg.

7. Islamic Bank of Bahrain
   Bahrain.

8. Islamic Development Bank
   Jeddah
   Saudi Arabia.

9. Islamic Investment Co.
   Geneva
   Switzerland.

10. Islamic Investment Co.
    BITCO, Nassau
    Bahamas.

11. Islamic Bank of Sharjah
    Sharjah.
    U.A.E.

12. Investment Corporation of Pakistan
    National Bank Building
    I. I. Chundrigar Road
    Karachi
    Pakistan.

13. House Building Finance Corporation
    Shaikh Sultan Trust Building
    Beaumont Road
    Karachi
    Pakistan.

14. National Investment Trust
    National Bank Building
    I. I. Chundrigar Road
    Karachi
    Pakistan.

Chapter 4

FISCAL POLICY IN AN ISLAMIC ECONOMY

4.1 THE ROLE OF FISCAL POLICY

Fiscal policy is an important component of public policy. It encompasses government's revenue, expenditure and debt policies. The role of fiscal policy in any economy is determined by the level of government's involvement in economic activity which is in turn determined by its socio-economic objectives, ideological commitments and the nature of the economic system. In a communist system the public sector is all embracing. In a capitalist system the role of public sector is relatively small but still crucial. In an Islamic economy, while the right of private property is recognized, the government is responsible to ensure a decent living for its citizens. It is committed not only to achieving economic well-being for the largest number of people but also to facilitate their spiritual uplift and to spread the message and teachings of Islam as widely as possible. Some of the important features of an Islamic economy which will have implications for the role of fiscal policy are as follows:

(1) Irrespective of the economic conditions in an Islamic economy, a Muslim government must ensure that

Zakah is collected from every Muslim whose wealth exceeds a specific minimum value and that the proceeds are used for the purposes specified in the Holy Qur'an. This built-in fiscal policy device is unique to Islamic economies. However, *Zakah* cannot be used as a discretionary fiscal tool in the same way as other taxes, since the rate of *Zakah* as well as the areas in which its proceeds can be utilized are fixed.[1]

(2) The rate of interest does not play any role in an Islamic economy. This changes the nature not only of monetary policy but also of fiscal policy. Since the rate of interest which achieves equilibrium in the money market will not be available, some alternative must be found. One of the alternative tools being suggested is the rate of dues on idle cash.[2]

(3) Since all loans in Islam are interest-free, much government spending would be financed either from the proceeds of taxes or on a profit-sharing basis. Hence, the size of the public debt would be much smaller.

(4) An Islamic economy is committed to assist less-developed Islamic economies and to spread the message and teachings of Islam. Thus, part of government expenditure will be devoted to activities which promote Islam and increase the welfare of Muslim brothers in other less-developed Islamic economies. The tax-payer in an Islamic economy realizes that part of the taxes he pays are committed to the service of Islam.

(5) Islamic state is a welfare state, where welfare has a much wider meaning than the Western concept.

[1] However, *Zakah* does have some elements of discretion. For example, the government may withhold spending part of *Zakah* proceeds during peak years and disburse them in recession.

[2] For details see pp. 56-57.

It includes material as well as spiritual aspects with greater emphasis on the spiritual side. The Islamic state is responsible for the protection of people's religion, life, offspring and property. Thus, everything that implies promoting these things (or any of them) is desirable while everything that implies harming them is undesirable. This gives the Islamic state a very wide scope.

(6) In a war, Islam expects people to offer not only their lives, but also their wealth for the preservation of religion.

(7) Finally, but most importantly, the right of taxation in an Islamic state is not unlimited. Some people even go to the extent of saying that a taxation policy beyond what is defined by *Zakah* is not possible except under exceptional circumstances. This controversy will be examined in detail in Section 4.3.1.

4.2 OBJECTIVES OF FISCAL POLICY

The objectives of fiscal policy in an Islamic economy will differ from their secular counterpart both in interpretation as well as emphasis. The goal of all economic activity – nay all human activity – is to maximize human welfare. Public policy is a tool to achieve that objective. In secular economies the concept of welfare is limited to attaining maximum benefits to individuals in this world. No regard is given in those societies to the spiritual needs of man. In Islamic economies the concept of welfare is extended to include the life in the hereafter and spiritual elevation is given more emphasis than material prosperity. While the secular economic system is value-free, in Islamic economic system moral values are the center-piece. These differences must always be kept in mind because they give precise interpretation of various objectives and indicate the priorities.

Fiscal policy in capitalist economies aims at: (i) allocating resources efficiently; (ii) achieving economic stability; (iii) sustaining economic growth; and more recently; (iv) attaining an equitable distribution of income. As pointed out by Muslim economists [4, 12], these objectives may remain valid in an Islamic economy. However, their interpretation will be different. These differences have already been pointed out in Chapter 2 and need not be repeated.

In addition to these, fiscal policy in an Islamic economy will also aim at safeguarding and spreading the religion within the country as well as in the world at large. All the papers presented in the seminar recognize this unique objective of Islamic fiscal policy.

Even though the objectives of growth, stability, etc. remain valid in an Islamic economy they become subservient to the objective of defending Muslims and Islam both as a political and religious entity and a world-wide spreading *da'wah.*

We close this section by noting, that these objectives must be considered to be the objectives of public policy of which fiscal policy is but one component and then see to what extent fiscal policy can contribute to achieving these objectives and how. To that we will return in the section on mechanism of fiscal policy.

4.3 COMPONENTS OF FISCAL POLICY

In this section we discuss the three major components of fiscal policy, viz. government revenue, government expenditure and public debt in an Islamic perspective. We take them in turn.

4.3.1 Sources of Government Revenue

Some taxes or tax-like levies, e.g. *Zakah, Ushr, Kharaj,*

Jizya, have clear support from *Shariah* and hence no controversy exists with respect to their permissibility in the modern Muslim countries. There is, however, a debate on the right of the state to impose additional taxes. Since the question is very important, let us review the various arguments on the issue at some length.

Scope of Taxation in Islamic Economies

It has been argued by some knowledgeable people that a taxation policy beyond *Zakah* is un-Islamic. The argument relies on the sanctity of private property recognized by Islamic *Shariah* and contends that any compulsory government charge on it is unjust. It is, maintained for example, that the levying of taxes, in addition to *Zakah,* is an exception and not a rule [7]. It is argued that in an Islamic economy a clear distinction must be made between the subsistence welfare and the desired welfare. Provision of the subsistence level is not only an objective of economic policy, but is also an obligation, whereas the provision of an adequate standard of living is only desired. Included in the first category are aids and services provided to people stricken by a natural calamity, war, famine, or lack of production to below certain subsistence level, etc. The second category includes social services aimed at improving the economic living of the poor. Some of the writers believe that in fulfilling what is required, the state has to acquire the necessary resources while in providing what is desired, it is limited to the use of the available resources only. Writers in this line of thought have suggested five conditions for imposing additional taxes: (a) regular revenues are depleted, (b) defence expenses exceed current resources, (c) taxes are levied temporarily, (d) taxes are imposed only to the extent that total receipts do not exceed the needs, and (e) taxes are levied on the rich only.

Most of the Muslim economists are, however, of the opinion that an Islamic state can impose additional taxes to fulfil its obligations as a welfare state. Nevertheless, the powers of the state to impose taxes are not unlimited and it has to take into consideration the ability of people in various classes to pay taxes and at the same time try to reduce its expenditure to a minimum level compatible with its objectives. It is argued that there are certain constraints in the Islamic economy that prescribe the permissibility frontiers of taxation. Two unique built-in system constraints are mentioned [4]. Firstly, the Islamic taxation policy will be designed to compensate or supplement the 'resource gap' arising out of or incidental to *Zakah* and *Sadaqat.* Secondly, Islamic taxation system will be so structured as to fill in the 'objectives gap' indicated by or incidential to *Zakah.* It will serve to promote primarily the same ends for which *Zakah* has been levied. The first of these constraints is in principle the same as imposed by the other school with the important difference that the resource gap is defined in relation to a much longer list of objectives. The second constraint mentioned above has been subjected to criticism on the grounds that the very rationale for imposing additional taxes is that, since *Zakah* is an earmarked levy, and since government may have other objectives to achieve for which *Zakah* proceeds cannot be utilized, it will have to impose other taxes. Thus by definition other taxes will have objectives different, at least in part, from that of *Zakah.*

To sum up the discussion on the issue of taxation, the majority of Muslim economists believes that an Islamic state is permitted to impose taxes in addition to *Zakah,* and that it is not an encroachment on the right of private property recognized by Islam. Even though the taxes may not have to be restricted to rich only, the ability to pay the taxes must be a fundamental consideration. In order to minimise the genuine needs for taxation, the Islamic government must be very watchful in its expenditure.

In designing its taxation policy, the government has to follow certain criteria. In this regard if any of the Western criteria of imposition of taxes is in conformity with Islamic values, there is no harm in using it but there is nothing sacrosanct about those criteria. We are not obliged to follow them religiously. In an Islamic economy we have to use our own criteria. We may have, for example, a "social justice criterion" or a "piety criterion" etc. We should not feel ashamed of having non-material or value-oriented criteria.

An effort should be made to keep the taxes on the poor to a minimum. Specifically, even though it is permissible to impose some taxes on the poor, e.g. tax on unnecessary consumption, they will be mostly corrective taxes and not basically revenue raising taxes. To ensure that taxes do not fall on the poor, it will be necessary to have a clear idea about the incidence of various taxes. It is in this sense that Islamic economies will generally favour direct taxes. The sources of government revenue in Islamic economies are as follows:

(i) Zakah and Ushr: Just as abolition of the rate of interest is central to the monetary policy in an Islamic framework, imposition of *Zakah* and *Ushr* is the most important element of fiscal policy. It is not appropriate to call it a tax because it is in the real sense an *Ibadah.* However, we can call it for convenience a tax-like-levy because it does have economic implications similar to taxes. *Zakah* is imposed by a Qur'anic injunction but no rate has been prescribed by the Holy Qur'an. But Prophet (peace be upon him) has prescribed cretain ratios for different types of assets. According to *Fuqaha* these rates are fixed and unchangeable.

A minimum exemption called 'Nisab' is allowed in the assessment of *Zakah.*

Ushr[1] is a levy imposed on agricultural output. The rates of *Ushr* are also fixed, which are 5 percent of the output from irrigated land and 10 percent from the output of non-irrigated land.

(ii) Kharaj: Kharaj is a rental fee on the land that becomes the property of an Islamic State as a result of its liberation by Muslim troops. It was the consensus "Ijma" among the companions of the Prophet (peace be upon him) to keep such lands as a property of the state and lease them to people for a rental fee. The rate of *Kharaj* can be varied which makes it an important fiscal tool. It was one of the major sources of revenue for Muslim states in the past but its scope is reducing in the modern world.

(iii) Jizya: It is a tax leviable on all non-Muslim adults living in an Islamic state in lieu of exemption of non-Muslims from compulsory military service. The rates can be varied according to the ability to pay.

(iv) Government Investments and Natural Resources: Return on government investment was a new source of revenue introduced by Walid Ibn-Abdul Malik whereby he established a new department responsible for investments undertaken by the government. As pointed out earlier, government may enter into various projects on the basis of equity financing and the profits will be shared in an agreed proportion. Many Muslim scholars have also said that ownership of minerals and natural resources such as rivers, forests, etc. is restricted to the Islamic state. The revenue from these resources is the biggest source of government revenue in many Muslim countries at present time.

(v) Fees: Many government services may be provided against

[1]A broader definition of *Zakah* will include *Ushr* but the rate will be as given in the text.

fees that cover all or part of their costs. However, fees may not exceed the cost of services rendered.

(vi) Voluntary Contributions: The Islamic state has an important source of revenue by voluntary contributions that are donated by individuals in response to its appeals for financing specific projects and ventures. This was the most promising source at the time of Prophet (peace be upon him) and there is no reason why it should dry up in our times.

(vii) Other Taxes: As pointed out earlier, in addition to these conventional sources government may resort to other taxes to fulfil its *genuine* needs, or to achieve some desirable objectives. It may impose taxes to reduce unnecessary consumption or luxury imports or to change the allocation of resources. It may tax capital income to change the distribution of income and wealth. However, the power of the government to impose taxes is not unlimited. The limits and bounds on these powers have already been discussed.

4.3.2 Government Expenditure

Public money should be spent to achieve goals of the Muslim state. It is the duty of the government in a Muslim state not to squander public money but to utilize it to improve living standard of the public and for their spiritual elevation. Thus part of government expenditure will be devoted to activities which promote Islam and increase the welfare of Muslim brothers in other less-developed Islamic economies.

It must be mentioned here that *Zakah* proceeds have to be dealt with separately. The purpose for which these can be used have been explicitly mentioned in the Qur'an and must be strictly adhered to. The government does not have much flexibility in terms of spending these proceeds. They are basically meant for the poor and the needy to improve

their lot. If *Zakah* proceeds are not enough to fulfil the distributive function, the government may impose additional taxes on the rich and distribute them to the poor.

The size of other government spending will obviously depend on the objectives assigned to the fiscal policy. Thus the controversy on the objectives and the permissibility of taxation will have implications for the size of government expenditure. Majority of the Muslim economists believe that the government expenditure may be allocated in such a way as to achieve its objectives of stability, growth and allocative efficiency etc. The government is also responsible for providing some public goods which it has to do in such a way as to favour the poor even though the rich may also benefit from them.

The administrative expenditure has to be kept to a minimum. The *Khulafa-al-Rashedoon* have provided illustrious examples in this regard. Abu Bakr took a very small allowance and then again at the time of his death he is quoted to have told Ayesha to hand over to Umar whatever was left in his house from 'Al-Fay'.[1] Umar is quoted to have told *Sahaba* that he should be paid what would provide him a winter and a summer dress and his living expenses as an average person and that he, like any other person, should suffer during hard times.[2]

An Islamic state should also try to establish an elaborate social security system. Obviously it will depend on the available resources but within that constraint the government should try to do its best. In the past Muslim states have provided children allowance, allowances to orphans and widows, welfare money to disabled people, and also have paid off debts of people who were unable to do that

[1] Abu Obeid, "El-Amwal" p. 341.

[2] *Ibid.*, p. 344.

themselves. Umar used to say, if financial resources were abundant he would have paid every Muslim one thousand for buying a horse, another for weapons to go to *Jihad,* the third for travel expenses, and fourth to subsist his family while he was away protecting and defending the cause of Islam.[1] Islam also gave some extra benefits to those who worked for the state (in the cause of Islam). The Prophet (peace be upon him) is quoted to have said "those who work for the state will be given marriage allowance, a means of transport and a servant".[2]

4.3.3 Public Debt

Public debt consists of voluntary and obligatory internal borrowing and borrowing from abroad. The fact that in Islam all loans must be interest-free makes the scope of public debt very limited in an Islamic economy. Nevertheless, there may be some voluntary domestic loans motivated by Islamic inspiration and patriotism. There may also be some obligatory loans which may be obtained directly from the public or indirectly in the form of loans obtained from the central bank. Borrowing from the central bank is a form of forced borrowing which may reflect badly on the general price level. Therefore, its use should be restricted to the extent that does not destabilize prices. Loans from other countries on an interest-free basis are generally hard to find and, therefore, one may not count much on their availability. However, within the Islamic *Ummah,* it is the duty of the rich nations to help, in terms of grants or laons, the poor Muslim countries.

4.4 MECHANISM OF FISCAL POLICY

The objectives listed in Section 4.2 are not automatically

[1] Al Rayes "Al-Kheraj and the Financial Systems of the Islamic State". Dar Al-Ansar, Cairo, 4th Ed. p. 143.

[2] Abu Obeid, "El-Amwal", p. 338.

achieved. It is well-known that these objectives are not always compatible with one another. There are many trade-offs involved and the "rate of substitution" of one objective for the other depends on the social and ethical values of the society. There must be a mechanism to ensure that the socio-economic goals are accomplished. Modern economies offer two institutions namely, the market and the government, to jointly achieve the objectives. In the so called free-enterprise economies, private sector is the prime allocative and distributive mechanism whose excesses, lapses and distortions are corrected by the public sector. The socialist economies reverse this role. Public sector is the prime allocative and distributive mechanism while the private sector acts as the minor partner in the process. In comparison to these, an Islamic economy may be characterised as a three-sector economy. It will comprise of private sector, public sector and a voluntary sector. The voluntary sector encompasses all such individual and social activities which are not, by intent or design, undertaken to attain any economic or material benefit for the doer, but generate wide-ranging economic repercussions. In an Islamic economy, a sizable part of total resources flow through voluntary economic institutions. The objective of public policy will be achieved by an inter-action of all the three sectors.

Let us now take up the various objectives one by one:

(i) Efficient Allocation of Resources

Fiscal policy has to aim at achieving an efficient allocation of resources whereby they will yield maximum benefits to the society. In an Islamic state, the concept of efficiency is defined to include harmony between spiritual and material desires. Thus an optimum allocation of resources may be defined as the one that establishes an equilibrium between moral and economic imperatives. The moral imperatives will

be primarily taken care of through the voluntary institutions while the institution of market will reflect its economic imperatives. This does not however mean that the private sector will have no moral imperatives or the voluntary sector has no economic implications. It only means that the private sector being motivated by profit will be best suited to achieve the economic goals and the voluntary sector may try to fulfil its lapses. The public sector will not only supplement these two but will also act in a way calculated to ensure a better performance by both. The government may alter the pattern of voluntary institution's expenditure through its educative role. It may provide the necessary information in respect of needs of the poor classes, alter the time and spatial distribution of *Zakah* and *Sadaqat* etc. It may also change the behaviour of the private sector in the desired way through taxes and subsidies. It may encourage flow of resources to certain sectors by providing subsidies or tax-holidays and vice versa. In affecting these reallocations, the guiding principle will be the maximization of aggregate social welfare which has both a material as well as spiritual dimension.

(ii) Equitable Distribution of Income

Islam rejects the orthodox fiscal-neutrality criterion. In *Zakah,* Islam has a built-in redistributive mechanism. Islam abhors accumulation of income and wealth in a few hands and it has provided various tools to achieve an equitable distribution of income and wealth. *Zakah* is of course the most important of these but is not the only one. In addition, there are *Nafaqat-ul-Wajiba,* laws of inheritance, charity and the abolition of the rate of interest, all of which tend to redistribute income and wealth. Moreover, as has been pointed out earlier, the government may resort to other measures such as progressive taxation to achieve this objective. A system of negative income tax to make transfer payments to people falling below the poverty-line but above

nisab, has also been suggested [4]. The poverty-line may be determined according to the prevailing circumstances. The idea is a useful one, but care must be exercised to ensure that the disincentive for work which negative income taxes may entail, is somehow neutralized. One of the suggestions in this regard is to pay only a proportion of the difference between the povertyline and a family's income.

The government expenditure may also be used for redistributive purposes. The state by providing public goods, especially public health, education, provision of accommodation and other services generate a great impact on the distribution of income. The provision of public goods should be designed in such a way as to favour the poor. In addition to this, a social security system for the poor may also be developed. Transfer payments such as child allowances, old-age benefits, welfare payments to disabled etc., are also important redistributive techniques which have been used very extensively in early Islamic states. The voluntary sector may also make significant contribution by transferring resources to the production of goods and services which cater to the needs of the poor.

(iii) Full Employment without Inflation

Stability in the value of money is fundamental to Islamic economic system and unemployment must also be cured in order to provide a decent living to the Muslims. Fiscal policy can make significant contribution in achieving the stabilization objectives. Rather, one of the writers [10] takes an extreme position by saying that this objective has to be the major function of fiscal policy since he believes that monetary policy being left without the tool of rate of interest and open market operations which achieve the equilibrium in the money market, will not be able to perform this function. As an alternative mechanism, he proposes economic dues on idle cash to achieve equilibrium in the money market. The

problem with economic dues on idle cash is that you have to specify a minimum exemption limit as well as a minimum time period for which they should be held before economic dues can be imposed and if both of these are done, it becomes very similar to *Zakah* and in fact amounts to varying the rate of *Zakah* which may not be permissible in *Shariah*. The fear about monetary policy's incapability to achieve equilibrium is unfounded. The abolition of interest rate does not mean that there are no other variables which can control demand and supply of money. An alternative mechanism for achieving monetary equilibrium has already been discussed in Chapter 2[1] and need not be repeated. The assertion that open market operations would not be very effective in an Islamic economy [10] is also unjustified. Furthermore, stock exchange will play a greater role in Islamic economy because of the extensive use of equity financing as a substitute for borrowing.

There is a possibility of inflation both because of demand-pull and cost-push factors and the government has to try to keep it within safe limits. The major tool will be the control of money supply by the central banks. Money supply does not necessarily has to grow at a constant exponential rate equal to some proportion of the rate of growth, as asserted by some people, but it will be controlled at base and will be related to the rate of growth of national income. If necessary a 100 per cent reserve ratio may also be imposed. Further details of monetary policy to combat inflation have already been discussed in Chapter 2.

As regards unemployment there are some built-in factors in the Islamic system which combat unemployment. *Zakah* is one of those. The effects of *Zakah* on crucial economic variables have been investigated quite rigorously. Two major conclusions mentioned in this regard are: Firstly, because of

[1]See Section 2.5.2.

the imposition of *Zakah,* both the average and marginal propensities to consume would be higher in an Islamic economy than in a non-Islamic economy which does not have a similar fiscal measure. Secondly, the investment gap at each level of income would be smaller in an Islamic economy than in a non-Islamic economy [10]. If true, both of these effects will tend to increase aggregate demand and hence employment. The first conclusion, however, does not go uncontested. Many people argue that the pattern of consumption is determined by a host of factors. It is true that *Zakah* will lead to a more equitable distribution of income and wealth but that does not necessarily mean that the overall propensities to consume will be higher. As a matter of fact Duesenberry has shown, with the use of Veblen's demonstration effect, that consumption as a proportion of a given level of income could be higher under inequality than under a more equitable distribution of income. Moreover, in an Islamic system, the injunctions against *Israf* will, in particular, tend to reduce consumption propensities. That in itself will help to reduce unemployment since by reducing unnecessary consumption more resources may be released for productive investment.

The second conclusion, i.e. "the demand for investment at a given expected rate of profit will be always higher in the economies of Islam than in non-Islamic economies" found wide-spread support. By penalizing idle resources, the rate of *Zakah* discourages hoarding and stimulates investment.

The fact that in Islamic system the pre-dominant mode of investment will be *Mudarabah,* will also work as a built-in stabilizer since the entrepreneur will bear smaller risk in times of recession. Thus, entrepreneurs, in an Islamic economy will be less cautious and more adventurous during recession than their counterparts in the capitalist system. The financial institutions will also play a more active role.

By accepting lower share in profits in times of economic downturn they can stimulate investment.

Inspite of that, we cannot rule out the possibility of aggregate demand falling short of aggregate supply. In that event, the government may use discretionary fiscal policy to increase aggregate demand. One of the measures suggested is imposition of economic dues on idle assets [10]. By making the alternative to investment more costly, the imposition of economic dues will stimulate private investment. In other words, if the rate of dues on idle assets were higher than the expected rate of loss on investment, more investment would be forthcoming. In addition to that, government expenditure may also be used to stimulate demand. Islamic philosophers like Ibn-Khuldun have advocated such expenditure long before Keynes.

Chapter 5

ECONOMICS OF PROFIT-SHARING IN AN ISLAMIC ECONOMY

5.1 THE NEW SYSTEM

The rationale for the new system is to eliminate interest and to adopt a system of profit-sharing. There will be no room for interest in any form in an Islamic economy. Financial accommodation will have to be provided on profit-sharing basis where the funds are required for business activities. If the financial accommodation is required for purposes other than business then this will have to be in the form of *Qard-Hasanah,* i.e. a loan with no interest or obligation at all.

Switching over from the long established interest-based system to this new financial system is obviously a big change. Introducing a completely new system requires a number of questions to be answered about the possible consequences of the system for the economy. These consequences have to be traced at micro level as well as macro level.

The institution of *Qard-Hasanah,* as has already been discussed in Chapter 2, will generally be operating either

on cooperative basis or from the social security programme of the government. A well-developed institution of *Qard-Hasanah* operating on Islamic lines will have consequences on the consumer behaviour, for example, on the income allocation between consumption and saving, as well as on the economy as a whole in the form of affecting aggregate effective demand. These consequences, however, are not difficult to analyse as they can be traced within the framework of conventional economic theory.

The institution of profit-sharing, however, needs considerable attention as this is to completely replace a conventional instrument 'interest' which is supposed to perform a number of 'useful' economic functions in the modern economy. The system, which will mainly be affecting the working of the financial institutions, has been discussed at length in Chapter 3. The major form in which the banks will be providing financial accommodation to the entrepreneurs will be the *Mudarabah* where the financier will share profits of the entrepreneur (the borrower) at some mutually agreed rate.[1] This is entirely a different concept and may raise numerous questions.

One basic question, though not usually raised but which needs to be clarified in the beginning, is whether the concept of *Mudarabah* introduced in the Islamic economies of medieval times is still valid in the modern economies. One major consideration in this regard is that in the medieval times there used to be personal rapport between financier and entrepreneur. This personal rapport is not available in the present economies. This consideration, however, does not carry much weight particularly when we see the successfully operating joint stock companies which are a form of

[1]The financier will also share losses. Sharing losses, however, will be strictly in proportion of the contribution made by the financier to the total capital of the entrepreneur. No other rate of sharing the losses can be mutually agreed upon.

Mudarabah enterprise. Also the successful operation of various Islamic banks working on the principle of *Mudarabah* is a further evidence that the concept is not outdated. Another consideration that some time comes up is that the introduction of profit-sharing system might generate profiteering activities leading to the realization of excessive profits and hence exploitation. In fact, the profiteering or excessive profits in a society are generated because of a particular market structure. The mere fact that profits will be shared between financier and entrepreneur cannot create excess profits in the economy. No economic theory has so far been developed to substantiate this. Islam does not allow a market structure that leads to excessive profits. Profit-sharing in an Islamic economy, therefore, will not lead to exploitation. Any system is liable to be misused if it is not implemented in its true spirit and institutions are not built to lend support to the system. An economic system based on profit-sharing, therefore, cannot be discarded merely on the ground that it was developed in medieval times. What we simply need is developing proper institutions in which profit-sharing could operate in the present day economies. A detailed discussion, how this sytem should be operated and what institutional arrangements need to be made, has already been done in Chapter 3.

Once the question is settled that the profit-sharing system has to be implemented, the next set of questions is about what are going to be the economic consequences of this system. A whole range of consequences can be brought into discussion.

The most important implication of the system that should be brought into focus is with respect to the allocation of productive resources. How will the Islamic system fair compared to the interest-based system in allocating resources in an economy is, therefore, one of the basic questions.

Interest which is fixed and predetermined is to be eliminated and replaced by the sharing of profits. Profits in an enterprise are not fixed. They are flexible and not predetermined. This raises the apprehensions that a profit-sharing system will be exposed to wide fluctuations as the changes in the entrepreneural profits will be communicated back all along the line. How far these apprehensions are valid? In other words are we going to have a stable economy under profit-sharing system? One important function of interest in the modern economies is that it serves as a market indicator of the discount rate to be used for discounting future benefits/costs when two projects with different time horizons are to be compared for the purpose of the allocation of investible funds. If two projects compete for the same funds where project A gives Rs. 1000 next year and project B gives Rs. 1100 two years after, which project is more beneficial for the allocation of the present funds? The answer will depend on the rate at which we discount our future benefits relative to present benefits. Interest rate has been proved to be a justified market indicator of the discount rate. The question, then is, what would we do in this respect after we eliminate interest from the economy. Would we still discount our future benefits/costs and if yes then at what rate?

When an institution is eliminated and a new institution is introduced, questions arise not only with respect to those functions that the previous institutions used to perform, but also about what new functions can be performed by the new system. For example, profit-sharing is a system that not only distributes profit between financier and entrepreneur but it also distributes risk between the two. Distribution of risk is a tool that can be utilized not only to improve efficiency but also to improve the income distribution. Thus, the introduction of profit-sharing system provides us a tool for risk distribution also. This tool can be utilized to achieve the

objective of income distribution to reduce the existing inequalities. How this can be done is an interesting question to be studied in the context of the economics of profit-sharing.

These and many other questions cannot be answered completely in one sitting. Research and dialogue to support a system is a continuous process. The Islamabad Seminar picked up only a few of the most important questions to be answered, leaving the rest to be discussed in the follow-up seminars. The questions that were addressed by the papers presented in the Islamabad Seminar broadly, were:

(a) Will the economy be stable, functioning smoothly, under the profit-sharing system?

(b) How the resources will be allocated in the absence of interest and will the resulting allocation be more efficient than the one obtained in the interest-based system?

(c) How the projects, at micro level, be evaluated for the purpose of investment decision particularly when the interest rate will no more be available to serve as a discount rate?

(d) Can we improve income distribution letting workers share the risk by making them participate in profits of the enterprise?

The discussion on these questions is summarized below:

5.2 STABILITY OF ECONOMY UNDER PROFIT-SHARING SYSTEM

In an Islamic economy, the rates of interest paid by the banks to the depositors will be replaced by a percentage share

of profits accruing to the banks and the rates of interest received by the banks (from borrowers) will be replaced by the percentage share of profits accruing to the entrepreneurs. The two types of ratios of profit will be the instruments to mobilize savings and channelize them to productive activities. Though the ratios of the profit-sharing will be predetermined, since the level of profits can fluctuate, the rate of return on capital will also fluctuate and therefore, will be uncertain. The system based on an uncertain rate of return on capital can, therefore, be apprehended to be subject to wide fluctuations and unstable conditions.

Muslim economists, however, emphasize that there are built-in forces in Islamic economic system to ensure stability. Introducing a system of profit-sharing is, therefore, assumed to be causing no problems as regards the smooth functioning and stability of the economy. The approach so far, however, has been intuitive. No rigorous work has been done to prove these assertions.

To shed the apprehensions that the system of profit sharing is likely to be exposed to wide fluctuations and will destabilize the economy, a lot of rigorous theoretical work is needed. Muslim economists have now started applying themselves to the problem.

An analytical paper presented in the seminar tried to prove that the introduction of ratios of profit-sharing to replace rate of interest will not destabilize the economy and that the changes in the entrepreneural profit will not get communicated back all along the line [13]. It goes even further to try to establish that the system based on profit-sharing will also ensure a better allocation of resources and more equitable distribution of wealth. The paper adopted a partial equilibrium approach to demonstrate that how the mechanism of the determination of supply and demand for savings and advances will remain same as it is in the theory of

loanable funds of modern economics and that how the system will tend to fall back to the equilibrium position if certain forces created a disequilibrium. The paper, which was described as a preliminary exploration in the monetary dynamics in an Islamic economy, however, lacked the rigorous analysis required to substantiate such claims as of stability in an Islamic economy. There was a near consensus that intuitively there could hardly be any reason to believe that the Islamic economy will be unstable, but how to theoretically demonstrate it still remained a question. Much more than the partial equilibrium theory of loanable funds approach was needed in this respect. The theory of loanable funds cannot describe what we call an Islamic economy. More revealing analysis would be possible if it is done in the broader framework of an Islamic economy. Also the replacement of interest by the ratios of profit-sharing will not affect the capital market only. It will have repurcussions for the whole economy. To simply demonstrate that the introduction of profit-sharing system will not destabilize capital market does not mean that the whole economy will remain stable. The stability has to be seen in the context of general equilibrium in the economy.

A paper, on more general lines, was also contributed to the seminar [8]. This paper adopted a general equilibrium approach to the Islamic economic system. The paper argued that there is no reason to doubt the instability of an economic system simply because the price of one of the factors is an uncertain variable. It will depend on what commodities and factors we treat in our model, particularly what treatment we give to 'uncertainty' and 'risk' in our model. This paper which, though presented but not discussed because of the absence of the author, was more in general term also did not answer the question as to how the introduction of a profit-sharing system will affect the capital market and other sectors of the economy. It was

generally felt that an analysis of the economics of profit-sharing was needed on the following lines.

(a) What are principal economic determinants of the supply of savings, supply and demand of bank deposits and advances and the demand for investment in an Islamic economy.

(b) What will be the nature of consequences of replacing interest by ratios of profit-sharing not only on the equilibrium in the capital market but on the general equilibrium in the economy. The public sector (taxes and tariffs), the foreign sector (particularly the international prices), economic activities in the real sector are some of the important variables to be included in such analysis that is aimed at tracing the economic consequences of the introduction of a system. It will also be instructive to demonstrate if there is any relationship between profits resulting from *Mudarabah* (profit-sharing) and profits resulting from other activities in the economy.

(c) What will be the role of central bank in the profit-sharing system and how would it affect or control the consequences of the system is also an area for further research. If a central bank exists and if the ratios of profit-sharing can serve as tools for achieving the objectives of the monetary policy, then it needs to be established what would happen to these objectives if the system is stable or unstable.

(d) Will the system remain stable if there is also a stock market operating in the economy. The share market will be in direct competition with the banks. An analysis of the consequences of profit-sharing system will have to include share market also.

(e) If the theory of loanable funds is to be followed to trace the effects of profit-sharing, the ratios of profit-sharing will not be the correct variables for the analysis as they cannot be considered to be the determinants of supply of and demand for deposits/advances. To explain supply of and demand for deposits/advances, the appropriate variables should be the rates of return to banks/depositors/entrepreneurs.

5.3 ALLOCATION OF RESOURCES IN A PROFIT-SHARING SYSTEM

Two basic questions in the allocation of resources are:
(a) How the resources will be allocated between sectors?
(b) How efficient this allocation is going to be?

Sectoral allocation of resources in competitive economies is fully explained, in modern economics, by the expected rate of profit. The introduction of the system of profit-sharing will not disturb this mechanism. A proportionate sharing of entrepreneural profits by the supplier of money capital has no effect on the economic role of the expected rate of profit. The entrepreneur's urge to maximize profits and the tendency of competition to ensure equality in the rate of profit in various sectors are not affected by the institutional arrangement that the entrepreneur has to surrender an agreed percentage share of the profits to the financier. The absence of rate of interest from the scene does not pose any problems whatsoever particularly when it has also been shown that the profit-sharing system will not create instabilities in the economies. The present role of interest in investment decisions actually depends on the fact of its existence – an institutional reality rather than an economic necessity [13].

The absence of rate of interest does not take away the tools of monetary policy. The profits-sharing rates can serve as monetary tools. Though a view exists that the spirit of the

system of profit-sharing is based on the concept of equitable distribution of profit and, therefore, the tools cannot be used for allocative purposes, the possibility of using these tools by monetary authorities to achieve some allocative objectives without adversely affecting the equity concept, cannot be over-ruled completely.

The efficiency of the profit-sharing system is believed to be higher than the efficiency of the interest-based system on the following ground:

(a) The supply of entrepreneurship is likely to be large in a profit-sharing system as compared with an interest-based system, since the obligation of fixed interest payment discourages the marginal entrepreneur. It has been elaborately argued [13] that expected rate of profit will serve as a perfectly rational market indicator for the allocation of resources and the absence of interest will not pose any problem whatsoever.

(b) The resource allocation through the mechanism of the determination of the ratio/rate of profit for depositors, bankers and entrepreneurs will be more rationale and efficient than the one claimed by the institution of interest.

5.4 PROJECT EVALUATION IN THE NEW SYSTEM

When it is a question of allocating resources to projects whose benefits are spread over different time span, the investment decisions have to consider:

(i) Whether or not to discount future benefits (versus present benefits); and

(ii) If yes then at what rate.

Modern economics answers these questions as:

(i) Yes, because time preference is a rationale economic behaviour; and

(ii) Interest rate can serve as a market indicator of the rate of time preference.

In an Islamic economy, where the interest rate will not be available, the following questions arise:

(a) Do we have a concept of time preference in Islam, i.e. is discounting allowed in Islam?

(b) Is the concept of time preference a valid base for discounting?

(c) What will be the market indicator for discount rate if discounting is allowed in Islam?

These fundamental questions do not have very simple answer. Lot of research is still needed in this area. The directions in which the final answer is to be sought is, however, very clear and is presented below:

Is Discounting Allowed in Islam?

It is a general agreement that discounting is allowed in Islam. This is irrespective of the agreement on the question whether or not there is a concept of time preference in Islam. The fact that a Muslim is permitted to choose any of the several *Halal* investment opportunities in the society for a quite likely positive return makes the money now in hand more valuable than money in future. It justifies discounting.

Is the Concept of Time Preference a Valid Basis for Discounting?

The answer to this question that came up in the seminar is in negative [14]. Human beings consistently do not have a positive time preference and, therefore, time preference cannot serve as a valid and stable base for discounting [14]. Even in an interest-free economy, where interest rate serves as a discount rate, the time preference cannot be considered to be the rationale base for discounting. The argument that human beings do not consistently have positive time preference is quite convincing. Many consumers found to be keeping interest-bearing bank account even when the real expected rate of interest is clearly negative is one of the examples of the prevalence of negative time preference. This and other examples mentioned in one of the papers [14] are obviously enough to cast doubts on the validity of time preference as a basis for discounting.

What should be the Market Indicator of Discount Rate in an Interest-Free Economy?

Even to those who believe that the time preference can be a valid basis for discounting, the search for a market indicator of time preference has always been a major issue. For an interest-free economy an author, however, presents a simple answer to this question. According to him the rate of return on equity in projects of comparable risk should be the discount rate. This is based on the concept of marginal productivity of capital which is not only a market indicator but also has a consistant behaviour [14].

Though controversy may arise on how a representative rate of return is to be calculated to serve as a discount rate, very little difference of opinion can arise on the validity of rate of return on equity as a market indicator of the discount rate. This is something that even the modern economists

would not contest. In fact, the modern literature on Investment Decisions is already emphasizing the use of rate of profit, instead of rate of interest for discounting future benefits and costs.

To some minds, it may, however, not be very clear, as to what substantial difference does it make to replace interest rate by the rate of return on equity. The basic rationality behind this choice lies, of course, in the legitimacy of the instruments. The fact that the rate of return is a legitimate instrument whereas interest rate is an illegitimate instrument in an Islamic economy precludes the use of latter in favour of the former. The fact that two instruments can perform same activities obviously does not justify that both will be legitimate.

Another substantial difference pointed out in this respect is that the rate of return in an Islamic economy is a completely different concept from the profit rate in capitalism and, therefore, it need not be confused to be the same when the western economists say that the rate of return be used as a discount rate.

Doubts are also expressed with respect to the validity of the rate of return on equity as a discount rate at macro level because at macro level need arises to define a social rate of return. What will be the social rate of return that we can use at macro level for the projects in public sector is a question yet to be looked into.

The question, however, remains that how the rate of return on equity will be calculated in practice to represent the discount rate. An attempt has been made to describe the quantitative methodology for calculating the discount rate in an Islamic economy [3]. Making a few assumptions about the investment behaviour of private and public sector, an

author of one of the paper finally comes up with a measure of discount rate that would:

(i) Use the Islamic welfare function to obtain Islamic accounting prices of all Islamic objectives. Anyone objective must be used as a *numeraire* or unit of account.

(ii) Compute all annual benefits and costs of a project using Islamic accounting prices to obtain an estimate of net Islamic benefits for each year of project life.

(iii) Use a suitable discount rate to obtain the Islamic net present value of the project.

No major controversy can arise on these steps in evaluating the projects in an Islamic economy, though controversies may exist in specifying the welfare function particularly in giving priorities to the goods and services to be provided by the projects.

The idea that a manual for project evaluation should be prepared needs immediate attention from the Islamic Development Bank, in particular, and from the economic institutions of Muslim countries, in general.

5.5 PROFIT-SHARING AS A TOOL FOR INCOME DISTRIBUTION

A new aspect of profit-sharing system also came under discussion [1]. Apart from its aspect of allocation of capital, the profit-sharing system has another aspect which deals with the sharing of risk. In the present institutional framework, the owners of physical capital can distribute the risk by separating the management and liability in the form of joint stock companies. The owner's of human capital, on the other hand, remain under privileged in the sense that they

cannot diversify their risk as the owners of physical capital can do.

If access to risk income is made more easily available to those who only possess human capital, this will not only lead to distribution of income but will also optimize the risk allocation. This can be achieved by letting labour share the risks and profits of the firm in the sense that they will be allowed to acquire a claim to share the uncertain future profits of the firm. Since complete uncertainty about wages is not allowed in Islam, there will be minimum fixed wage and also labour will have the option not to participate the risk at all (and have some more (fixed) income)).

This risk and profit-sharing by labour was claimed to reduce employment risk in comparison to that in a fixed wage system [1].

The issue, however, is of practical nature. In theory, it can be proved both ways. To which way it would actually work will depend on how and where it is implemented. The scheme, in principle, does not have anything against *Shariah* and, therefore, can be tried on experimental basis in some selected sectors. The scope can later on be expanded if the scheme comes out to be fruitful.

Chapter 6

SUMMARY

6.1 INTRODUCTION

Islamic economic system is just a part of the Islamic Order. Various aspects of the Islamic Order are closely inter-related. Any effort to establish the Islamic economic system or any aspect of it, such as fiscal and monetary system, without aiming at the broader goals of *Shariah,* is quite likely to become an excercise in futile. Therefore, the distinct and unique features of the Islamic system should be kept in mind while formulating its monetary and fiscal components. Some of the distinguishing features which will have implications for the monetary and fiscal systems are as follows:

(1) Islamic state is a welfare state where welfare is defined to include material as well as spiritual aspects with greater emphasis on the spiritual side. It, therefore, follows that part of the government expenditure will be spent on activities which promote Islam and increase the welfare of Muslim brothers in other less developed Islamic economies.

(2) Human dimension is the main aspect of economic enterprise in Islam. Elimination of poverty and deprivation and of exploitation and injustice reign supreme in Islamic economic reform.

(3) Moral aspect is fundamental to the Islamic economy. Individual and collective economic motives are constrained by moral bounds placed by Islam.

(4) Growth is no doubt important, but in an Islamic economy, moral aspects and consideration for future generations who are equal owners of God-given resources, put effective constraints on the growth objective. The emphasis will change from volume to the composition and justice orientation of growth.

(5) Islam stands for justice to all parties. Since inflation involves injustice to *riba*-free lender, stability in the value of money is fundamental to the Islamic economic structure and not just a desirable thing.

(6) Interest is prohibited in Islam. The abolition of the rate of interest in an Islamic economy changes the nature not only of monetary policy but also of fiscal policy. Since the rate of interest which achieves equilibrium in the money market will not be available, some alternative must be found.

(7) Islamic society has to get rid of all sorts of exploitation. This requires elimination of *riba* in all its forms. At the same time profiteering or exploitative profits will also have to be eliminated. There is, however, nothing wrong in earning genuine normal profits.

(8) Since payment of *Zakah* is obligatory for every Muslim the collection and distribution of *Zakah* serves as a built-in fiscal device which is unique to Islamic

economy. However, the role of *Zakah* as a discretionary fiscal tool is somewhat limited since the rate of *Zakah* as well as the areas in which its proceeds can be utilized are fixed.

(9) Since all loans in Islam have to be interest-free, much government spending would be financed either from the proceeds of taxes or on a profit-sharing basis. Hence, the scope of public debt would be much smaller.

(10) Along with private and public sector, another unique sector – the altruistic sector – plays an important role in an Islamic economy.

(11) In a national war, Islam expects people to offer their lives as well as their wealth.

(12) Finally, the right of taxation in an Islamic state is not unlimited. Some people even go to the extent of saying that a taxation policy beyond what is defined by *Zakah* is not possible except under exceptional circumstances. Most of the Muslim economists are, however, of the opinion that an Islamic state can impose additional taxes to fulfil its obligation as a welfare state. Nevertheless, the power of the state to impose taxes is not unlimited.

6.2 MONETARY POLICY

6.2.1 Objectives of Monetary Policy

The objectives of monetary policy in an Islamic economy will include stability in the value of money, equitable distribution of income and wealth and full employment and economic growth. There exists a view that this multiplicity of objectives will over-burden the monetary policy. The argument relies on Tinbergen and Mundell Principles which require matching of policy objectives with policy tools,

failing which we may not be able to achieve anything. There is some weight in this opinion as the objectives listed above may not always be compatible. However, the Mundell Principle is too text-book type to be strictly adhered to. It is desirable to have multiple objectives in view all the time. However, these must be thought of as objectives of public policy and then use different policy tools including the monetary policy to collectively achieve these objectives. In this regard, it will be desirable to 'rank' these objectives from the point of view of effectiveness of various policy tools. The contribution that monetary policy can make to the achievement of these objectives has been discussed in detail.

6.2.2 Role of Money

Money is an integral part in any modern economy. Islamic economies will be no exception. Money will perform its usual functions of unit of account, medium of exchange and the store of value. Although some Muslim economists have doubts about the permissibility of holding speculative balances in an Islamic framework, a large majority of economists feel that it is permissible. The doubts stem from the fact that Islam prohibits hoarding and most forms of speculation. The confusion perhaps arises because of a misnomer. The speculative demand for money is not necessarily hoarding or speculation. A more appropriate term is "asset demand" for money. The question is that of relative rates of return on different assets, of which money is only one. If people want to keep their savings in liquid form to take advantage of expected changes in relative prices of assets, this is quite permissible.

6.2.3 Role of Banking System

The banking system as a whole has to perform two fundamental functions:. (i) to provide 'adequate' liquidity to the system so that the production and exchange are smoothly effected, and (ii) to mobilize investible resources and to allocate them to the investors. In the capitalist system, these functions are performed from a lender's vantage point. Money balances are lent on the basis of being repaid in fixed monetary sums with an agreed interest return. In such a system, solvency of the borrowers becomes paramount while the 'productivity' of investment undertaken by them is considered secondary. On the contrary, in an interest-free system, productivity becomes more important. Thus the most important distinction is that whereas the capitalist system is lending-based, Islamic monetary system will be productivity based.

(i) Provision of Liquidity

With respect to the provision of 'adequate' liquidity, there is a school of thought among Muslim scholars who think that the money supply should be controlled at base and the commercial banks should not be permitted to create credit. It is argued that a monetary system based on fractional reserves suffers from an "inherent instability". It is also argued that the credit creation by commercial banks is inequitable because the major beneficiaries of this process are the banks themselves and the big industrialists to whom these resources finally flow.

In the present circumstances, the argument does have a lot of appeal. However, there is another school of thought who argue that a 100 per cent reserve requirement will be too restrictive and will work counter to full utilization of resources. They maintain that the problems of instability and inequity can be solved within the framework of

fractional reserve system. If there are suitable checks and balances, the process of money creation will not be unstable. Also, the fact that at present the direct beneficiaries of credit creation are big industrialists, is not a natural or necessary outcome of the system of fractional reserves. Measures can be adopted to ensure that the allocation of derivative deposits is such that the benefits are equitably distributed.

The subject needs further probing but there is agreement to the extent that, if fractional reserve is permitted, there must be checks, *both* on the *creation* of credit by commercial banks and on its *allocation.*

(ii) Mobilization of Resources

The interest will have to be abolished at micro level as well. The basis of cooperation between capital and enterprise which Islam cherishes is equitable sharing of risks and gains. A fixed and pre-determined rate of return on capital has no room in an Islamic economy. The mobilization of resources and their allocation to the investors will be done in a profit-sharing framework and not on the basis of fixed rate of interest. The financial market can offer a wide spectrum of financial instruments to the savers which include demand deposits, profit-sharing accounts, corporate stocks, various kinds of commercial bank investment certificates and the central deposit certificates of the central bank. The nature and characteristics of these instruments have been discussed at some length. Financial accommodation for non-productive loans will be provided as *Qard-Hasanah,* (i.e. without any charge or obligation over and above the principal).

6.2.4 Islamic Alternatives to Interest-Based Operations

The whole system, however, cannot be changed overnight. In the transitional period, the system may be

supplemented by some alternative arrangements. These arrangements include, service charge, indexation, investment auctioning, mark-up, hire-purchase, leasing, *Murabaha,* or *Bai-Muajjal,* time multiple counter loans and financing on the basis of normal rate of return. The nature and working of these arrangements has been discussed in Chapter 3. Out of these 'service charge' and 'indexation' do not gain much support since the Islamic jurists do not pass them as legal. The other alternatives receive some support, though reluctant, for their use as an alternative to profit-sharing in an interest-free economy. This support is, however, strictly on the condition that they will be applied only in the transitional period during which the mechanism for the working of the profit-sharing system will be rapidly built up.

6.2.5 Organizational Structure of the Islamic Monetary System

Although there may be some similarities in that the organizational structure of Islamic monetary system is not very different from the existing system but there are fundamental differences in the functioning of different institutions. The financial structure comprises of the central bank, member banks, non-bank financial intermediaries, the treasury, stock market, investment cooperatives *(Shirkah* institutions) and *Qard-Hasanah* institutions. The last two institutions have a unique position in the Islamic monetary system. The other institutions exist in the present system but their mode of operation will be quite different in the new system. The central bank will create fiat money but not against government interest-bearing securities. It will anchor the growth of money supply to the growth rate of the economy. The treasury will collect and distribute *Zakah,* manage society's natural resources and handle monopolies, externalities and market disorders. The member banks will undertake direct investment in the form of equity shares, profit-sharing and leasing ventures, etc. Their liabilities will

consist of noninterest-bearing deposits and deposit certificates issued to their customers on the basis of profit-sharing.

There are now many banks in various parts of the world working on Islamic principles. A review of the performance of these banks gives a sense of satisfaction. They provide an evidence of the practicability and viability of the Islamic financial institutions. The real success of these banks, however, would be in how far they have been able to contribute to the realization of Islamic goals of social justice. The experience of these banks in this respect is yet to be studied. Particularly it is yet to be seen that who are the beneficiaries of Islamic banks compared to those of interest-based banks.

6.2.6 Instruments of Monetary Policy

In order to ensure smooth functioning of the market system and to accomplish the socio-economic objectives of the society, the monetary authorities will monitor the whole system through various tools of monetary policy. The abolition of interest will rule out the instruments of discount rate and open market operations in interest-bearing government securities. However, this should not be taken as a disadvantage. Alternative instruments can be, and are being, designed to control the monetary sector. These instruments include the control of money supply at base, statutory reserve requirement, value-oriented allocation of credit, public share of demand deposits and central deposit certificates. The mode of operation of these instruments has been discussed.

6.2.7 Strategy for the Implementation of the System

The implementation of the profit-sharing system would require a planned approach. This approach should be such

that each step leads to the next step leading finally to the ultimate objective. The argument that interest should not be eliminated before changing the whole economic system fails to get any real support. Interest should be eliminated as soon as possible and meanwhile steps should be taken to incorporate other aspects of Islam, i.e. economic philosophy. The nature and functions of the existing economic institutions like central bank, commercial banks, treasury, etc. should be changed on the lines suggested above. At the same time new institutions like investment cooperatives and *Qard-Hasanah* institutions should be quickly built-up to cater the needs of the new system.

Reforms in tax-structure will also be needed because the tax structure of interest-based economies will remain no more consistent with the new system. Within the realm of Public Policy another important change that will be required is the reduction in the wasteful public spending. This is because in the interest-free economy, government will not be able to depend very much on deficit-financing or on public borrowing to meet its expenditure.

6.3 FISCAL POLICY

6.3.1 Objectives of Fiscal Policy

The role of fiscal policy in any economy is determined by the level of government's involvement in economic activities which is in turn determined by its socio-economic objectives, ideological commitment and the nature of the economic system. The objective of fiscal policy in an Islamic economy will, therefore, differ from their secular counterpart both in interpretation as well as emphasis. Fiscal policy in capitalist economies aims at: (i) allocating resources efficiently; (ii) achieving economic stability; (iii) economic growth; and more recently (iv) attaining equitable distribution of income. These objectives may remain valid in an Islamic economy.

However, their interpretation will be different. These differences have been discussed in Chapter 2. In addition to these, fiscal policy in an Islamic economy will also aim at safeguarding and spreading the religion within the country as well as in the world at large. This last objective will occupy a very high position on the priority list in an Islamic state.

6.3.2 Components of Fiscal Policy

Various components of fiscal policy viz. government revenue, government expenditure and public debt have been discussed in an Islamic perspective.

(i) Sources of Government Revenue

With respect to government revenue the scope of taxation in an Islamic economy, which has given rise to considerable debt, has been discussed at some length. It was concluded that according to the majority of Muslim economists an Islamic state is permitted to impose taxes in addition to *Zakah* and that it is not an encroachment on the right of private property recognized by Islam. Even though, the taxes may not have to be restricted to only rich people, the ability to pay the taxes must be a fundamental consideration. In order to minimize genuine needs for taxation the Islamic government must be very watchful in its expenditure. The other sources of government revenue include *Zakah* and *Ushr, Kheraj, Jizya,* Fees, government investment and natural resources and voluntary contributions.

(ii) Government Expenditure

The government expenditure will be incurred to improve living standard of the public as well as their spiritual elevation. The size of government expending will obviously depend on the objectives assigned to fiscal policy. Majority

of the people believe that the government expenditure may be allocated in such a way as to achieve its objectives of stability, growth, allocative efficiency, etc. An Islamic state should also try to establish an elaborate social-security system. The administrative expenditure has to be kept to a minimum. In this regard illustrious examples set by *Khulafa-al-Rashedoon* have been quoted.

(iii) Public Debt

The fact that in Islam all loans must be interest-free makes the scope of public debt very limited. Nevertheless there may be some voluntary domestic loans motivated by Islamic inspiration and patriotism. There may also be some obligatory loans which may be obtained directly from public or indirectly in the form of loans obtained from the central bank. Excessive loans from the central bank, however, may reflect badly on the general price level and should, therefore, be restricted. Loans from other countries on interest-free basis are hard to find but within the Islamic *Ummah* this source may be a useful way of meeting the genuine needs of poor Muslim countries.

6.3.3 Mechanism of Fiscal Policy

The objectives of fiscal policy are not automatically achieved. There must be a mechanism to ensure that the socio-economic goals are accomplished. The modern economies offer two institutions, namely, the market and the government to jointly achieve the objectives, with the relative importance of the two sectors depending on the type of economic system. In comparison to this an Islamic economy may be characterised as a three sector economy. It will comprise of private sector, public sector and a voluntary sector. The voluntary sector encompasses such individual and social activities which are not, by intent or design, undertaken to attain any economic or material benefit for the

doer, but have wide-ranging economic repercussions. The objectives of public policy will be achieved by an interaction of all three sectors.

An optimum allocation of resources in an Islamic economy is defined as the one that establishes an equilibrium between moral and economic imperatives. The moral imperatives will be primarily taken care of through the voluntary institutions while the institution of market will reflect its economic imperatives. This does not, however, mean that private sector will have no moral imperatives or the voluntary sector has no economic implications. It only means that private sector being motivated by profit will be best-suited to achieve the economic goals and the voluntary sector may try to fulfil its shortcoming and rectify imbalances. The public sector will not only supplement these two but will also act in a way calculated to ensure a better performance by both.

As regards the distribution of income, Islam has a built-in redistributive mechanism as *Zakah* which plays the major role in achieving the redistributive function of fiscal policy. However, in addition to *Zakah,* there are *Nafaqat-ul-Wajiba,* laws of inheritance, charity and the abolition of the rate of interest, all of which tend to redistribute income and wealth. The system of negative income taxes has also been proposed to make transfer payments to people falling below the poverty-line but above *Nisab.*

Fiscal policy can also make a significant contribution in achieving the stabilization objective. *Zakah* and economic dues on idle cash tend to discourage the holding of idle resources and thus ensure better utilization of resources. It has also been shown that the investment gap at each level of income would be smaller in an Islamic economy than in a non-Islamic economy. That will also tend to increase aggregate demand and hence employment.

6.4 THE PROFIT-SHARING SYSTEM

6.4.1 Stability of the Economy under Profit-Sharing System

Muslim economists believe that introduction of the system of profit-sharing in place of interest will have no adverse effect on smooth functioning of the economy. The profit-sharing system simply broadens the base for the equity participation. Increasing the equity base by eliminating interest, should not have any adverse consequences for the economy. The economy should rather function more efficiently as the supply of entrepreneurs in the economy will increase with the introduction of profit-sharing system. These assertions must, however, be substantiated by theoretical analysis of Islamic economy. Attempts are now being made to probe into the efficiency and stability aspects of Islamic system by using proper analytical techniques. These attempts are, however, still in the stage of infancy. A lot needs to be done to fill theoretical lacunae in this field.

6.4.2 Distributive Aspects of Profit-Sharing System

The system of profit sharing not only distributes profits but it also distributes risk. This aspect of profit-sharing can be utilized for the purpose of income distribution between labour and capital. This can be done by letting labour participate in management and share the risk and hence profit of the enterprise. There may be some administrative problems in implementing such a device but this is something that deserves attention of the public policy-makers in the Muslim countries.

6.4.3 Project Evaluation and Discounting

Discounting future benefits and costs for the purpose of investment decisions is allowed in Islam. The rate of time preference, however, does not get any support as a valid basis for determining the discount rate because human beings do not consistently have a positive time preference. Marginal productivity of capital is more consistent and hence a better measure of the discount rate. Thus the rate of return on equity is a valid discount rate. How the rate of return should actually be calculated in practice is, however, yet to be explored.

Project evaluation in the public sector in an Islamic framework will have to be done in the light of a welfare function of the Islamic economy. What arguments will enter into the welfare function and what weight should be given to each argument is yet to be settled. Some guidance in this respect is, however, available in the work of Muslim philosophers and *fuqaha*.

Chapter 7

AREAS FOR FURTHER RESEARCH

Research and dialogue is a continuous process particularly when a whole new system is being developed. Within the field of monetary and fiscal economics, it is strongly felt that the following areas need to be studied in depth.

1. How to Eliminate *Riba-al-Fadl*

Bank interest is not the only thing to be eliminated from the society. All forms of exploitation and injustice in financial transactions are a form of *riba* and they should be eliminated. Whereas a lot of work has been done to find out ways and means to eliminate *Riba al-Nasia* or *Riba-al-Jali,* no work has been done to find out ways and means to eliminate *Riba-al-Fadl* or *Riba al-Khafi.* A lot of injustice exists in the agriculture sector of most of the economies in the form of market structure, pricing system, etc. All these financial injustices have to be removed from the economy. Muslim scholars should identify various forms of financial injustice in a Muslim economy and suggest measures to eliminate them.

2. Reorganisation of Stock Markets in Muslim Economies

Various malpractices and abuses prevalent in stock market will not allow a successful implementation of interest-free economy. The business of the stock markets will have to be organized to make the functioning of these markets consistent with Islamic teachings. Reforms will also have to be made in capital markets so that business in economy depends more on equity participation than on borrowing. Studies of capital markets need to be made in all Muslim economies in the above perspective.

3. Structural and Institutional Changes Required for the Successful Elimination of Interest from the Economy

It is not enough to simply suggest the alternative instruments that can replace *riba*. A successful elimination of interest would require various structural and institutional changes in the society. These changes need to be investigated and recommended so that:

(a) the conditions favourable for the successful functioning of Islamic banking are obtained; and

(b) economic goals of an Islamic economy are achieved.

Recommendations also need to be made for new institutions to be created. One immediate need, for example, is of a social security set up based on *Zakah* and other resources which could finance the financial needs for consumption purposes.

4. The Mechanics of Credit Creation and its Equitable Distribution

The mechanics of credit creation and its equitable distribution need to be studied in detail. The dimensions in which this needs to be studied have been discussed in detail in Chapter 2.

5. Indexing of Loans by the Rate of Inflation

The *Shariah* aspect of indexing by the rate of inflation is yet to be explored. Various forms of indexation need to be examined, e.g. the cost of living index or some other price index or the average rate of return on profit-sharing investments.

6. The Justification of the Normal Rate of Profit as an Alternative to Interest Rate

The justification of the normal rate of profit as an alternative to profit-sharing in an interest-free economy and how this rate will be determined is another question unresolved. The Muslim economists are rightly concerned that sharing of profit might lead to the practice of generating exploitative profits which will be against Islamic values. This requires the definition of a normal rate of return beyond which the profit will be exploitative and un-Islamic. But there can be no single normal rate of return. It will vary from situation to situation and a number of factors have to be considered in the determination of normal rate of return. How the normal rate of return should be determined is a subject yet to be explored.

7. The Mechanics of the Effects of Monetary Policy on the Real Sector

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In a capitalist economy the monetary policy affects the real sector only through the rate of interest. In an Islamic economy the rate of interest will be replaced by the rate of profit. The rate of profit, however, depends on the business conditions. Thus the saving and investment decisions in an Islamic economy will not depend on the rate of interest but only on the expectations about business prospects. How, then the monetary policy will affect the real sector?

One possible mechansim is as follows. Suppose central bank decides to expand money supply. It will provide more funds to commercial banks as *Mudarabah* funds. Having excess supply, the commercial banks will be willing to accept a lower share of profit when they provide these funds to investors. The businessmen will thereby earn more net profit neutralizing the effect of low business expectations and the desired expansionary results will be achieved.

Are there any snags in this mechanism? What if the commercial banks do not agree to a lower share in profits? Is there an alternative transmission mechanism? These questions need to be investigated.

8. Implications of the Proposal of Public Share in Commercial Banks' Demand Deposits

Under multiple credit creation the banks receive a regular flow of resources which may be called "seigniorage" by analogy to the resources which used to accrue to sovereign rulers who had the right to mint coin with a face value larger than the intrinsic metal value of coin and the cost of manufacturing. Since the creation of credit is a social prerogative and since the banks do not pay any return on demand deposits, it has been proposed that a part of the demand

deposits should be made available to the government. The scheme will provide for part of the genuine needs of the government. Another advantage of the scheme is that making the public share of demand deposits a variable will provide the authorities with another policy tool which may be valuable in the absence of some other policy tool.

However, the rate of public share in demand deposits will affect the money multiplier which will have implications for the monetary policy. It will also affect the profitability of commercial banks. On the one hand it seems to be desirable to siphon off excess profits of the banks. On the other hand, since banks will themselves be working on profit-sharing basis, it might adversely affect the mobilization of savings.

The proposal is exciting but needs to be analysed in much more detail.

9. Consequences of Profit-Sharing on the Stability and Efficiency of the Economy

These need to be studied rigorously. A framework of the theory of loanable funds may not be enough to trace the effects of profit-sharing on the economy. A broader framework will have to be used in which the effects of profit-sharing will be traced in all sectors of the economy. Further details of the direction of such a study have been mentioned in Chapter 5.

10. How the Discount Rate for the Purpose of Project Evaluation should be Calculated in Practice

In theory, it may be convincing that the rate of return on projects of equivalent risk may serve as a discount rate in project evaluation. But how the rate of return is to be calculated, how the risk is to be defined and calculated, how

the divergence in the rates of return and risks should be reconciled, are the issues that need to be solved before the concept can be made practicable. The definition of a discount rate for public sector projects is another issue that still needs to be resolved. In theory, social rate of return on capital can be said to be the appropriate discount rate but how this is to be calculated in practice is a subject open for the researchers. The preparation of a Manual of Project Evaluation in Islamic Perspective should be considered so that it is available for the planners of the Muslim countries for practical use.

11. Limits to Deficit Financing in an Islamic Economy

Stability of the value of money is one of the major objectives of economic policy of an Islamic state. But deficit financing also has important benefits particularly for developing countries. Can we assign an optimum limit to deficit financing in an Islamic economy and what would be the procedure to determine this limit?

12. Consumer Behaviour in an Islamic Economy

The imposition of *Zakah* and elimination of interest is assumed to have implications for consumer behaviour. This is what has led some economists to say that the propensity to consume in Islamic economy will be higher. However, others believe that Islamic injunctions against *Israf* will tend to decrease the marginal propensity to consume in an Islamic economy. The issue needs further probing.

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2. Chapra, M. Umer. "Monetary Policy in an Islamic Economy".

3. Chaudhry, Masudul Alam. "The Rate of Capitalization in Valuation Models in an Islamic Economy".

4. Faridi, F. R. "A Theory of Fiscal Policy in an Islamic State".

5. Haq, Ziaul. "Theory of Mudaraba in Islamic Jurisprudence".

6. Al-Jarhi, Ma'abad. "A Monetary and Fiscal System for an Interest Free Economy".

7. Kahf, Monzer. "Taxation Policy in an Islamic Economy".

8. Khan, M. Ali. "Non Interest Pricing and General Equilibrium in an Islamic Economy".

9. Khan, M. Fahim. "A Report on the Existing Islamic Banking Practices in the World".

10. Metwally, M. M. "Fiscal Policy in an Islamic Economy".

11. Panel of Economists and Bankers. "Report on the Elimination of Interest from the Economy".

12. Salama, Abidin Ahmed. "Fiscal Policy of an Islamic State".

13. Siddiqui, Nejatullah. "Economics of Profit Sharing".

14. Zarqa, Anas. "Economics of Project Evaluation in an Islamic Perspective".

Annexure 1

PROGRAMME OF THE SEMINAR

Inaugural Session

- Welcome Address by Mr. Ghulam Ishaq Khan, Minister for Finance, Planning & Economic Affairs.

- Address by Dr. Abdullah Naseef, President, King Abdul Aziz University, Jeddah.

- Inaugural Address by Gen. Mohammad Ziaul Haq, President of Pakistan.

- Keynote Address by Prof. Khurshid Ahmad, Chairman, Institute of Policy Studies.

Session 1

Subject: *Existing Islamic Banking Practices*

Chairman: Dr. Ahmad Mohammad Ali

"A Report on the Existing Islamic Banking Practices in the World" by Dr. M. Fahim Khan

Discussants

- Dr. Taufiq Al Ammar
- Mr. Fouad Abdul Gadir Agabani

Session II

Subject: *Monetary Policy in an Islamic Economy*

Chairmen: (i) Dr. Ziauddin Ahmed
(ii) Dr. Mohammad Sakr

Paper: "Monetary Policy in an Islamic Economy". by Dr. M. Umer Chapra.

Discussants

- Dr. Munawar Iqbal
- Dr. Mohammad Ariff

Paper: "Theory of Mudaraba in Islamic Jurisprudence". by Dr. Ziaul Haq

Discussant

- Dr. Hasan-uz-Zaman

Session III

Subject: *Resource Allocation in Islamic Economy*

Chairmen: (i) Prof. Dr. Syed Nawab Haider Naqvi
(ii) Dr. Ghazi Madni

Paper: "Economics of Project Evaluation in an Islamic Perspective" by Dr. Anas Zarqa

Discussants

- Dr. M. Ali Khan (Comments circulated)
- Dr. M. Fahim Khan

Paper: "Risk Bearing and Profit Sharing in an Islamic Framework: Some Allocational Considerations" by Dr. Syed Aftab Ali.

Discussants

- Dr. A. R. Kemal
- Dr. Nevzat Yalcintas
- Dr. Mohammad Abdul Mannan

Session IV

Chairmen: (i) Prof. Dr. Mohammad Omar Zubair
(ii) Prof. Dr. Rafiq Ahmed

Paper: "Fiscal Policy in an Islamic Economy" by Dr. M. M. Metwally

Discussants

- Dr. Asghar Qadir
- Dr. Sultan Abu Ali
- Dr. Rafiq Ahmed

Paper: "A Monetary and Financial System for an Interest Free Economy" by Dr. Ma'abad Al-Jarhi. (Paper introduced by discussant)

Discussant

- Dr. Ishaq Nadri

Session V

Subject: *Fiscal Policy in an Islamic Economy*

Chairmen: (i) Dr. Ishaq Nadri
(ii) Dr. Nevzat Yalcintas

Paper: "Fiscal Policy of an Islamic State" by Dr. Abidin Ahmed Salama

Discussants

- Dr. Sabahuddin Zaim
- Dr. Syed Waseem Ahmed

Paper: "A Theory of Fiscal Policy in an Islamic State" by Dr. F. R. Faridi.

Discussants

- Dr. Anas Zarqa
- Dr. Muhammad Zubair
- Dr. Mohammad Sakr

Session IV

Panel discussion on:

"The Report of the Panel of Economists and Bankers and of the Council of Islamic Ideology on the Elimination of Interest from the Economy".

Chairman: Prof. Khurshid Ahmed

Presentation of report by:

(i) Dr. Ziauddin Ahmad
(ii) Mr. Abdul Jabbar Khan

Discussants

- Dr. M. Umer Chapra
- Dr. Nejatullah Siddiqi

Session VII

Subject: *Fiscal Policy in Islam*

Chairman: Dr. Sultan Abu Ali

Paper: "Taxation Policy in an Islamic Economy" by Dr. Monzer Kahf.

Discussants

- Dr. Anwar Siddiqui
- Dr. Abdel Hadi El-Naggar

Session VIII

Subject: *Profit-Sharing*

Chairmen: (i) Dr. Mohammad Ahmed Sakr
(ii) Dr. F. R. Faridi

Paper: "Economics of Profit Sharing" by Dr. Nejatullah Siddiqi

Discussants

- Dr. Monzer Kahf
- Dr. Ziauddin Ahmad

Paper: "The Rate of Capitalization in Valuation Models in an Islamic Economy" by Dr. Masudul Alam Chaudhry

Discussant

— Dr. Asghar Qadir

Concluding Session

Chairman: Dr. Mohammad Muslim Al Raddadi

— A Review of the Seminar — Prof. Khurshid Ahmad
— Future Research and Seminar Communique.

Annexure 2

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