

TEACHING PUBLIC FINANCE IN ISLAMIC PERSPECTIVE

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Foreword

Most, if not all countries encounter problems of finance. For less developed countries financing development is a crucial task. In raising the needed funds they may indulge in heavy borrowing with no prospects of repayment. Decisions that are taken now will undoubtedly contribute to the happiness or misery of future generations.

We believe the Islamic concepts can and should play a role in this context. The best way to ensure this is that these ideas find their rightful place in the teaching of Public Finance in our universities, resulting in a generation of decision makers who know and care.

The Centre for Research in Islamic Economics produced a working paper on introducing Islamic Concepts in the teaching of public finance and invited comments from a number of scholars. Professors and head of the economics departments in the Kingdom also discussed the issue in a meeting held at the Centre.

Dr. Nejatullah Siddiqi has done a good job in preparing this volume which comprises his working paper and the Scholars' comments summarised by Dr. Fahim Khan. The Centre is pleased to release this publication for general benefit.

Ghazi Obaid Madani
(Director)

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**TEACHING PUBLIC FINANCE IN
ISLAMIC PERSPECTIVE SECTION**

SECTION 1: INTRODUCTION

1.1 Purpose of these Notes

An effort is being made through these notes to evolve an Islamic approach to the teaching of conventional courses in Economics. These notes are addressed primarily to teachers. They discuss how to give the students a clear understanding of how the contemporary economy works, how would it work if economic agents behave in accordance with the teachings of Islam, and how the existing reality can be transformed into the one desired by Islam. Thus the whole of modern economics is involved, but we go further and, after identifying the relevant Islamic rules, also analyse a hypothetical Islamic *economy*. When it comes to economic policy as distinct from positive economic analysis we draw upon the Islamic goals while taking into full consideration the policies recommended by modern economics insofar as our goals are similar and the latter do not conflict with the rules and objectives of *shariah*. We are trying to blend together what is true and useful in modern economics with what is relevant in *shariah* to economic affairs so as to equip the student to analyse economic problems with a fresh insight and explore solutions which are distinctively Islamic, wherever called for.

This note on teaching Public Finance is the third in our series. The two earlier notes dealt with the core of economic theory: microeconomics and macro economics respectively. These are still being discussed by a sizable group of teachers and scholars with a view to reaching a consensus. That may, however, elude us for quite sometime, part of the reason lying in the nature of economic theory itself. Meanwhile, it is desirable to make similar attempts in such areas as public economics, international trade, economic development, etc. even before some sort of consensus is achieved in the core. A clearer vision on the parts will definitely help in having a better view of the whole. Moreover, the *shariah* is directly relevant to economic policy

whereas economic theory can be blessed largely by the implications of these policies. A discussion in Islamic perspective of the conventional courses dealing with policy more than they deal with theory will therefore help in a better formulation of a *shariah* inspired economic theory.

It is presumed that the reader of these notes on teaching public finance has the two earlier notes on microeconomics and macroeconomics before him. The 'Introduction' to the note on microeconomics as well as the section dealing with methodology are relevant to our present discussion also.

1.2 Nature and Scope of a Course on Public Finance

This note covers the ground traditionally covered by an undergraduate course on public finance. These courses confine themselves to the budgetary sector of public policy, dealing with taxes, public expenditure and borrowing. The larger issues relating to public economics such as public sector production and pricing are generally left out for separate study at a later stage. We can follow this convention only partly. We would not discuss how public sector production should be organised but we cannot avoid dealing with it as a possible source of revenue. Public ownership is a conceptual part of an Islamic society and public property has been a major source or revenue of the Islamic state since its inception. Unlike capitalism, the state in Islam is not born of the necessity to safeguard individual interests. It is part of the original and essential design of Islamic living. Moreover, in the absence of the rate of interest, a modern Islamic state would resort to profit-sharing as the chief instrument of mobilising private savings for investment in the public sector, making the public sector's share in the resulting profits a significant source of capital formation. This makes the inclusion of the revenue aspect of public enterprises very relevant to the capital budget, in place of debt and amortisation policy.

A course on public finance is by nature a mixture of the positive and the normative. This applies to the present exercise also. The positive elements relate to such questions as the impact of taxation, supply of public goods, income transfers, etc. on the incentives to work, savings, taking risk etc. The positive analysis closely follows conventional approach except where it is found necessary to differ from the underlying behavioral assumptions with reference to the Islamic behavioral norms. In all such cases the results of conventional analysis are to be faithfully reported before the case for a different conclusion is established. The normative policy elements derive from the Islamic goals and objectives, the duties of the Islamic state and the Islamic behavioral norms in general. Another important area in which the Islamic rules, are relevant to public finance relates to public decision making. Apart from the fact that the *shariah* has prescribed certain 'taxes' and public expenditures, the Islamic principle of *shura* (decision by mutual consultation) and the obligation of the ruler to be guided by public interest (*maslaha*) have important bearings on public finance in an Islamic economy.

It is heartening to note that even now the courses on public finance in almost all universities in the Arabic speaking Islamic countries and in a large number of universities in the rest of the Islamic world do refer to *zakat* and certain other Islamic provisions. The textbooks on public finance being used in these Universities have an Islamic component which has no counterpart in the textbooks on other courses such as economic theory, international trade and economic development,' being used in the same Universities. But the Islamic component in the public finance courses of Universities in the Muslim world is largely historical. There is little effort to integrate it with the rest of the course to make it relevant to contemporary living. Part of the reason has been the absence of a coherent vision of an Islamic economy in modern times, and a lack of Islamic perspective in economic analysis in

general. These deficiencies are being gradually removed, thanks to the many contributions to Islamic economic literature during the last ten years. We wish the teachers of public finance in the Islamic world to have a fresh look at what they are teaching and bring the Islamic concepts and values to bear on the solutions of the contemporary economic problems. The present note may be found of some help in this regard.

1.3 Structure of this Note

The structure of the note may be briefly described before going into details. We begin with a brief discussion on the goals of Islam relevant to economic life and state the functions of the Islamic state in this context. Then we focus attention on the fiscal functions as stated by modern economists i.e. allocation, distribution, stabilization and growth, examining them in the Islamic perspective set earlier. Keeping this perspective before us, and the fact that the present day Islamic countries belong to the group of developing countries, we pay special attention to the role of fiscal policy in redistributing income and engineering economic development. Since the realisation of these objectives entails fiscal as well as monetary policies, we note the need of a proper monetary and fiscal policy mix. As the discharging of state functions entails expenditure we list some heads of expenditure distinguishing between those permanently prescribed by *shariah* and those which may arise with changes in time and circumstances. With the obligation to spend the *shariah* has *ipso facto* provided the Islamic state with some sources of revenue on a permanent basis and others contingent on need. The possibility of borrowing from the public and mobilising savings on the basis of profit-sharing is also explored. The whole discussion is conducted with the modern (capitalist) approach to public expenditure and revenue in the background. This is followed by an analysis of taxes, and their economic impact. We go down the conventional list of taxes and examine the desirability or otherwise of their continuation in a modern

Islamic state. Then we discuss *zakat* in a modern Islamic state and see how it can be integrated with the other taxes. Issues in expenditure policy such as supply of public goods, income transfers, etc. are examined in the light of economic analysis and Islamic values. This is followed by a review of policies geared to income redistribution, stabilization and economic development in the third world. We also devote a section to the economics of public debt in an interest based as well as in an interest free economy to arrive at an Islamic approach to public debt. Since the entire discussion so far had been in the context of a closed economy, a measure of realism is introduced by discussing some international aspects of public finance. In a concluding section we note the special problems relating to public finance in the developing countries.

Let us remind the reader, even at the risk of sounding repetitive, not to expect any substantive discussion on the subjects listed above, as that would fill a book of a few hundred pages! We aim at a mere listing of the points to be discussed and indicating the necessary dimensions of that discussion, occasionally stating some likely conclusions of that discussion.

SECTION 2: GOALS AND FUNCTIONS OF AN ISLAMIC STATE

Conventional courses in public finance rationalise the role of the state in economic life on the basis of market failures and the need to modify the distribution of income resulting from the market process in accordance with commonly shared norms of distributive justice. Some go further in hypothesizing a social welfare function-to be maximized “by the public authority. The criterion of Pareto optimality is generally used for choice between available options. At a more advanced level public decision making is sometimes explained by a theory of government based on the assumption that the voters, the legislators and the bureaucrats all seek to maximise their own advantages guided solely by self interest.

The teacher may briefly review these approaches as discussed in conventional textbooks, emphasising the point that there is no escape from a theory of state and government in any discussion on public policy. It may be pointed out that a discussion on this point in public finance textbooks is very recent in origin and remains the least convincing part of the literature.

While conventional theory grapples with the hopeless task of devising social goals on the basis of individualism and self interest, the Islamic approach to public finances has a clear basis in the overall goals of Islamic living and the well defined role of state in Islamic society.

2.1 Goals

The goals of the Islamic system relate to all aspects of life. It is neither possible nor necessary to discuss all of them. We need discuss only those goals which are directly relevant to economic life. Nevertheless, it must be noted that Islam seeks to organise society in such a manner that every individual is enabled to live as Allah wills to man, free from the tyranny of

other humans and free of fear and hunger. This is done by ensuring basic freedoms as well as basic needs within an orderly social life governed by fair rules. Islam does so by orienting behaviour through faith and moral values as well as by providing codes of conduct, rules of transaction and institutions securing social cohesion such as the family and the state.

The specifically economic goals of the Islamic system are three: (1) Fulfillment of the basic needs of all human beings, (2) economic development (with a view to sustaining the objective of need fulfillment for a growing population as well as for acquiring the wherewithal of a strong entity able to defend itself, maintain its cultural identity and to help similar entities in the same task), (3) keeping in check the inequalities in the distribution of income and wealth as they tend to grow over time. The teacher is advised to substantiate these points citing the relevant verses from *Quran*, traditions from the Prophet, opinions of Islamic jurists and the available contemporary literature on the subject. It may also be pointed out that some of the objectives rightly emphasised by economists like full employment are clearly implied by the above mentioned goals.

2.2 Functions of Islamic State

A discussion on the goals of the system should be followed by a closer look at the state and its functions in an Islamic society, especially those related to economic life. Islam obliges the Muslim community to have a ruler, set up through mutual consultation, whom it charges with specific duties. The government has some functions permanently assigned to it which are stated in the *Quran* and *Sunnah*. There is a second category of functions not textually specified but derived from *Quran* and *Sunnah* by *ijtihad* which covers analogical reasoning (*qiyas*) as well as reasoning based on public interest (*maslaha*). This second category is especially designed to meet the changing needs of society as times and circumstances change. The third and

last category of the functions of an Islamic state includes such tasks as the people at any time and place may assign to it. This category derives its legitimacy from the Islamic principle of *shura* i.e. decision by mutual consultation.

Each one of these categories merits some elaboration. The teacher should also try to explain each category by giving some examples.

2.3 Public Decision Making

But before we note some points which might help the teacher in this task it will be useful to dwell a while on the principle of *shura* as the Islamic mode of public decision making. First of all it must be clear that *shura* is not a means of discovering what is right or wrong in the ethical sense. That is the prerogative of the *shariah*. *Shura* is a means of decision making. It concludes what is to be done. The individuals involved in the process should strive their best to achieve unanimity, or at least a consensus, failing which the majority is decisive. But the status of the decision is not affected by unanimity, consensus or majority – it remains operational without any dogmatic or ethical property. The overruled minority or even the largely outnumbered dissenters retain the right to their opinions without any moral stigma, but they have to accept the decision in practice. Secondly, it is imperative for the teacher to distinguish the Islamic *shura* from the democratic mode or decision making despite the obvious similarity between the two. The constant urge towards a consensus has as clear obligations for the majority as it has for the minority. At the same time, the denial or moral status to the decision minimises the chances of the tyranny of majority rule, as it recognises the right to dissent as well as the possibility that the decision may, in due course, be modified, even reversed. In conclusion, it may also be pointed out that the Islamic approach, while fully recognising the role of legitimate self interest on part of any participation in the decision making

process, can not accept the theory that these participants seek to maximise their own advantages guided only by their self interest. This theory stands rejected on the normative level in view of clear Islamic teachings obliging rulers to be guided by public interest and the ruled to be sincere and take the interests of others into consideration. It is also rejected as a positive theory of behaviour as individuals, in all societies, do have some perception of social goals and common interests distinct from narrow self interest and they do care for them. In any case the theory would be unrealistic if applied to an Islamic society in which individuals behave Islamically. Reference may be made to Islamic history, in this context.

2.4 Functions Based on Texts of *Quran* and *Sunnah*

Going back to the functions of an Islamic state, the first category comprises those specified by the text of *Quran* and *Sunnah*. Of these dispensation of justice and maintenance of law and order (largely through implementation of the penal code of Islam) and civil administration are the exclusive responsibility of the state. Then come functions which also devolve on individuals but the ultimate responsibility of doing the needful devolves on the state. These include defense, *da'wah* (i.e. communicating the message of Allah to mankind) enjoining right conduct and forbidding wrong (*al amr bill ma'ruf wa'l nahi 'an al munkar*), need fulfillment and other socially obligatory duties (*furud kifaya*). The teacher is advised to elaborate on each one of these functions and substantiate their authenticity by quoting *Quran* and *Sunnah* and referring to the jurists. The concept of *fard kifaya* calls for detailed elaboration which we take up later in these notes.

2.5 Functions Based on *Ijtihad*

The second category of the functions of an Islamic state is based on *ijtihad*. The teacher would do well by pointing out that *ijtihad* may either relate to discovering what is a certain rule of Islamic law, or it may relate to identifying the circumstances in which a certain rule of law is to be applied. In the present context we are primarily concerned with the second kind of *ijtihad* (characterised by Islamic jurists as *tahqiq al manat*). Changing circumstances and emergence of new conditions due to increase in population, technological progress, availability of new information, etc. may call for new types of state action in order to ensure preservation of human life and protection of property which in themselves are textually ordained obligations. It will be useful to dwell a little on the five basic human interests whose protection is commonly regarded by Islamic jurists as objectives of *shariah* i.e. religion, life, family, property, and intellect (*Din, nafs, nasl, mal and 'aql*). Thus the second category of functions may comprise, in the modern circumstances, protection of environment, stabilization of prices in particular and economic activity in general, promotion of scientific research, capital formation and economic development, and supply of 'public goods'. The concept of 'public goods' calls for some elaborations which is done later in this section.

2.6 Functions Assigned by People

The last category of functions comprises tasks assigned to the state by the people in accordance with the general provision that "their affairs are conducted through mutual consultation" (*Quran*, XLII: 38). It is a matter of convenience and public interest. No hard and fast rules exist excluding or including any economic activity under this category. The decisive factor would be people's own choice keeping in view the overall considerations of efficiency, distributive justice and the objective of preserving individual freedoms.

2.7 Public Goods

This section may be concluded by a discussion on public goods and the concept of *fard kifava*. Public goods or social goods are those which all individuals enjoy in common in the sense that one individual's consumption does not subtract from any other individual's consumption of the same good. Pure public goods have also the property that they can not be supplied in a way which excludes anyone from their consumption. Defense, law and order, air purification, public parks and light houses are some obvious examples. Put differently, these are goods whose costs or benefits has spillovers so that the price an individual is willing to pay does not equal its social cost or benefit. Because of these 'externalities' (or spillovers) the market fails to supply them in optimum quantities (i.e. an output at which the price equals marginal cost). As regards the pure public goods, the market fails to supply them altogether. The society, therefore, needs a process other than the market mechanism for their supply as they are essential for human survival and social felicity. We need a political process to arrange tile supply of public goods, pure as well as mixed, and to allocate the costs involved. The teacher is advised to clarify the concepts of market failure, exclusion, externalities, and public goods with reference to suitable economic literature. It is also advisable at this stage to introduce the concept of 'merit goods' which have to be supplied by the state not because of market failure but on the basis of an ethical judgement that their consumption is necessary for the welfare of tile individuals who may fail to acquire them in adequate quantities because of ignorance, error in judgement or lack of means, (on similar grounds the state may intervene to block or minimise the consumption of 'demerit' goods such as drugs and tobacco).

While discussing the problem of how to allocate the cost of public goods among individuals, the phenomenon of ‘free riding’, the tendency to consume public goods without the willingness to pay their price, may also be noted.

2.8 *Fard Kifaya*

It will be useful at this stage to introduce the concept of *fard kifaya* which are duties directed at ensuring common interests of a community of individuals but not devolving on every individual, so that if enough people come forward to perform them others are absolved of this responsibility. These are distinct from *fard ‘ain* which are duties directed at ensuring necessary individual interests and devolve on all individuals. Many of the public goods identified by modern economists fall under the Islamic legal category of *fard kifaya*, such as defense, environmental control and education.

Since *fard kifaya* is a moral concept it complements, sometime even replaces, the utilitarian benefit – cost calculation by an urge to seek the pleasure of Allah by performing the relevant duty. The divergence between social marginal costs or benefits and individual marginal costs or benefits, which causes market failures, does not affect this urge, insofar as it exists. Since this urge can be created and strengthened by appropriate education, there is a possibility of minimising market failure and getting social goods supplied through private action. The concept of *fard kifaya* also has some implications for the ‘free rider’ problem. A sense of duty may make the individuals reveal their true preferences in bidding for social goods. Even though because of non-excludability, partaking in consumption is not made contingent payment, individuals may pay out of sense of duty.

The upshot of this digression on *fard kifaya* and public goods is that an Islamic society in which individual self interest is tempered with care for others and concern for public interest, is better equipped to ensure optimum provision of public goods, a fact which should be fully reflected in the designing of public policies as well as in the theory of public finance in Islamic economies.

SECTION 3: FISCAL FUNCTIONS

3.1 Priorities

Having categorised the functions of state in an Islamic economy in the perspective of *shariah* we proceed to study them in terms of their economic role. In doing so we take all the three categories of functions i.e. those based on the texts of *Quran* and *Sunnah*, those derived by *ijtihad* and the ones assigned by the people, together and, following modern economists, focus on *allocation, distribution, stabilization* and growth effected through budgetary policies of the state. It would be explained how revenue collection and public expenditure in their many forms affects the economy in the four different ways noted above. Also, the state has to have clearly ‘defined objectives relating to allocation, distribution, stabilization and growth and development which are to be realised through fiscal measures. The teacher should distinguish these objectives from one another with the help of suitable examples, also explaining how they are inter-dependent. It may also be pointed out that a conflict may sometimes arise between these objectives which is to be resolved in the light of the priorities assigned, and keeping in view the trade off between them. Even though the priorities need not be same in all circumstances, and have to be decided at any time and place by the competent authority by a process of *shura* explained above, two general observations seem to be in order. First is the high priority Islam attaches to distributive justice and to keeping in check the inequalities in the distribution of income and wealth. This requires that top priority be given to the distribution function of fiscal policy. It does not preclude, however, the possibility that proper allocation and growth oriented measures may be necessary to ensure that there is more to distribute and that it increases as, or even faster than, the population increases. Secondly, the great emphasis placed on stabilization policies in the public finance literature reflects largely the conditions obtaining in the highly developed western countries. These

conditions do not obtain in the developing countries of the third world whose economic woes call for top priority being given to engineering economic development. Fiscal policy in the developing Islamic countries should therefore be designed to promote economic development and reduce inequalities in the first place. It should aim at a rational allocation of the Society's resources between private and public goods and protect the economy from economic fluctuations, especially inflation, indigenous or imported.

3.2 Distributive Function

Focusing on the distributive function the available fiscal measures in the form of taxes and income transfers may be explained. Next it should be pointed out that tax financed supply of public goods also serves the distributive objectives. Lastly, taxing the consumption of private goods largely consumed by the rich and subsidising those largely consumed by the poor also serves the same purpose. In all such cases some efficiency costs are involved which should be pointed out. The concept of a 'dead weight loss' or costs which arise due to interfering with consumer or producer choices by taxation may be explained. The need for realising the distributive ends with least costs in terms of efficiency may be emphasised. As to how this can be done would be possible to discuss only after the economic impact of various tax and expenditure measures are analysed in detail, a task to be taken up later in this course.

3.3 Growth Function

Many textbooks do not discuss the growth function separately but in conjunction with stabilization function, on the assumption that proper allocation of resources will ensure growth if economic fluctuations are prevented. This can be true only of the already developed western economies. For the third world countries at a very low level of development

a deliberate effort to build the necessary infrastructure and create the right environment for private investment is necessary in order to effect economic development. The role of the public sector in mobilising savings should be examined with special emphasis on the potentialities of profit-sharing as a means. The limited scope for taxation in the poor countries and the still more limited scope for public borrowing in an interest free system should be noted. It should be pointed out that the policy of expanding the public sector to include key industries like steel, cement, fertilizers, electricals, machines and machine tools with a view to accelerating economic development adopted in a number of developing countries in the past has largely failed to deliver the goods. The role of fiscal policy *in* creating the right climate for private entrepreneur efforts becomes very important in the light of that experience. Among the instruments available are tax concessions, subsidies, price support policies, import tariffs etc. Their economic impact has to be discussed later on when these measures came up for detailed consideration. The pros and cons of deficit financing are also to be discussed at a later stage.

3.4 Allocation Function

The proper allocation of society's resources between the production of private goods and public goods is an important matter of public choice. Efficiency consideration requires that in equilibrium the sum of the marginal rates of substitution between public goods and some private good equals the marginal rate of transformation. Put differently, spending in the public sector should be pushed in each area until the social value of the next unit of expenditure equals the marginal social cost measured in the same unit. These are highly hypothetical formulations, however, and in practice the public has to balance the disadvantage of withdrawing resources from the people, which would have largely been spent on private goods, against the advantages of spending them for supply of public goods, in a broad sense. It

may also be noted that this formulation ignores revenue from public property which does not involve any withdrawal from the people and whose expenditure on public goods is a net addition to social welfare.

3.5 Stabilization Function

The recent phenomenon of stagflation - high inflation rates coupled with high unemployment, has vested the stabilization function with added importance in the developed countries. In general, fiscal policy is to be directed at maintaining price stability with low levels of unemployment in the domestic economy and a sound balance of payments position.

The simple macroeconomics of income determination need being repeated at this stage to explain the role of taxes and transfers in maintaining a high level of income and employment. The expansionary and, when needed, contractionary uses of fiscal policy should be demonstrated with an emphasis on the underlying assumptions about productive capacity. It may be pointed out that these (Keynesian) fiscal measure are designed for advanced industrial countries with surplus productive capacity. Economies which are predominantly agricultural, or which suffer from shortage of capital and skills, do not respond to these policies.

In the context of the instruments of stabilization policy/the impact of a balanced budget, and that of budget surpluses and deficits should be analysed along conventional lines, with a reminder about the underlying assumptions. The notion of built in flexibility as distinct from discretionary changes in the budget should be clarified. It may be noted that the Islamic approach to budget deficits or surpluses devolves on *maslaha* (public interest) in a particular time and place.

3.6 Fiscal-Monetary Policy Mix

Fiscal policy has to be coordinated with proper monetary policy in order to prevent economic fluctuations and ensure a reasonable degree of stability in the level of prices (i.e. in the purchasing power of the currency). First the scope of monetary policy in an interest based system should be briefly explained. The impact of an increase or a decrease in the supply of money on economic activity should be noted. It should be explained how changes in the rate of interest may affect the level of investment, and therefore of income and employment, by changing the cost of capital. The possibility of combining an expansionary fiscal policy with a cheap money policy (i.e. a low rate of interest and ample supplies of credit) with a view to raising the level of income and employment; and that of a contractionary fiscal policy with a dear money and tight credit policy with a view to curbing inflation may be discussed. The teacher may like briefly to review the recent literature on a proper fiscal-monetary policy mix. He may also comment on the recent U.S. experiments with a loose fiscal-tight money policy (1981-1985) and tight fiscal - easy money policy (1985-).

The teacher may then note the replacement of interest by profit-sharing in an Islamic economy (a subject already covered in ‘teaching macroeconomics in Islamic perspective’). It should be pointed out that an effective monetary policy will be feasible as the supply of money and, to a lesser extent, the cost of capital could be manipulated (via the ratio of profit sharing). The design of a suitable mix of fiscal and monetary policy to serve the needs of particular circumstances would therefore continue to be an important task of the policy maker.

Lastly, it should be noted that no economy operates in isolation from the rest of the world. The policies which affect the levels of income and employment also affect the country’s exports, imports, and balance of

payments. These in turn affect the economic position of other countries, as the domestic policies of other countries affect the economic position of the country under study. Hence a discussion on stabilization policy has to take into consideration the subject of international economic coordination, to which a subsequent section is devoted.

SECTION 4: EXPENDITURE POLICY

The universally accepted rationale of public expenditure is the provision of public goods and merit goods and performance of the fiscal functions noted above. Having already discussed the mode of public decision making in this regard, both in conventional economies and in an Islamic economy we proceed, in this section, to elaborate upon a tripartite classification of public expenditure in an Islamic economy which follows our three-fold classification of the functions of an Islamic state described above. Later on in this section we discuss the principles of project evaluation in the context of the goals of the system and the existing fiscal constraints.

4.1 Three Categories of Public Expenditure

The first category of public expenditure in an Islamic economy comprises expenditures on tasks explicitly ordained by *shariah*: (i) Defense, (ii) Law and order, (iii) Justice, (iv) Need fulfillment, (v) *Da'wah*, i.e. communicating the message of Allah to mankind, (vi) Enjoining right conduct and forbidding wrong (*al amr bi'l ma'ruf wa'l nahi 'an al munkar*), (vii) Civil administration, and (viii) Fulfillment of such socially obligatory duties (*furud kifaya*) as the private sector fails to fulfill. It will be noted that almost all of these activities amount to the provision of pure or mixed social goods and merit goods. Resources for financing these expenditures would come out of the income from public property, out of *zakat* revenue in some cases, and out of the revenue from additional taxes when these two are not sufficient to meet the needs – and eventuality which we take for granted under modern conditions. Lastly, some of the public goods may be supplied at a price, which would be an additional source of revenue for financing their supply. Postponing further considerations of the revenue aspect for a later part of these notes, we turn to the second category of public expenditure in a modern Islamic state.

The second category comprises expenditures necessary in the light of *shariah* in the present circumstances. The activities which are the subject of these expenditure are required in order to secure necessary Islamic objectives. This is established by *ijtihad* which links a particular activity, in the present circumstances, to a particular *shariah* objective or rule. We regard protection of environment, scientific research, capital formation and expenditures necessitated by the stabilization objective as included in this category. The teacher should explain why these activities must be undertaken by a modern Islamic state in order to realise the goals of Islam noted above. In mobilising resources for financing these activities greater recourse may be taken to charges fees and additional taxation, but some of them may also draw upon income from public property. It may also be noted that most of the activities in this category partake the character of supplying public goods, some pure, e.g. protection environment and stabilization and some mixed, e.g. scientific research and capital formation.

As regards the third category, i.e. expenditures necessitated by tasks assigned to state by the people, it is presumed that the people would be willing to pay for the goods and services involved. A distinctive characteristic of these tasks is that they amount, generally speaking, to supply of private goods. The reason why the people may sometimes assign provision of private goods to the public sector usually lie in the economies of large scale production but there are also some other considerations attending such a decision. Public utilities such as supply of clean water, electricity, postal services etc. are best examples in this category.

It is important to warn the student against the simplistic view of regarding these three categories as mutually exclusive or taking their dividing lines to be rigidly defined. They are not. There are important activities which in parts, may fall in all the three categories. Education seems

to provide the best example. Some basic education is definitely included in 'need fulfillment' whereas education at the secondary (and even higher) level may rightly be placed in the second category. But there are types of education and skill creating training programme which are purely in the nature of private goods, and may be partly provided by the state if the people so decide. Health and medical services also provide a similar case. The three fold categorization is, nevertheless, helpful in analysis as well as design of policy.

4.2 Size of the Budget

Efforts made by modern economists to lay down criteria for deciding upon the size of the public sector, or the total of public expenditure, have met a number of insurmountable conceptual and practical difficulties. It involves measurement of 'social benefits' and adding up of individual benefits of public expenditure and of the 'costs' to individuals resulting from the withdrawal of needed resources from the private sector. Some of these criteria have already been noted in the previous section while discussing the allocation function. It is, however, necessary that each individual decision on expenditure should be rational in the sense of balancing the benefits against the costs, as far as possible. This is sought to be realised through project evaluation and cost-benefit analysis of public expenditure projects. Such a process is necessary for making a choice between options available for realising the same purpose i.e. between alternative projects. It is desirable for the teacher to familiarise the student with the essentials of project evaluation in the light of available economic literature.

A distinction between divisible and lumpy projects and the difference between project evaluation in the context of a fixed budget or a variable budget should be made. It should be explained how the concept of consumer's surplus can be used in estimating the benefits of a project.

Distinction should be made between real and pecuniary benefits. Real benefits may be direct or indirect, tangible or intangible. Tangible benefits can be measured whereas intangible benefits (spiritual, aesthetic, social, etc.) can only be assessed in a rough way. In the Islamic perspective, different weights can be assigned to different intangible benefits in the light of their perceived contribution to *shariah* objectives. The concept of an objective function defining the social benefits to be maximized should be introduced, keeping in view the recent Islamic economic literature on the subject. ‘Costs’ of social projects are also subject to some considerations similar to those noted in context of ‘benefits’. Since the assigning of weights and the interpretation of *shariah* objectives in particular circumstances may be controversial, a recourse to the process of *shura*, at the appropriate level, will be necessary.

4.3 Project Evaluation

Public sector projects generally involves costs as well as benefits extended over a period of time. Choice between alternative projects would therefore involve discounting future values to make a comparison in the present possible. Recent discussion on the subject has thrown up two alternatives, broadly speaking. The rate of return on equity capital, or the one on investment deposits in Islamic banks, reduced to an average for the economy as a whole, may be used for discounting future income streams from a project, and the discounted present values may be compared for making a choice. Alternatively the internal rate of return of each project may be calculated, whenever feasible, and these rates may be compared for making a choice. Both methods suffer however, from the defect that they can handle only such benefits as can be assigned a monetary value. Secondly, they do not distinguish between social and private projects, missing thereby the important point that whereas individuals may have, generally speaking, a positive time preference, the society being a permanent entity interested in

the welfare of future generations as much as it is interested in the welfare of present generation, may not, have a significant positive time preference. The practice of discounting all future values **at** the same rate of discount suffers from the further defect of ignoring greater uncertainty surrounding (expected) future values. The teacher is advised to review the recent contributions to the subject by Islamic economists. He should also briefly report the current practices in project evaluation in the contemporary interest based system.

Since public expenditure involves withdrawing resources from the private sector, the economic impact of doing so may be examined in a general way before specific measures are discussed. Measures of withdrawing resources that reduce private consumption are, generally speaking, preferable to those which affect private investment, though the distinction is not as sharp in practice as it appears. Notice should be taken in this context of the recent debate on the possibility of public borrowing crowding out private investment. It may be pointed out that investible funds for the public sector productive projects would be based on profit-sharing (as it can not take the form of interest based loan) which will minimise the ‘crowding out’ effect in so far as it exists at all.

The theoretical discussion on expenditure policy needs being supplemented by some case studies, so that the principles and techniques involved become clear to students. Highway construction and education may be two appropriate cases.

4.4 Public Supply Versus Production in Public Sector

Supply of a good of service by the social authority, generally based on the reason of the good being a pure or mixed public good or a merit good, does not imply that it should be produced in the public sector. On the other

hand, natural monopolies enjoying decreasing costs may provide a better case for public sector production even though the product be a private good. The two decisions, that of public provision of a good and public production of a good are entirely separate and must be taken on their own merit. As a matter of fact efficiency considerations as well as political considerations (related, for example to preventing concentration of power or limiting the size of bureaucracy) recommend greater recourse to private production of I goods to be supplied by the public authority whenever feasible.

It is an empirical fact that the growth of public expenditure, especially the increasing recourse to public sector production of goods and services entails growth in the size of the bureaucracy – the body of salaried public servants. Economists have only recently turned to the complex subject of bureaucratic decision making and its level of performance. The teacher is advised briefly to report the finding of these studies. The bureaucracy does not have a shining record of efficiency in production. This is especially so in the developing countries generally infested with corruption and inefficiency. Even though the economic models of the functioning of bureaucracies may not be very relevant to an Islamic economy as they generally hypothesize pursuit of narrow self-interest by the public servants, they deserve some attention. Even after making due allowance for moral standards and a sense of duty among Islamic bureaucrats, its functioning may not compare favourably with that of an equally morally oriented private sector. This should be a major consideration before the legislators in an Islamic system who, through due process of *shura*, would decide on a choice between public production of goods or their private production for being supplied by the social authority.

4.5 Procedural Norms

In the end, it may be noted that in the absence of any clear cut technical criteria for determining the size of public expenditure and scope of public sector production in a changing and uncertain world where a large number of projects and complex tangible and intangible costs and benefits are involved, the society has, ultimately, to rely upon procedural rules of public decision making. At a particular time and place the appropriate size of the public sector will be that which is determined in consequence of decisions made by a process of *shura* at the relevant levels.

SECTION 5: SOURCES OF PUBLIC REVENUE

Public revenue may, in principle, arise either from public property (including public enterprises) or as resources withdrawn from the private sector.

5.1 Public Property

The public sector in all modern economies owns a sizeable part of the national wealth in the form of lands, buildings, equipments etc. while some of these properties are in public use, yielding no 'income' to be included in the budget, others, especially public enterprises, do yield some income. But the modern economies differ widely in this respect. Of course, the socialist economies leave little room for the private sector. The teacher is advised to give some illustrative examples in this regard.

As regards the Islamic state, the *shariah* has placed some properties permanently in its ownership, leaving the door open to acquire more out of the natural resources not already in private ownership, should the public interest so require. According to the preferred juristic opinion all mineral resources of the society belong to the state as also do certain categories of land. The teacher should substantiate this point with reference to suitable sources. Large waters, natural forests, mountains, wealth under water and in the atmosphere is regarded as communal property, everyone being free to help himself avoiding waste. But the state is entitled to reserve some of these for public purposes excluding their private exploitation to that extent. The state should also regulate private use of communal wealth to prevent disputes, waste and improper use. The student should be reminded that the early Islamic revenue category of *kharaj* emanated from public property in the form of rent. There is no bar on the Islamic state managing agricultural farms, fisheries, forests, mines and industrial production for public purposes.

These can be managed with a view to yielding a surplus (profits) to be used for public purpose.

Revenues from public properties are not earmarked like *zakat* revenue. They can be used for financing any heads of expenditure falling under the first two categories noted above (i.e. those explicitly ordained by *Quran* and *Sunnah* and those based on *ijtihad*). They can be justifiably used for capital formation and developmental projects, a subject included in the second category noted above.

A brief discussion on public sector pricing policy would be appropriate at this stage as some of the products of the public sector enterprises may be sold to individuals while others may be ‘sold’ to projects within the public sector. The economic case for pricing the public sector products at marginal cost should be examined with due emphasis on the efficiency of this policy in all transactions within the public sector, i.e. when the product of a public sector enterprise is sold to another public sector enterprise or institution. When a public sector product is sold to the ultimate (private) consumer a profit may be realised as a mark up on marginal cost price. The alternative suggestion that these prices should be proportional to marginal cost should also be examined. Marginal cost pricing of the products of industries with decreasing costs will involve deficits which will have to be made up by taxes.

Production of private goods and even those of ‘mixed’ public goods by the public sector also raises questions relating to their optimum supply, modes of financing their production, and the relative roles of the private and public sectors in their production. The issues involved may be explained by taking the example of education. The purpose should be to make the student aware of the issues involved and not to advocate particular policies.

5.2 Withdrawals From the Private Sector

Withdrawals of resources from individuals and organisations in the private sector constitute the bulk of public revenues of a modern state. It would be realistic to assume, in view of the enormous increase in public expenditure over the ages, that it will continue to be so with modern Islamic states as revenues from public property would hardly suffice for a fraction of their needs.

Withdrawals from the private sector may take the form of taxes or borrowing. It may also take the form of acquiring funds from the public on a profit-sharing basis. Fees, charges and prices of public sector products may also be included in this list as the relevant goods and services are covered by public expenditure as discussed above. But the major source of public revenue is taxation.

Taxes are sometimes earmarked for financing specific activities e.g. a toll tax to recover the cost of a bridge. More often they are meant to provide revenue which can be used for financing any state activity. It may be noted in this context that the *shariah* levy of *zakat* (including *ushr* the levy on agricultural products) is an earmarked 'tax'. A separate section is devoted in these notes to study the coverage and rates of *zakat* and the activities on which it is to be spent. These activities all fall in the first of the three categories of expenditures of an Islamic state noted above.

5.3 Shariah Justification of Taxes

Should the revenue from public property and *zakat* not suffice for meeting the first two categories of expenditure noted above, the *shariah* authorises the Islamic state to levy additional taxes and/or borrow from the public. It is also open for an Islamic state to mobilise public savings on a profit-sharing basis for investment in the public sector. The teacher is

advised to substantiate this important point with the help of recent Islamic economic literature on the subject. It is also advisable to establish the point that a modern Islamic state will in fact have to levy additional taxes in view of the large public expenditures required under the first two categories in modern circumstances. Special mention may be made in this regard of defense, education, social security and in case of developing countries, capital formation and economic development. These are claiming vast resources in every modern state, so vast that even the most hopeful estimates of *zakat* revenue and revenue from public property would fall short of matching them.

As regards fees, charges and prices of public sector products, it may be noted that they are generally linked with the third category of public expenditure i.e. financing activities assigned to the state by the people.

A distinction should be made at this stage between the *shariah* justification of taxation and the economic impact of a particular tax. It is the latter which forms the proper subject of public finance, though the former is an issue inevitably involved in a study of public finance in the Islamic perspective. It may also be noted that even though the permissibility of additional taxation is established in the light of *shariah*, the choice of a particular tax should depend on the cost-benefit analysis which takes into consideration the *shariah* arguments relating to *maslaha* and *mafsadah*. Thus a study of the suitability of a particular tax on grounds of the fiscal functions of allocation, distribution, growth and stabilization helps us in assessing the *maslaha* that a particular tax may serve, thereby helping the public decision makers in an Islamic economy to make an Islamic as well as a rational choice.

5.4 Economic Impact of Withdrawals from Private Sector

Even though the tax revenues are meant for financing public expenditure whose benefits flow to the public, a tax is a one way transfer from the taxed to the public authority with no liability on the public authority towards particular tax payers. This distinguishes taxes from borrowing or raising profit-sharing funds (by selling *Mudaraba* certificates or shares of public sector enterprises). The latter carry with them the obligation to repay the loan and refund the investment with profit (or loss), respectively. It is therefore, imperative that funds raised on the basis of profit-sharing or as loans should not be used for meeting the cost of civil administration or providing public goods which bring no financial returns. They should be used only for productive purposes so that they can pay their way.

We shall now proceed to study the economic impact of taxes, borrowing, and raising profit-sharing funds in a general way. Economic impact of specific taxes are discussed in the next section.

Taxes are amenable to a number of classification based on particular characteristics. Taxes may be direct or indirect. They may be lump sum, proportional, progressive or regressive. They may be imposed on persons, properties, commodities, or activities. Taxes may be levied by the central government, the state government or the local governments. The teacher is advised to explain these classifications with the help of suitable examples and indicate the usefulness of each classification for analysis.

A distinction should be made between the income effect and the substitution effect of any particular tax. The only tax which has only an income effect and no substitution effect is a lump sum tax on persons it does not depend on any action of the individual taxed -- there is no way the individual can change his tax liability. All other taxes have some substitution

effect in the sense that the individual taxed can change his tax liability by changing his behaviour. To the extent a tax makes an individual changes the choice he would have made in the absence of the tax (with respect to work, saving, risk taking, etc.) the tax distorts individual preferences. Understanding this phenomenon and, if possible, measuring the substitution and income effects of a tax separately helps the public authority in devising suitable tax policies. It should give due consideration in this regard to the effect of a tax on choice between work and leisure between various products, between present and future income, etc.

Textbooks on public finance generally discuss the characteristics of a good tax system which the teacher would do well to recount to the students. Of special significance are the concepts of horizontal equity - treating persons in similar circumstances equally -- and vertical equity treating persons in dissimilar circumstances differently. Elimination of excess burden, minimisation of administrative cost and, above all, willing acceptance of the taxes by the tax payers (ensured largely through their participation in the decision making process) should be priority considerations in the design of a tax structure. The teacher may remember to indicate of the presence of these characteristics in the *shariah* based taxes to be discussed later. It should also be pointed out that exemptions and loopholes which make it possible for the rich tax payers assisted by well paid legal brains to avoid taxes in the contemporary societies are highly undesirable.

The concept of incidence of a particular tax, the possibility of shifting the incidence of a tax and significance of the elasticities of demand and supply of a good or service in the context of indirect taxes should be explained in general terms at this stage to enable the student appreciate the later discussions. The general case of indirect taxes may also be examined

before taking up specific indirect taxes for discussion. The key feature of an indirect tax is that no characteristic of the individual other than the amount he purchases in that particular market is relevant for the determination of his tax liability: Appreciation of this feature helps the public decision maker in the choice of the right markets for indirect taxation. A recourse to indirect taxes is made because of administrative convenience and in view of the vast requirements of public expenditure and the limits to which direct taxation can be pushed. But the structure of indirect taxes can also serve distributive and allocative roles. This point need being explained with the help of suitable examples. It may also be explained why it is the local governments and the state governments which generally levy indirect taxes whereas the central government rely mostly on the direct taxes, generally speaking.

Withdrawals from private sector through borrowing are discussed at a later stage in these notes. As regards mobilisation of private saving for investment in the public sector productive enterprises it really does not amount to a withdrawal from the private sector since the public sector can get these funds only if and when the returns expected compare favourably with those expected from similar investments in the private sector. It is more meaningful to regard the public sector productive enterprises as part of the competitive market (i.e. the private sector) than to consider its mobilisation of profit-sharing funds as 'withdrawals' from the private sector.

SECTION 6: TAXES AND THEIR IMPACT

A brief survey of the various taxes generally levied in the contemporary economies is necessary for understanding public finance as it is being practiced as well as for devising a suitable tax structure for a modern Islamic state. This requires looking into the benefits they yield and the costs they entail. Our focus will mostly be the economic impact of specific taxes, but this does not deny that particular taxes may have specific psychological, social and political, consequences which should be taken into consideration in the choice of a tax structure.

6.1 Income Tax

Though more recent, historically speaking, than the age old excise duties and property taxes, the income tax has now become almost universal. It is a direct tax which cannot be shifted and comes very close to being a *general* tax in the sense of not imposing any differential burden on any particular individual or group. It also meets the criterion of 'ability to pay' insofar as the income of a person can be taken to be an index of his ability to pay. Explaining these points the teacher is advised to dwell upon some of the problems encountered in defining what constitutes income as a tax base, pointing out that money receipts may not always represent a person's real income which include incomes in kind as well as unrealised capital gains.

The rationale of an exemption limit based on equity considerations should be pointed out. Allowable personal deductions for number of dependents, charitable contributions, medical expenses, interest payments or personal debts and taxes paid to local and state governments (as the income tax is paid to the central government) should be noted and their rationale explained. The case for a progressive rather than a proportional income tax may then be examined, briefly reporting the ongoing debate on how

progressive an income tax should be. It should be noted that a progressive income tax develops inequitable features in an inflationary regime in which real incomes lag behind increasing tax liabilities. Proposals for rectifying this wrong by indexing tax liabilities may also be noted.

An income tax has pronounced substitution effects adversely affecting the choice between work and leisure. But the income effect of the tax tends to increase work effort and the net effect on the supply of work is uncertain, and the empirical evidence available is inconclusive. The income tax also reduces the net returns to savings indicating a reduction in the supply of savings. But the empirical evidence available does not support this result conclusively. An income tax also affects the incentive to take risks as it taxes risks bearing when it is successful resulting in profits but does not compensate for the losses in case of failure. A progressive income tax discriminates against ventures, occupations and professions which offer the individual a small chance of making big gains with many chances of incurring losses. A proportional income tax would have less disincentive effects both on savings and risk taking than a progressive income tax with the same yield. A progressive income tax is preferred mainly on distributive grounds.

6.2 Income Tax with *Zakat*

Should a personal income tax be levied in an Islamic economy some fresh adjustments would be inevitable in view of *zakat* levy which must, by definition, be there. As noted in the next section, *zakat* is assessed on wealth, except in the case of agricultural produce in which case it is assessed on current yield. In view of the fact that the *zakat* rates on agricultural yields are quite substantial it may not be advisable to impose the income tax on farm incomes covered by the *zakat* levy. In other words, it is worth serious consideration that income generated by zakatable crops should not be

assessed for income tax purpose. All other incomes could be subjected to income tax provided that the full amount of the *zakat* paid by the assessee (excluding the *zakat* paid on agricultural yield) is deducted from his income tax liability. However, even if the *zakat* due exceeds an individual's income tax liability the full amount of *zakat* should be realised from him (the income tax being dropped altogether). It may be noted that the subject has yet to be fully researched by Islamic economists. However, some arguments in favour of the above proposal can be advanced.

Firstly, even when the *zakat* is assessed on various forms of wealth, it is actually paid out of current income. The proposed deduction for *zakat*, is, therefore, necessary to avoid double taxation.

Secondly, insofar as the *zakat* revenue is going to finance activities financed in conventional economies by income tax (e.g. defense, education, health, etc.) the decrease in the yield of income tax due to deduction for *zakat* will not affect the financial position of the state. Moreover, to the extent the income tax yield falls short of the state's financial needs, it may be possible to revise the tax rates to cover the gap.

Thirdly, the above formula will ensure equity between the Muslim and non-Muslim subjects of a modern Islamic state. If *zakat* is not deducted from the income - tax liability of an assessee the Muslim subjects will end up paying more taxes than the non-Muslim subjects. (We presume that the benefits flowing to Muslim subjects from the *zakat* financed public expenditures will be provided to non-Muslim subjects also, being financed in their case out of the general revenue of the state).

Once the above proposal is accepted, it is only logical that it is extended to cover other personal taxes, such as wealth tax, capital gains tax and consumption (expenditure) tax, if any. Needless to point out that deduction for *zakat* from the tax liability of a person can be made only once, i.e. if a deduction has already been made from one of the personal taxes, it cannot be repeated in case of the other personal taxes.

6.3 Corporation Income Tax

Economists do not regard the tax levied on the net income (i.e. profits) of the corporate form of enterprise (whose shareholders have limited liabilities in the eyes of the law) as a fair and efficient tax. The fact that a progressive corporation tax finds favour with most modern states is generally ascribed to administrative convenience and popular support. Economic analysis regarding the effects of the corporation tax and its real incidence, specially the extent to which it can be shifted to consumers in the short or even in the long run, is not conclusive. The teacher should elaborate upon these points with reference to economic literature on the subject.

The most important issue in relation to corporation income tax in practice is the way depreciation allowance is made. The current practice in this regard and the practice in relation to treatment of losses should also be explained. Similarly, the effects of continued inflation on corporate income tax and the causes responsible for great fluctuations in the actual yield of the tax should also be explained.

Since *zakat* covers the entire stock in trade of all business units, corporate or otherwise, a deduction for *zakat* paid would be necessary out of the income tax liability of a corporation in a manner similar to the one outlined above.

It should be pointed out by the teacher that we, in this course, are not in a position to opine whether or not a corporation tax should be part of the tax structure of a modern Islamic state. The issue requires indepth study in the context of the economic effects of the corporation tax, the place of the tax in the total structure of taxes (including *zakat*) in a modern Islamic economy and its financial needs. Corporations will, however, be subject to *zakat* on stock in trade, in any case.

6.4 Capital Gains Tax

Capital gain is the increase in the market value of a capital asset held by a person -- a building, a machine, shares and stocks. If realised by selling the asset it becomes part of the current income. A number of questions arise: Should realised capital gains be taxed at the same rate as any other income or should it be taxed at a different rate? How to treat capital gains that are not realised; what should be the tax policy if capital gains arise largely due to inflation, and in all these cases, how to treat the capital losses? These questions arise in case of the personal income tax and the corporate income tax. As a matter of fact they are rooted in the possible definitions of income itself. The teacher is advised to report the different answers given as well as the practice in some typical countries. Due attention should be paid to the practicability of various proposals and equity of current practices.

6.5 Expenditure Tax

A tax on consumption expenditure is advocated as an alternative to personal income tax, arguing that it is more favourable to savings and growth. It is also claimed that it does not distort the choice between present and future consumption as an income tax does. However, when considered as an index of one's ability to pay it is not actual expenditure but the potential to spend which should be the focus. This necessitates that more than one year, in fact the entire life of a tax payer, be taken into

consideration. It may be pointed out that despite some theoretical arguments in favour of an expenditure tax as compared to an income tax, and a recent revival of interest in the subject, current practice continues to favour the latter alternative.

6.6 Wealth or Property Tax

Wealth or property may be regarded as an index of a person's ability to pay side by side with his income which includes the current yield of property. Concentrated wealth holdings justify taxation on distributive grounds as concentration of wealth is undesirable in itself and breeds social discontent. Insofar as wealth is held in the form of urban land and buildings it is difficult to assess them and tax the capital gains involved. The property itself serves as an easier target. As pointed out above, local governments find it more convenient to tax property to acquire the needed finances. Property tax is also suitable for developing countries where the yield of income tax is very low and distribution of property is highly skewed.

The substitution effects of a moderate wealth or property tax are not so significant as to affect the wealth owner's behaviour relating -to work, saving and risk taking. The income effect is relevant only insofar as taxing only some forms of wealth may induce the wealth owner to hold his wealth in the forms not taxed.

Insofar as a wealth or property tax is levied by a modern Islamic state on forms of wealth not covered by *zakat*, e.g. real estate, it should not pose any problems. Should their coverage overlap the method of deducting the amount of *zakat* assessed on the asset concerned should be adopted as already outlined above.

6.7 Death Duty, Inheritance Tax and Bequest Tax

Death duty is imposed on the total estate left by the deceased whereas inheritance tax and bequest tax is levied on the property received by an heir or a beneficiary. It should be noted, in the light of empirical data available on the subject, that the total yield of these taxes being modest relative to the yield of other taxes they are not as important as sources of revenue as measures directed against concentration of wealth. A wealth tax partly takes care of this purpose. As a distributive measure the inheritance tax is not suitable for an Islamic economy since that objective is taken care of by the Islamic laws of inheritance. If it is adopted as a measure of acquiring needed revenue, the inheritance received by a person being treated as the index of his ability to pay, the financial position of the recipient should also be taken into consideration.

A death duty is not permissible in Islam as the *shariah* has already distributed the estate of the deceased and it is only the new owners i.e. it is only the new owners i.e. the heirs, who can be taxed.

A tax on property transferred through bequest (which according to Islamic law is confined to a maximum of one-third of the estate) should be considered along with a gift tax. Whereas in case of an inheritance tax only the exemption limit merits consideration, in case of the bequest and gift the status of the beneficiary should also be taken into account. Gift or bequest in favour of charitable institutions, educational institutions, etc. should be exempted from these taxes, as also should be the individual beneficiaries who are poor.

The fact that in many modern tax laws it is the donor or the person making the bequest who is subject to the gift and bequest (estate) tax may be noted and its rationale explained. In the Islamic context, it should be argued,

it would be more reasonable to tax the beneficiary on whom the real incidence falls in any case.

6.8 Payroll Tax

A payroll tax is of very recent origin and serves as contributions made by both employers and employees towards a comprehensive social security scheme covering unemployment insurance, old age and survivor insurance, hospital insurance and disability insurance, etc. Revenue from payroll tax is earmarked for providing these benefits and is generally supplemented by additional grants from the state. The tax is collected from the employers who deduct the employees' contribution at source and no exemptions are allowed. The self employed have to report their income and pay the tax themselves.

A payroll tax is, in effect, a proportional tax on wages and salaries which cannot be shifted in view of its wide coverage. In the ultimate analysis the part of the tax paid by the employer also comes out of (would be) salaries and wages.

In the context of an Islamic economy the payroll tax and the corresponding social security benefits may be integrated with *zakat* and its benefits. But a number of points deserve attention in this regard.

In the case of *zakat* the 'tax payers' and the beneficiaries are two different set of persons --- the rich and the poor. In order to ensure, therefore, that the poor continue getting these benefits without in *quid pro quo* persons who are too poor to be liable to *zakat* should be exempted from the payroll tax, their share being paid out of the *zakat* revenue by the state instead of them.

Since the payroll tax paid by the employees rich enough to be liable to *zakat* is in the nature of contributions against some benefits, the principle of deducting the *zakat* paid out of a tax payers tax liability should *not* be applied to the payroll tax.

6.9 Sales Tax and Excise Tax

Sales taxes are imposed on the sellers side of product transaction. Since they are not imposed on persons they fail to take into consideration the personal circumstances of the tax payers and are, therefore, inferior to direct taxes on both horizontal and vertical equity' grounds. But they are convenient revenue raisers and are generally used by the state and local governments. A sales tax may be general covering all commodities or narrowly based. It may be imposed on manufacturers, wholesalers, retailers or on all these levels. A tax levied at all these stages *is* called a turnover tax. A tax only on the value added at a particular stage of production till it reaches the final consumers is called a *value added tax*. A tax on the production, sale, import --- or export of a particular commodity is termed an excise duty. The teacher is advised to explain the rationale of these taxes and give some examples in contemporary economies.

A sales tax raises the price of the products and results in a smaller output, the magnitudes depending on the elasticities of demand and supply. The burden of a general sales tax is borne by the factor owners and the consumers, the more general the tax the larger the shift of burden backwards to labour and capital. The burden of a tax on a specific commodity is generally shifted forward to the consumer with the possibility of some burden being passed back to factor owners. The teacher may elaborate these points with the help of standard references.

The main purpose of a tax on specific commodities is, generally speaking, not to raise revenue but to realise some other purpose. *Sumptuary* taxes are those imposed to discourage the consumptions of 'demerit' goods like tobacco. A tax on selected commodities may aim at indirectly charging a price of some related services e.g. a tax on petrol whose yield is earmarked for road building. Sometimes the purpose of an excise duty is to protect home industries (e.g. import duties) or prevent export of essential items (through export duties). More recently regulatory sales taxes have been proposed in order to conserve the use of exhaustible resources (e.g. energy) or control pollution of air and water. A tax on luxury items serves the double purpose of restricting the use of productive resources and raising revenue from those who have the capacity to pay. A general sales tax may also be used as a contractionary device aiming at reducing effective demand. But this use of sales tax presumes that it is removed when its purpose is served.

The idea of imposing sales taxes with the sole purpose of raising revenue is not favoured by Islamic economists. But a sales tax can be used for a variety of purposes and sometimes the revenue raising need also leaves few options, e.g. in case of state and local governments from which the citizens expect so many services. The decisive factor in the Islamic context is, therefore, the need and purpose for which a modern economy may be, considering a general or specific sales tax. The *shariah* has not barred such taxes though it did not prescribe them either. What is crucial is that the right Islamic method of decision making be observed in making a choice.

6.10 Taxation at Local and State Level

Since modern state administration comprises two or three different levels, some power to tax and spend must vest with the state and local authorities. The teacher would do well briefly to describe the distinctive features of state and local finance. It may also be pointed out that many

public goods and services for which people care a lot are, by their very nature, local in character. To finance local public services by locally raised revenue is more efficient as it may elicit willing cooperation from the taxed.

Issues in the inter-governmental financial relations are better left out of this course to be discussed at a higher stage.

SECTION 7: ZAKAT IN A MODERN ISLAMIC STATE

Zakat is the right of the poor in the wealth of the rich decreed by Allah, the absolute owner of all things. Briefly explaining the economic, social and spiritual purposes of *zakat* in the light of the Islamic literature the teacher should describe the coverage and rates of *zakat* fixed by *shariah*.

7.1 Coverage, Rates and Heads of Expenditure

The coverage of *zakat* may be explained using a three-fold classification:

- a) Capital assets: animals, stocks in trade i.e. all that is meant to be traded, including machinery, real estate and shares and common stock.
- b) Savings in cash and gold and silver.
- c) Current income in form of agricultural produce, minerals and marine product.

The total assets of an assessee falling in these categories is subject to *zakat* provided it is above a prescribed minimum called *nisab*. The rates are 2.5% for all assets except animals and agricultural produce for which there are special rates. The teacher is advised to report these with reference to standard works on the subject.

Zakat is an earmarked tax whose beneficiaries can be classified under two main categories: Defence and promotion of Islam (covered by the Quranic terms *fi sabilillah* and *al mu'allafatu Qulubihim*) and the needy (comprising the Quranic categories of *fuqara*, *masakin*, *ibn al sabil*, *al gharimin*, and *fi'lriqab*). Besides, the cost of collecting and disbursing *zakat* can be realised from *zakat* revenue (*al 'Amilin 'alaiha* in Quranic terminology). From this it can be hypothesized that the major portion of

zakah revenue in a modern Islamic state is to be spent on need fulfillment and, in normal circumstances, a minor part on defence and *da'wah* (communicating the message of Allah). As pointed earlier the *zakah* revenue and expenditure meant for need fulfillment can be integrated into a broader social security scheme.

7.2 Economic Impact of Zakat

The economic impact of *zakah* should be studied by taking both the revenue collection and the expenditure aspect into account and placing them in the context of the total tax and expenditure of a modern Islamic state. It should be explained *in* the light of recent Islamic economic literature that *zakah* may not have any significant effect on the choice between work and leisure, present and future consumption, and risk taking. The fact that idle savings are taxed at the same rate as savings invested with a view to earning a return is likely, however, to strengthen the propensity to invest. It may also be noted that *zakah* may end up in changing the allocation of resources in favour of essential goods and services by effecting a transfer from the rich to the poor. While the major function of *zakah* is distributive, the possibility of using *zakah* collection and disbursement for stabilization purposes may also be explored.

The possibility of using the yield of *ushr* i.e. *zakah* on agricultural produce for improving the condition of the rural poor deserves special attention. Apart from attending to needs that cannot wait e.g. hunger, shelter, etc. revenue from *ushr* may be used for supplying land to the landless peasants and buying equipments and fertilizers, seed, etc. for the marginal subsistence farmer.

It is necessary in the context of *ushr* to dispel the misconception that being a proportional levy it tends to be regressive. Whether a particular tax is regressive cannot be decided in isolation without considering it as part of an integrated tax structure and without taking into account the expenditure of its yield.

7.3 Need for Empirical Studies

The theoretical discussion on *zakat* in a modern - state must be followed by a report on the way *zakat* is being implemented by some contemporary Muslim countries such as Pakistan, Iran, Saudi Arabia, Sudan and Malaysia. Evaluating the performance of these countries in the light of *shariah*, the student may be supplied with some statistical data on collection and disbursement of *zakat* in these countries.

SECTION 8: THE STABILIZATION FUNCTION

8.1 Full Employment, Price Stability and Fiscal Policy

A study of the effects of tax and expenditure policies on the level of employment and prices is central to the study of public finance. Full employment of labour and full utilization of productive capacity in terms of capital is desirable as underutilization implies waste and unemployment means human suffering. Price stability refers to the average level of prices and not to relative prices which are liable to keep changing. Price stability is desirable both on grounds of distributive justice and the growth objective. The effect of taxes and expenditures on the levels of employment and prices has to be traced through their impact on demand as well as supply, the effects on aggregate demand being generally more pronounced than that on aggregate supply. Having already dealt with the Keynesian analysis of income determination, as advised in an earlier section, the teacher should explain the Keynesian fiscal policies designed for maintaining full employment and a stable price level. The concept of budget multipliers may also be explained in this context. It may be pointed out that if and when such a policy is needed in the context of a modern Islamic economy replacing the rate of interest by an expected rate of profit in the analysis may make it relevant to that context also.

It is increasingly being realised, however, that fiscal policy alone cannot deliver the goods and fiscal and monetary policy should be coordinated to secure the desired results.

It may be pointed out that the effectiveness of monetary policy will be greater the more inelastic the demand for money schedule, whereas a change in public expenditure will be more effective the more elastic the demand and for money schedule and the more inelastic the investment schedule. A mix of

fiscal and monetary policies has to be designed to ensure the desired level of aggregate demand. It should be noted, however, that fiscal expansion is less favourable to investment than monetary case is, as it may crowd out private investment.

The student should be made to grasp the essence of the entire approach. At any given level of prices a certain overall level of expenditure is needed to secure full employment output with price stability. A deficiency in expenditure would result in unemployment, an excess will cause inflation. The teacher should explain, in this context, how the fiscal and monetary multipliers work as taxes, expenditure and money supply is varied. The concept of 'fiscal leverage' should be explained demonstrating with the help of examples, how different budgets may have the same leverage.

It is also advisable to distinguish between changes in government expenditure and taxes secured by changing the expenditure programme or the tax rates and those which might occur due to built in flexibility i.e. automatic response to changes in the private sector. The techniques of measuring the magnitude of the built in flexibility may be explained in the light of available literature.

Issues involved in the timing of fiscal effects, policy lags, implementation lags, and response lags in the context of a flexible fiscal policy should be explained. The arguments against a discretionary fiscal policy and in favour of adhering to a balanced budget approach should also be examined.

Having conducted the analysis on the assumption of a given price level, the next step should be to envisage a situation in which changes in the aggregate demand cause changes in the price level rather than in the real

output. The resulting inflationary situation may be further complicated by cost push inflation. Special attention should be paid to the present malaise of the western advanced economies with persistent inflation coupled with high levels of unemployment i.e. stagflation. The Phillip's curve and its limitations should also be examined. The role of 'rational expectations' in making fiscal policy largely ineffective may also be discussed in the light of recent debate on the subject. The attempts to salvage the situation with 'supply side economics' should be examined.

8.2 Fiscal Policy in a Sharing Economy

Having conducted the analysis in conventional terms, it may be subjected to a fresh review in the context of an economy where profit-sharing is the dominant mode of contract both in the financial sector and in the labour market. It could be argued that stagflation could be handled more effectively in such an economy. While these policies are more relevant to the situation obtaining in the developed western countries, the role fiscal policy can play in capacity creation and economic development in the developing countries remains to be examined, a task to which the next section is devoted. Appropriate fiscal policies in the context of a modern Islamic economy can be discussed only in that framework. The purpose of this section, and the next one, is to equip the student with the necessary tools of analysis and give him a feel of the problems to be encountered in designing suitable policies for that purpose.

SECTION 9: FISCAL POLICY AND ECONOMIC DEVELOPMENT

9.1 Need for a New Approach

The theory of public finance developed mostly in the context of the already developed countries of the world and most of the discussion of fiscal policy in the standard textbooks is largely designed to meet the needs of those economies. Poor developing countries of the third world face an entirely different situation which call for new approach suited to the needs of their economies. To mention only some of the differences, it is not only the level of GNP but its *composition* which is most important for the third world countries where the basic needs of large masses of humanity remain unfulfilled keeping them depressed, weak in body, uneducated, unskilled and without any initiative. It is not only the volume of investment but its *direction* that is crucial to eliminate poverty. It is not enough to arrange for the provision of public goods and services but to ensure that they do not reach only the rich and the previliged in these poor societies but also reach the urban slum dwellers and the rural poor. Fiscal policy in the developing counties must meet these and similar other challenges.

The teacher will have to discuss some of these issues relying not on the standard text books on public finance but on the literature on basic needs and development strategies, especially the contributions of the third world economists.

9.2 Developmental Priorities

First priority attaches to the fulfillment of core basic needs such as food, clothing, shelter, medical care and education. Meeting these basic needs would not only ameliorate suffering but raise productivity and increase the supply of work. This requires a multi-pronged approach. These needs should be given priority in the provision of public goods and services

and arrangements should be made so that they reach the needy. When public services are supplied at a price, the consumed by the poor should be priced low while those consumed by the rich should be priced high. Food and essential items consumed by the poor should not be subjected to indirect taxation whereas goods with high income elasticity of demand should be taxed, the higher the elasticity, the higher the tax. Taxation should also be used to encourage the consumption of goods whose production is more labour intensive.

The emphasis in the education programme should be on creating the right kind of skills and improve human capital. When not provided by the state, such programmes can be supported by scholarships, reimbursement of tuition fees and supply of free lunch in the school.

High priority also attaches to strengthening the infrastructure in the rural areas to raise the productivity of agriculture, encourage home industries and prevent migration to urban centres. Building roads that provide access to markets, arranging supply of credit and improving irrigation and drainage facilities may go a long way to achieve these purposes.

It is not the purpose of this course to deal with the problems of developing countries at some length. The above is mentioned only to indicate some of the priorities of public sector expenditure and fiscal policy, and to emphasise that policies designed for capital rich developed countries are not relevant in their case.

9.3 Resource Mobilisation

It may also be noted that some of the resources needed for the above mentioned programmes can be mobilized by imposing wealth and property taxes. Instead of having a wide coverage and a low rate a policy of taxing

only very large holdings at relatively high rates may be more efficient. It is also desirable to have the lowest tax incidence on entrepreneurs, especially small entrepreneurs and put more reliance on taxation of rents, capital gains and corporate profits.

Since the key to long term growth and development is scientific research, and since development of new technology suited to the resource endowments of the economy is crucial for a less dependent strategy of development, research should receive maximum patronage by the state. Besides publicly funded research, deductions of expenditure on research by individuals and institutions may be allowed for tax purposes.

9.4 Deficit Financing

Developing countries are faced with a situation where there are idle men and idle productive resources but the market mechanism fails to bring them together (for a number of reasons which we cannot discuss in this course). Sometimes it requires only some money to hire the two and produce something which can pay back the money invested. But the returns may be low enough not to attract the private sector. Or, the project may take sometime so that a long term investment is needed. Often these projects also involve some capital which has either to be freed from other domestic uses or imported. It is these activities which justify 'deficit financing' in the sense of the public authority spending more than it collects by way of taxes or borrowing from the private sector.

In the context of an Islamic economy also some of these projects may not be appropriate for being financed by funds mobilised from the private sector on the basis of profit-sharing because of the low rates of return, the long periods gestation and the possible 'crowding out' effect. It may be suggested that such projects may, within certain limits, be financed by

outright creation of new money by the public authority. The limits in question are imposed by the need to maintain a reasonable degree of price stability. Every society needs more means of payments as its real income rises. Money creations as a means for financing developmental projects would be a safe method as long as it is ensured that the resulting increase in real production and the increase in production in the private sector can absorb the additional money supply without causing the average level of prices to rise. It will be also necessary to keep the creation of money by the private sector (banks) under strict control.

As argued in a subsequent section money creation should *never* be used for financing such public expenditure as does not result in any addition to marketable goods and services.

Some international aspects of development and fiscal policy are considered in a later section.

SECTION 10: ECONOMICS OF PUBLIC DEBT

10.1 Debt Financing Versus Finance by Taxation

When a public expenditure is financed by tax revenue, the cost of the benefits flowing from those expenditures is borne by those who pay the taxes, i.e. by the present generation. When it is financed by borrowing from the people the cost is not paid in that period but by those in the future periods who pay the taxes in order to service the debt and retire it. It follows that public expenditures expected to yield all or major part of their benefits in a short period of time should not be financed by borrowing as it would amount to making the future generation pay for the benefits enjoyed by the present generation. Borrowing is justified as a means of financing public expenditures which yield their benefits gradually over a long period of time, e.g. building irrigation dams, constructing roads, etc.

These considerations apply whether loans from the public carry interest or not, as long as they are given voluntarily. In the context of an Islamic economy there may be only a limited scope for (interest-free) borrowing from the public. Instead, funds mobilised on the basis of profit-sharing can be used to finance such public projects that yield a positive money return comparable to the returns of similar investments in the private sector. Since many projects may not qualify on this criterion, and taxation alone may not suffice for financing long term projects such as irrigation dams, bridges and highways recourse to 'deficit financing' and/or borrowing from abroad may become necessary.

10.2 Financing by Money Creation

Deficit financing generally takes the form of the government borrowing from the central bank which creates new money against the government's promise to pay. Government borrowing (at the central, state or

local level) from the commercial banks amounts to the same insofar as it results in the creation of new money (since the commercial banks use governments promise to pay for borrowing from the central bank). Much confusion can be avoided if this real nature of financing public expenditure by borrowing from the banking system (including the central bank) is kept in view. It amounts to financing public expenditure by creating new money. It can then be easily realised that the interest paid on such loans is unnecessary and calling them 'public debt' a misnomer. It is far more rational to do away with the fiction of 'borrowing' and openly finance such public expenditure by new creation of money as qualifies for this purpose, an issue already examined in the previous section.

10.3 Foreign Debt

A foreign debt incurred by the government enables it to finance some public project without any current cost to the domestic economy. Ultimately, it has to be serviced and paid back by withdrawing resources from the domestic economy. If the foreign loan has been utilised for projects with a positive return higher than the (interest) cost of the foreign loan, the withdrawal of resources from the domestic economy will not constitute any burden. In fact the economy may end up with a net gain depending on the productivity of the project. That, in fact, is the whole rationale of foreign borrowing by the developing countries.

It may be noted, in the context of an Islamic economy, that the case for foreign capital remains basically the same when its 'servicing' is done in the form of a 'variable' share in 'profits' actually realised by its domestic use. The obvious advantage of replacing foreign (interest bearing) loans by foreign equity capital is that it will have to be utilized in a productive manner so that the foreign equity holders' expectations regarding profits are fulfilled.

10.4 Outstanding Public Debt

There remains the issue of the outstanding public debt of a country, domestic and foreign. Many economists argue that it is neither necessary nor desirable to retire all the domestic public debt. The 'real' part of the domestic public debt, which is owed to the citizens, may gradually be retired with the help of unanticipated budget surpluses or by monetizing part of it whenever these measures are desirable in the context of stabilization policy. The part owed to the banking system may continue to exist but the cost of servicing it should be reduced as far as feasible.

In the Islamic context, the outstanding public debt has to be treated within the framework of the following principles the first two of which are dictated by *shariah* and last by the reality of the circumstances.

1. Interest payments on outstanding bonds have to be stopped.
2. All contractual debts have to be repaid.
3. It is not possible to repay all debts forth with.

Private bond-holders should be given the option of accepting profit-sharing investment certificates of public undertakings for their bonds. Those who do not choose to do so should simply wait till their loans are repaid gradually, no interest being paid meanwhile. All real debt (i.e. debt owed to private sector) is either to get converted into investment certificates or paid out of tax revenue or newly created money over a period of time. Debt owed to the central bank may simply be monetized by removing the fiction of its being a debt. In the long run, a modern Islamic economy may carry only some foreign as well as domestic real debt which is free of interest but has to be repaid, in accordance with the terms of the contract, by withdrawals from the private sector or by creation of new money as indicated earlier. It may, however, hold domestic and foreign funds on investment account with the

obligation to refund them with their due share of actual profits (or losses) at a time stipulated in the contract.

Money owed to others as loan or investment may be used for stabilization purposes by timing the repayments and fresh acquisitions to suit the macroeconomic considerations, as far as the terms of the relevant contracts permit. It is not difficult to devise these terms in a way which is acceptable to the lenders/investors and suits the stabilization needs also.

SECTION 11: INTERNATIONAL ASPECTS OF PUBLIC FINANCE

11.1 Interdependence of Modern Economies

Growing interdependence of the world economy necessitates concern with the international aspects of public finance. Provision of certain public goods is possible only through an international arrangement the cost of which has to be shared by nations e.g. protection of the atmosphere, prevention of nuclear radiation, use of communication satellites, eradication of diseases like malaria, etc. Should costs be shared according to nations' ability to pay e.g. in proportion to their GNP or as per benefits received? This and other issues involved should be discussed in the light of relevant literature.

Another set of issues are involved in the context of international distribution of income and wealth and development aid. What do high income countries owe to low income countries and what are the best ways of discharging these obligation so that the gain in international equity is achieved with least cost in terms of efficiency and growth. Redirecting capital flows from high income to low income countries may be considered as a suitable means. The relative merits of interest and profit-sharing as possible bases of international flow of capital may be examined. It may be demonstrated in the light of current Islamic economic research that profit-sharing may save nations from some of the problems created by interest based debt finance at the international level.

11.2 Exchange Rates and Tariffs

It should be pointed out that nations can not pursue stabilization policies in isolation from one another. Referring to the debate on fixed exchange rates versus flexible exchange rates, it should be pointed out that some sort of policy coordination on fiscal as well as monetary planes is

required in both cases for nations, big as well as small, to be able to pursue stabilization policies effectively at home. Some international agencies such as the U.N., the GATT, etc. relevant to these issues may be introduced in this context.

11.3 Intertwined Jurisdictions

Lastly, the fact that every nation has large number of aliens residing within its jurisdiction, often for quite long periods of time, as every nation has large number of its citizens residing abroad, poses certain problems for assessment and collection of taxes. The same problems, albeit in a greater magnitude, is posed by the multinationals and firms in one country owned by people in another country. These problems too call for coordination at the international level.

The significant role regional grouping of countries in the form of common markets, customs union, common currency, etc. can play in the economic development of countries should be mentioned and the case for an Islamic common market and other forms of economic cooperation between Muslim countries should be stated with special reference to its implications for fiscal policy.

SECTION 12: CONCLUSION: PUBLIC FINANCE IN DEVELOPING ISLAMIC COUNTRIES

In conclusion the teacher is advised to discuss in the group of developing countries to which the Muslim some of the diseases afflicting the conduct of public finances countries with a potential for becoming truly Islamic countries belong at the present. Wasteful extravagance, widespread corruption, inefficiency in resource utilization, wrong priorities in expenditure policy, excessive foreign borrowing, absence of effective public disclosure and lack of public accountability has characterised almost all of them in the recent decades. Not a few of these can be ascribed to the absence of the process of *shura* with the Islamic democratic institutions it implies. The low level of literacy and education are also no less responsible. The people in general, but especially the rulers and the decision makers, lack a sense of responsibility, whereas Islam envisages them to be conscious of the trust reposed in them and to be imbued with a sense of mission. To create an urge to improve the lot of the *ummah* with a view to enabling it to perform its mission with humanity, which requires it to be truly independent of non-Muslim powers and economically strong, appears to be the first step toward fiscal reforms in these countries. Highest priority should then be attached to restoring the Islamic process of public decision making to its rightful place. The bureaucracy should be infused with the sense of trust and accountability Islam imparts.

The tax structure should be simplified as far as possible and the priorities in public expenditure policies should be redefined to serve the Islamic objectives of need fulfillment, reduction of inequality and economic development. This will also go a long way in securing the willing cooperation of the masses and removing their present apathy caused by the widespread feeling that public finances serve the interests of the few and enrich the rulers. Justice in administration is a precondition to rooting out or

corruption and in-efficiency. Reliance on foreign 'aid' should be replaced by greater cooperation among Muslim countries and more trade. Spenders of public money should be fully account able before the public and the tax payer which can be ensured only through proper disclosure of public accounts.

Rational action requires full information. A serious impediment to proper administration in developing countries is the poor quality and scant nature of statistical data. Every effort should be made to increase the quantity and improve the quality of information relating to all aspects of the economy, population, natural resources, skills, capital stock, animal wealth, crops, land use, prices money credit and internal and external trade.

Lastly, the policy makers should be thinking for themselves and finding their own solutions rather than emulating policies designed for different circumstances and relying on advices intended to increase the dependence of developing people on the developed world. The implications of this for the teacher of public finance and his students would not be lost, we hope.

TEACHING OF PUBLIC FINANCE IN ISLAMIC PERSPECTIVE

VIEWS OF A CROSS SECTION OF ISLAMIC ECONOMISTS

Some notes on teaching Public Finance in Islamic Perspective were prepared by Siddiqi* to highlight what is unique in the Islamic view on Public Finance and how it should be taught in a course at undergraduate level. The notes were circulated to a cross section of Islamic economists for their comments and suggestions. The response was very encouraging and detailed comments and suggestions were received from several economists having interest in Islamic economics.

Keeping in the view the variety and richness of response received, the present paper presents a summary of this response not only to highlight the point of convergence and divergence among Islamic economists on the subject but also to provide a supplement to *Siddiqi's* "Notes on Teaching of Public Finance in Islamic Perspective" for the guidance of teachers in this area. This summary, in fact, can also prove to be a basis for developing a text book on "Public Finance in Islamic Perspective".

The comments received on the Notes were of two types, (a) editorial comments reflecting upon presentation or phraseology, choice of words etc. and (2) substantive comments aimed at improving the substance of the paper achieve its objectives i.e. teaching of public finance in Islamic perspective.

This summary confines itself only to the second type of comments.

* M.N. Siddiqi, some Notes on Teaching Public Finance in Islamic Perspective, Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah, 1989.

CHAPTER 1

NEED AND PURPOSE OF NOTES ON HOW TO TEACH PUBLIC FINANCE IN ISLAMIC PERSPECTIVE

Siddiqi felt the need to write the Notes in view of the fact that several Universities in Muslim countries as well as elsewhere are teaching Islamic components of Public Finance only in the form of historical facts which have no counterpart in the text books in other courses, such as economic theory, international trade and economic development, being used in the same Universities. There was, therefore, a need that teachers of Public Finance have a fresh look at what they are teaching and bring the Islamic concepts and values to bear on the solution of the contemporary economic problems.

Discussants of his Notes, generally, had full agreement with the above mentioned need and they agreed that the Notes serve for which they have been written. *Requibuzzaman*, for example, regarded these Notes as excellent suggestion about ways to incorporate Islamic economic perspectives into teaching public finance in colleges and Universities in the Muslim countries, covering well the traditional topics studied in Public Finance. He also suggested that these Notes should be made available to the US readers as well through well known publishers. *Hashim Awad* regarded the Notes a work of comprehensive nature encompassing most of the issues of Public Finance from Islamic economists on these issues. *Abedin Salam* appreciated the articulated integration of Islamic literature with modern literature on the subject.

Despite that, there was no discussant who did not substantially comment on these Notes and present his own views on various aspects of the subject as will be clear in the discussion later on.

1.1 Target Group

The target group of Siddiq's Notes was the teachers of Public Finance at undergraduate level. The state of the art as well as the need of the discipline is that Islamic economics as a course can be introduced at present only at undergraduate level. The introduction at graduate level, of course, will be the second step. Siddiqi, very specifically intended to address his Notes for the undergraduate level teaching only. A couple of discussants, however, felt that some topics and discussions in his Notes were not suitable for discussion at undergraduate level because such topics were being taught at higher levels in modern Universities. *Hamid Daraz*, for example, think that following three branches of Public Finance have been mixed up in *Siddiqi's* Notes:

1. Theory of Public Finance.
2. Fiscal Policy.
3. International Finance.

According to Daraz, the undergraduate level course on Public Finance should cover the theory of Public Finance which should not cover topics like fiscal, and monetary, and stabilization policy, economic development and international aspects of Public Finance.

Adil Ahmad Hashish also made similar comment and pointed out that following three branches of Public Finance have been mixed up:

- i) Theory of Public Finance
- ii) Economics of Public Finance
- iii) Fiscal Policy

Most of the discussants, however, did not face any problem with respect to the consistency of the contents and the intended target group. *Hashim Awad*, in fact, suggested that the target group of such Notes should

be writers of text books, instead of teachers. According to him the tenets of Islamic Public Finance are so radically different and pervasive, when compared to those of conventional Public Finance, that teachers unaided with proper text books, cannot convey them to students through sporadic comments on the subject matter of conventional courses.

1.2 Structure of the Course

Siddiqi selected the following topics in the framework of a standard textbook and gives his opinion how these topics can be handled by a teacher while teaching in Islamic perspective:

1. Goals and Functions of an Islamic State.
2. Public Decision Making.
3. Public Goods.
4. Priorities in Fiscal Functions.
5. Distribution Function.
6. Growth Function.
7. Allocation Function.
8. Stabilization Function.
9. Fiscal and Monetary Policy Mix.
10. Expenditure Policy of Public Sector.
11. Size of the Budget.
12. Project Evaluation.
13. Public Supply and Production in Public Sector.
14. Sources of Public Revenue.
15. Taxes and their Impact.
16. Economics of Public Debt.
17. Fiscal Policy and Economic Development.
18. International Aspects of Public Finance.

Some discussants objected to drawing upon western books for selecting structure of the book. *Daraz* objected that 75 percent of the material discussed in *Siddiqi's* Notes exists in western textbooks which has nothing to do with Islamic concepts. Majority, however, did not have any objection to the above mentioned structure of the course. The state of the art is such that the subject is still in infancy and has yet to go a long way to develop into a final shape. Until that state is reached, the existing stock of knowledge has to be taught in some framework and western textbooks provide a ready reference for a suitable framework.

Some discussants, while agreeing to the structure of the course suggested re-shuffling of the topics or suggested new topics or recommended dropping some of the topics.

Sidiq made the following general suggestions in this respect:

- i) Role of *hisba* to be included with special reference to its relationship with economic activity in private and public sectors.
- ii) Expenditure policy should not be discussed after Fiscal Functions. It would better be placed after every thing pertaining to revenue side been discussed.
- iii) Before discussing Expenditure Policy, heads of expenditure needs to be discussed as an independent topic.
- iv) Fiscal and monetary policy mix should be discussed later in the course after the stabilization function of state has been discussed in detail.
- v) Discussion of the transformation process from the existing reality to an Islamic one seems to be less appropriate at this level for a course on Public Finance. In any case, not much has been outlined in the Notes about the transformation process, although

it has been mentioned in the beginning while explaining purpose of the Notes.

Raquibuzzaman suggested that the discussion of the functions of Islamic state should be followed up with a detailed analysis of the structure of desired governmental institutions which are needed in order that state can be entrusted with responsibilities Islam imposes upon it.

Raquibuzzaman believed that goals of an Islamic system have generally been the goals of development plans for many of the Muslim countries as well as others for the last three to four decades, which produced little results, if any. According to him unless each branch of the government and the various institutions, agencies and bodies of the state are made accountable to the public for their actions, there is little hope of achieving the goals, Islamic makes incumbent on the Muslims.

Zaman believes that the author stress at the outset (1) the need for public accountability (2) the importance of an independent judicial system (3) a free press and (4) the existence of vigorous competitive financial information of an Islamic economic system.

Zaman emphasized the inclusion of the role of *hisba* also in this chapter on public or governmental institutions.

Sultan Abu Ali suggested that discussion on expenditure policy should be made after concluding the entire discussion on all aspects of government revenue including *zakah* whereas *Siddiqi* discussed the public expenditure in the very beginning soon after discussing the goals of fiscal functions of an Islamic state. (Discussion on government revenue and *zakah* came afterwards).

This difference in opinion may not be taken on the face of it, as merely a matter of rearrangement of teaching material. This, in fact, reflects difference of opinion on fundamental philosophy of public finance in Islamic perspective. There are two polar views on government's economic role and its implications for public revenue and expenditure. One view implies that sources of public revenue are almost fixed and do not have much flexibility hence public expenditure has to be tailored according to the revenue raising capacity of the government. This school of thought would, of course, like to discuss government revenue first before discussing public expenditure in a course of Public Finance. The other view is that the government is required to play a substantial role in the economy which in turn gives the government enough flexibility to decide the size of budget keeping in view the needs of the society. By implication, government gets enough flexibility in its power to mobilize required resources (through taxation, borrowing etc.). This school of thought would naturally like to discuss public expenditure first before discussing various aspects of government revenue.

In a course on Public Finance, it should be quite instructive for a student to know about this controversy and the underlying arguments in this controversy. This is something that *Siddiqi* must educate his target group of prospective teachers of Public Finance. A sub-section needs to be added in the chapter on fiscal function briefly explaining the tents for the government to raise resources, to interfere in economic activity, to determine its size of budget and to decide on borrowings from the private sector at home and abroad. A summary view on these will help keep the student in proper perspective from the very beginning about the proper position of government and government revenue. It may not then be a matter of controversy whether public expenditure is discussed first or public revenue.

Sultan Abu Ali also made the following suggestions with respect to the structure of the course:

- i) Each of the four fiscal functions i.e. Distribution Function, Growth Function, Allocation Function and Stabilization Function should be discussed in separate independent sections. (*Siddiqi* discussed all the functions in one chapter under the heading Fiscal Function and then devoted an independent chapter to Stabilization Function).
- ii) A full section is needed dealing with the budget and principles governing its preparation, adoption, implementation etc.

Abedin Salam is of the view that it is not proper to discuss *zakah* on the taxes side alone. In his view, *zakah* is a separate fiscal branch which had to be analysed on its own. *Zakah* should be integrated in the overall fiscal system and in this respect we have to see it could be integrated in the revenue, expenditure, transfer payments etc.

Salama also expressed his reservations on briefly discussing in the chapter on Fiscal Functions the proper mix of monetary and fiscal policy. Student at this level may not be aware of the proper tools of monetary policy or fiscal policy and how they interact in actual life.

Iraj Toutonchian suggested following topics to be added in the course:

1. Priority of public over private interests.
2. Priority of preventing loss over gaining a benefit.
3. Adherence to the principle of 'No Injury' in economic activities.
4. Islamic concepts of *nafaqat*, *sadaqat*, *khairat*, *haqq*, *ma'lum*, and their impact on economic variables such as consumption, savings and investment with special reference to their role in

reducing income inequalities as in reducing the burden on government budget.

Hashim Awad also felt the need for similar arrangement in the structure of the course. He thinks that though *Siddiqi's* introduction, at the beginning of the course, on the goals and fiscal function of the Islamic state is well warranted, yet at this stage to merely narrate Fiscal Functions in western framework and leave the Islamic standpoint on them for a later discussion, is not proper. According to *Awad*, logic dictates that the principles, functions of goals (whatever they may be termed) of a fiscal system should be examined from Islamic point of view before the policies that implement them are discussed. In more specific terms, *Awad's* suggestion is that the policy issues discussed under the heading of “stabilization function” and fiscal policy and “economic development” at the end of the course need to be discussed in the beginning of the course where fiscal function, goals etc. of an Islamic state are being discussed.

Hashim Awad had the view that it would have been more instructive if the fiscal functions of state had been divided into following three categories:

- i) Fiscal Art
- ii) Fiscal Economics
- iii) Fiscal Policy

The development use of fiscal tools would fall into the category of fiscal art, the economic effects of these tools should be discussed under fiscal economics and the objectives, priorities, programmes etc. should be discussed under fiscal policy.

Hashish also emphasized the need of paying more attention to explaining goals and functions of an Islamic state with particular reference to the following:

- i) Nature of Public Goods
- ii) Nature of Public Services, and
- iii) Nature of Merit Goods

as these concepts have a lot of significance in the context of social needs, the provision of which is the responsibility state.

Hashish also observed that there were some topics which were traditionally covered in such a course but were ignored by *Siddiqi*. He specifically mentioned the following topics:

1. Nature of public expenditures and order of priority for these expenditures.
2. Impact of public expenditure on national income and expenditure and on distribution in the economy.
3. Importance of surplus in the public sector which has special importance for developing countries particularly for fixing prices of public goods for their efficient utilization.
4. Public budget and its relation to economic planning and in achieving economic equilibrium in the economy.

1.3 Significances of Analytical Treatment

Keeping in view the increasing significance of the use of modern analytical tools in economics, *Junaid* suggested that there should be specific analytical applications of the concepts more akin to Islamic economic so as to give some feel of the Islamic perspectives. *Junaid* suggested to include the following where literature is available directly or indirectly.

- (a) Elasticity of *zakah* revenue with respect to income and its variability in relation to changing structure of the economy.

- (b) Impact of *zakah* on consumption and aggregate demand and therefore as fiscal tool.
- (c) The existence or otherwise of negative income tax concept in an Islamic economy.
- (d) The role of *takaful* in health services as opposed to direct government provision of such goods.
- (e) How *shura* can be guided in determining the ‘most optimal’ combination of equality and development on one hand, and allocative efficiency on the other?
- (f) For an open economy, how to use exchange rates in stabilization and development model, depending on whether it is based on flexible or fixed or controlled flexible rates..lm

Junaid's suggestions, though relevant for developing the discipline or Public Finance, may not be acceptable for teaching a course at undergraduate level. Analytical treatment is something that will take some time to develop. The above examples suggested by Junaid are the areas which require rigorous research before they could be made a part of the undergraduate research. The most important area that requires analytical treatment (before we could come to issues like negative income tax implications of *zakah* and other *nafaqat* and *sadaqat* in an Islamic economy) is how to trace the relative efficiency of fiscal and monetary policies in order to arrive at a proper mix of two policies in an Islamic economy. An Islamic alternative of interest-based IS-LM framework is yet to be found.

Teaching of Public Finance course at undergraduate level, however, does not require to wait for the development of such analytical perspective.

1.4 Approach in Teaching the Course

This is perhaps the area where discussants were most critical and where most forceful comments and suggestions have been received. These views can be grouped under the following heading:

1.4.1 Approach in General

Siddiqi's general approach in preparing his Notes was that “we are trying to blend together what is true and useful in modern economics with what is relevant in *shariah* relating to economic affairs so as to equip the student to analyse economic problems with a fresh insight and explore solutions which are distinctively Islamic, whenever called for.”

Some discussants regarded this approach as self defeating. According to *Abdul Hamid Junaid*, such as approach puts capitalistic model at the centre and the Islamic perspective only seems to appear to be seen from certain angles whereas the true picture should be reverse.

Mohmoud Abu Saud regarded *Siddiqi's* approach as “treating the subject on the usual capitalistic lines, patching the textual study with some Islamic prescriptions and principles”. *Abu Saud* did not agree at all that we can blend what is relevant in *shariah* with what is true and useful in modern economics as it is difficult to judge what is true and useful there. According to him, it would have been quite advisable to specify the major outlines of the Islamic principles that will govern the modern Public Finance.

Sultan Abu Ali also did not agree with the suggested blending. His main objection is that we cannot have the Public Finance of an Islamic state on the principles derived from an alien ideology, be it liberal or socialist. According to *Abu Ali*, our aim, instead, should be to reach a better understanding and a more truthful science using modern economics. There is

no harm using or benefiting from the present state of science yet it must be kept in mind that value loaded concepts should be dealt within a careful manner specially if we have a better Islamic concept. For example, the concept of basic needs (repeated in several places) has a better Islamic alternative called *hadd al kifayah*.

1.4.2 Emphasis on Comparative Approach

Some scholars emphasized to adopt a comparative approach while presenting the material to the students. *Saidi* suggested that the case of a hypothetical Islamic economy may be kept in view while using appropriate tools of analysis from traditional economics and to show how the analysis differs from the traditional analysis. In this process, we may also discover our own tools of analysis where necessary. According to *Sidiq*, Islamic economic should be dominant in the discussions of the teacher and traditional economics should be brought in for comparison only. He however, did not mean that one should deal with the traditional economics only in passing. According to him, it should be analysed fully to help students master the art.

Sadiq thinks that until we have not developed a course on the subject, it may be alright to continue teaching traditional economics with a comparison to Islamic economics but when we are able to develop full course then the approach should be reverse i.e. material of Islamic economics should be presented with a comparison to traditional economics.

Iraj Toutonchian is of the view that while presenting this course to the students, the issues relating to the theory of Public Finance should be kept distinct from the practical issues facing the contemporary Muslim societies. The solution of economic problems in theory, thus, should not be addressed

to Muslim societies only but should be addressed to the rest of the world as well.

Abdul Hamid Junaid suggested that all course that involve Islamic perspective should have coverage on methodology of Islamic economics to remind students and the teacher of the development of the discipline, where we are heading and the approach we are adopting in presenting the Islamic perspective.

Hashim Awad also emphasized comparative approach in presenting the material of this course. He feels a comparative approach would be far more fruitful at this stage of evolution of Islamic thought on public finance than a descriptive approach as adopted by *Siddiqi*, by simply explaining the goals and functions of an Islamic state and hence deriving issues of Islamic fiscal policy with respect to revenue, expenditure, incorporation of *zakah* etc.

According to *Awad*, researchers and students of the subject can benefit a great deal from a comparative study of Islamic capitalist and socialist fiscal systems and policies, for they can see immediately how these systems and policies emanate from basically different perceptions of human and political relations in the three doctrines. *Awad* believed that it was this comparative approach that was first used by the pioneer writers on Islamic economics in general and has helped to produce the extensive and recognizable body of literature denoted as such.

1.4.3 Significance of Historical Perspective

Abedin Salama did appreciate *Siddiqi's* idea to integrated historical approach in teaching Public Finance though he wondered how it could be done as *Siddiqi* did not elaborate on this point *Salama*, recognizing the importance of historical perspective, suggested that efforts should be made

to rewrite old books on Public Finance such as *kharaj*, *zakah* etc. So that modern students could be able to grasp principles of Public Finance. According to *Salama*, it may be advisable if a historical growth of fiscal sources of finance in Islamic countries is focused in this type of course in order to see the impact, those system made on western fiscal systems. In this respect coverage of the historical growth of modern taxes will also be important as it would reflect more clearly the impact of Islamic fiscal system on western fiscal system.

Abbas Mirakhor also emphasized the significance of historical perspective particularly, the history of early period of Islam. According to *Mirakhor*, the policies instituted by the Prophet (peace be upon him) and Abu Bakr, Umar bin al Khattab and Ali bin Abi Talib, May Allah be pleased with them, provide the most beautiful and succinct specification of policies implemented by the faithful rulers (*Uli al Amr al Mumin*) as secondary laws. Unfortunately not enough published research by economists exists which analyses these policies. The dissertation of Dr. Hassanuzzman made a start but it was an inadequate source on the policies of the Prophet (peace be upon him) and Khulfa Rashedeen. Its emphasis is on Ummayids and Abbasids which, because of their deviation from the Quran and *sunnah*, are irrelevant to the theory of *iqtisad* (although not to an economic history of the *ummah*). The first sixty years of Islam include enough material on economic policies to provide a firm foundation for economic policy.

1.4.4 Building Up Shariah Perspective of Students

Abbas Mirakhor suggested that *Siddiqi's* Notes could benefit the students pedagogically if it were to point out to them at the beginning that an Islamic system is composed of a core, which is invariant with respect to time and place, and a periphery which can change according, to the circumstances. The core will include immutable rules, laws, (*ahkam*), which

no one can change and all Muslim societies share them in common without variation. These *ahkam* and prescriptions are derived from the Quran and part of the *sunnah*. The second sphere (or the periphery) include what can be referred to as *ahkam* under the control of the faithful rulers, who may institute policies at variant from time to time and place to place. Part of the *sunnah* of the Prophet (peace be upon him) and the policies of Khulafa Rashedeen fall in this category. So where as *zakah* falls in the first category, *kharaj* falls in the second. Policies based on public interest (*al masalih al amah, al masalih al mursalah*) also fall in the sphere of secondary laws of rulers. It is obvious that a necessary condition for is that they don't contradict the rules of the core (some scholars go in so far as suggesting that policies by the *ulu al amr* (rulers), can not even contradict the spirit of the rules at the core. The book *Iqtisadna* by the martyr Baqir al Sadr, which in my opinion, is best book written comprehensively discussing the characteristics of an Islamic system, has a very good discussion of these two spheres.

Much of the confusion existing among present day "Muslim Economists" on certain issues such as whether or not a Muslim state can impose levies over and above *zakat* could be removed if a clear differentiation was made between the core and the periphery of the system.

1.4.5 Significance of Profit-Sharing in Public Finance

In view of the absence of interest in Islamic economy, *Siddiqi* visualized a significant role for profit-sharing system in mobilizing resources to finance some activities in the public sector. Some discussants, however, were quite critical of *Siddiqi's* view that profit-sharing based financing from the private sector activities will be a significant source of capital formation for public sector and hence will be a distinctive feature of public finance in Islamic perspective.

Daraz and *Salama* considered that this type of approach was giving an exaggerated role to profit-sharing based financing as naturally very substantial part of public sector investments cannot generate material profits. *Salama* even regarded it controversial and complicated issue. According to him, most of the government utilities are non-profitable activities and applying profit-sharing may not be an appropriate measure to attract saving unless the writer is of the opinion that there should be a wider role for the state and that it could undertake commercial activities as well. In *Salama's* view, such activities should not be left to the government.

Junaid, however, took a favourable stand on the significance of the institution of profit-sharing. He was of the view that since profit-sharing as a means of financing public projects has been mentioned in several places in the Notes, it is imperative that simplified version of such model should have been explained at the very start of the Notes, even if it is assumed to have already been covered in courses on macroeconomics or on money and banking. In fact, *Junaid* went even as far as to suggest that there should be an independent course entitled: "Profit-Sharing in Islam" in which the topic, covered from mathematical, logical and *Shariah* point of view, presents an independent model of this economic institutions. This model then can be used in several related courses including money and banking, monetary economics and history of Islamic economic thought.

Junaid also suggested that the course in Public Finance should pay attention to the potential of utilizing the institution of profit-sharing in infrastructure and other developmental projects where the element of public goods are involved. *Junaid*, however, did not give any details about how profit-sharing could be done in the infrastructure building and developmental projects.

The fact is that neither *Siddiq*'s Notes nor discussants' comments and suggestions realized two basic issues involved in mobilizing resources from the private sector for public sector financing. Firstly, profit-sharing is not the only Islamic mode for mobilizing resources from the private sector. Leasing based and mark-up (with deferred payment) based financing also have potential applications in financing various activities. Leasing based financing, for example, can be mobilized for the development of infrastructure where a private company develops an infrastructural requirement and leases it to the government. Similarly mark-up based financing can help government meeting its needs to finance various supplies required by the government for its different activities.

Secondly, it is not merely the possibility of earning extra income that can mobilize the private sector to advance resources to the government. Besides the objective of earning an income the private sector also looks for following two features before investing its resources:

- i) Low risk of default
- ii) Liquidity

whereas there is no risk of default when advancing the funds to the government, there still remains the issue whether investment in government activities on profit-sharing, leasing or mark-up basis can be liquidated when needed. This is not an issue in the interest-based system where government bonds have a secondary market. Islamic financial system, however, cannot be considered to be void of such governments which can have effective secondary markets. It should not be difficult for the government to develop financial instruments whose income (to be derived either on profit-sharing basis or on leasing basis or on mark-up trading basis) is shared with the private sector. In a society where interest option is not available such instruments or government will be more effective for mobilizing resources for the government because of the following reasons:

- i) There is no risk of default.
- ii) The instruments generate income.
- iii) The risk of incurring a loss is lesser in government than in any instrument of the private sector because of the government's ability to spread risk.

In view of all this, *Siddiqi's* approach to give profit-sharing a significant role in public finance is very much realistic. Because of this significance and because of the possibility of this institution being used in a variety of forms, *Junaid's* suggestion is very relevant that an independent chapter is needed on this institution in the teaching material on public finance.

1.4.6 Relevance of Self-Interest

Siddiqi's view that "unlike capitalism, the state of Islam is not borne out of the necessity of safeguarding individual interest and that it is a part of the original design of Islamic living" drew serious criticism from some scholars.

Daraz raised the basic question. Why or how state is a part of the original design of Islamic living. *Siddiqi's* Notes have no elaboration on this point. In the first place, *Daraz* did not see any thing wrong with "safeguarding individual interest" as a sufficient reason for the state to exist even in Islamic perspective. *Junaid* also expressed similar views.

Though *Siddiqi* did not oppose the motivations generated by self interest nor he opposed the role of state as safeguarding individual interest (particular phrasing seems to have caused such misunderstanding) yet *Abbas Mirakhor* came out very forcefully in defence of self interests and individual (private) interests as a response to the following position taken by *Siddiqi*.

“The upshot of the [discussion] on *fard kifaya* and public goods is that an Islamic society in which individual self interest is tempered with care for others and concern for public interest, is better equipped to ensure optimum provision of public goods, a fact which should be fully reflected in the designing of public policies as well as in the theory of public finance in Islamic economics.”

According to *Abbas Mirakhor*, self interest, in Islam is “much more naked and is far stronger than in any other system of thought, including capitalism. There is not one rule of behavior prescribed in the Quran that somehow is not followed by some form of “it is good for you”. There is absolutely nothing that *Allah Sabhanah wa ta’ala* or His Prophet (peace be upon him) have asked to do that is not for our own self-interest; pure and simple. When one defines an individual Muslim’s planning horizon to extend into infinity and when one is cognizant of the fact that Islam requires a belief in hereafter (*ma’ad*) and accountability and recompense there is no need to resort to conditioning side-arguments. Individual Muslims care for others because rationally this is cost-minimizing and return-maximizing behavior [a rational expectation argument would say that the reason why they are not doing so presently is because either they don’t have sufficient information, or, if they do, they are not utilizing it; which is what the Muslim ethicists have argued for a long time that the reason people do not behave Islamically is because they are ignorant (*jahil*), an argument for which there are numerous *Ayahs* of the Quran as support, that is, they don’t have enough information or they have chosen not to process the information in their possession].

The above argument should be clear because Allah says “He that does good shall have ten times as much to his credit” (Quran, Ch. 6, Verse 16) and there are very few things one can do with one’s wealth other than caring for his fellow Muslim that would, on the average, have a better return assuming an infinite planning horizon reaching the hereafter. Not to mention the example given of each good deed resembling a seed which grows into a plant with seven branches each having a hundred seed. What a fantastic rate of rates.

Mirakhor’s stand on self interest in Islamic perspective is commendable and it provides a food for thought for those who are working on theory of economics in Islamic perspective and often get trapped into the trap of explaining economic motivation of Islamic person different from selfishness and self interest.

Abbas Mirakhor needed to go a bit further to say how this sanctity of self interest becomes relevant to the stand taken by *Siddiqi*. *Mirakhor* may not be implying that Islamic economy would not be better equipped to ensure optimum provision of public goods. Probably what he may be implying is that an Islamic economy will still be better (or at least equally) equipped to ensure optimum provision of public goods. But the question, “how or in what way”, has been addressed neither by *Siddiqi* nor by *Mirakhor*.

Mirakhor’s coment, however gives rise to one important consideration for teaching this course. Like profit-share, there should be an independent section or chapter on the nature of significance of self-interest and its role for economic behavior in Islamic perspective, before the discussion on various components of public finance starts. This will be helpful for teachers as well

as students to have their own proper perspective when going into certain details of public finance. Two areas where such perspective may be needed are the following:

Firstly, if the sanctity of self interest and individual interest is so important, its protection should be an important reason (if not the only reason) of the existence of state. This gives an important function to the government *viz.* to intervene in the market whenever market fails to protect private interest of some individuals. The forms of such market failures are too many in the contemporary societies.

Secondly, the sanctity of self interest implies that resource mobilization from the private sector for public sector financing has to be done as far as possible without encroaching upon individual (private) interests. Mobilization of resources through the market, therefore, should be preferable to imposing additional taxes. In the absence of the option of raising resources through interest-based instruments, there will be need to develop Islamic instruments for raising resources from the market. These instruments can vary from project to project. (The variety of Islamic modes of financing provide flexibility to the government to introduce such variation, if needed).

In this respect, *Junaid* pointed out that *Siddiqi* seems to accept the legitimacy of self interest, but what he seems to be denying is the concept of maximization and the minimization behaviour. Hence, there seems to be a logical gap that needs to be erased. *Junaid* wonders whether “We can have positive economics that are acceptable to Islamic norms where maximization motive is excluded. “If yes, then, according to *Junaid*, this should be delved in theoretical analysis and should be reflected in such notes on teaching Islamic economics. *Junaid* suggests that, in that context,” ‘M’ inefficiency concept may be explored.

CHAPTER 2

THEORY OF STATE

Siddiqi proposed to start the course with a discussion on the theory of state. According to him “there is no escape from a theory of state and government in any discussion on public policy.” He also stressed that “the Islamic approach to public finances has a clear basis in the overall goals of Islamic living and the well defined role of state in Islamic society” unlike the conventional theory which “grapples with the hopeless task of devising social goals on the basis of individualism and self interest.” Discussants like *Mirakhor* obviously did not like discounting the significance of individual and self interest to be a basis for devising social goals. In fact there is no need to implicitly place any such discounting on self interest. *Siddiqi* himself recognizes that goals of Islamic system relate to all aspects of life and human activities based on individualism and self interest are an important aspect. What is needed is to distinguish how the Islamic approach to self interest and individualism will be different from any conventional approach that will not be based on Islamic principles. This discussion should appear in detail in the course on microeconomics and this course should only make a reference to the microeconomic discussions while elaborating the goals and functions of Islamic state.

This is what seems to be emphasized by *Junaid* as well, when he commented that the discussion on the “Goals” of Islamic economy is not sufficient without elaborating the science of Islamic economics as we need theories as the basis of consistent policies.

The question, then is, how we develop and teach the theory of state as a starting point on the course of Public Finance.

Sultan Abu Ali's suggestion, in this respect, was that this course should start with a discussion on theoretical differences between the role of state under both capitalism and socialism. This might, then, be followed by the theoretical discussion in the evolution of the growth of the role of the state, and hence developing basis.

Rauf Azhar points out that before elaborating the goals and functions of Islamic state, a teacher must also develop a basis, how to resolve conflicts among various objectives and functions of the State. *Abdul Hadi Najjar* and *Daraz* also raised this issue. According to *Azhar* value judgement is the inevitable basis for this purpose. His elaboration on the point is as below:

“Conventional economics normally shuns any discussion about value judgement and relegates it to the political process, which is normally assumed to be democratic.

In a democracy, absolute sovereignty rests with people and therefore there is no scope for stipulation of any permanent value judgement – which holds for all times and places, and this absence of a permanent value judgement absolves economists of any explicit discussion on this issue except to acknowledge that it is not their business to make any normative pronouncement.

Not so in Islamic economics. For us some of the value judgement are immutable as given in Qur'an and *sunnah* while some are subject to change depending on time and place”

Azhar, thus, recommended this aspect of the economic decision making in an Islamic economy to be taught as an independent section. He realized that this aspect has been covered to a large extent in *Siddiq's* Notes under the

heading *Functions of Islamic State* where *Siddiqi* describes three sources of government duties namely, the Quran and *sunnah*, *ijtihad* and *shura*. *Azhar*, however, suggests that the discussion of this section requires to be titled as “Sources of Value Judgements and the Duties of State” and not as “Functions of an Islamic State” particularly when there is a separate section on Fiscal Functions covering the functions like allocation, distribution, growth, etc.

Though *Rauf Azhar*’s view is very valid that the section describing the sources from which state derives its duties should be captioned as “Sources of Value Judgements” yet he probably did not realize that *Siddiqi*’s Notes include an independent section on public decision making which in fact is supposed to cover all that *Azhar* Wanted to be covered under the heading of sources of value judgement. Public decision making is a better caption than sources of value judgements in the context of a course on public finance. *Siddiqi*, however, may like to note that, in view of the presence an independent section on public decision making and an independent section on fiscal function of state, a separate section on functions of Islamic state becomes redundant. It seems that it may be more coherent if the contents of the section of “Function of Islamic State” as presented in *Siddiqi*’s are merged into the section on “Public Decision Making” and are taught in the start of the course even before discussing goals and functions of Islamic state.

Asa’d Mahammad al-Ras probably made the most pointed objection to the approach of *Siddiqi* to categorize the functions of state into the three categories. According to *Ras* the categorization as such is quite confusing and rather illusory. *Rus* particularly points out a confusion between *ijtihad* and the application of rule of *shariah* that *Siddiqi*’s Notes create while discussing the functions based on *ijtihad*.

Ras points out that the distinction between “functions based on *ahkam shariah* (*nussos*) and functions based on *ijtihad* is illusory because *ijtihad* is involved in both cases. Even the application of *nusoos* and *ahkam shariah* may often require *ijtihad*.

Monzar Kahf made a similar point by saying that some of the functions that Notes referred to as “function based on *ijtihad* in fact should be referred to as functions based on Quran and *sunnah*.”

Though both *Ras* and *Kahf* do have a point that the Notes are not very clear when discussing “functions based on *nusoos*” and “functions based on *ijtihad*”, yet their comments do not help in clarifying the issue under discussion. *Ras*’ comments particularly created confusion between what the Notes referred to as goals of *shariah*. *Ras*’ comments however, did seem to show an agreement that there is a need to classify function of state on the basis of the nature of *ahkam shariah*.

Siddiqi pointed out that we need to distinguish between two types of *ijtihad* when discussing theory of the functions of state. One *ijtihad* is that relates to identifying and investigating what is a certain rule of law for particular situation. The other *ijtihad* is that relates to identifying the circumstances in which a certain rule of law is to be applied. *Siddiqi*’s position is that theory of the functions of state *primarily* relates to the second type of *ijtihad*. *Ras*, however, claims that theory of functions relates only to the second category of *ijtihad* when are talking of *ijtihadi* function of state. *Monzar Kahf*, on the other hand takes the position that theory of functions of state will have to take into account both kinds of *ijtihad*. *Kahf* gives the following example.

“Is protection of wild life a *maslaha*”? The answer to this is an application of a certain rule under particular circumstances.

“Is protection of tigers in a particular forest at a particular point of time useful and effective”? The answer to this is the identification of circumstances in which a certain rule of law is to be applied.

In the context of the theory of functions of state, *Monzar Kahf* suggested to include the following when discussing “functions based on Quran and *sunnah*”:

- a) Role of state to service and promote relation.
- b) Functions relating to the use of public property and funds.

Regarding the function of state assigned by *shariah*, *Monzar Kahf* further argued that this discussion must proceed a statement of the limits of such a choice in order to distinguish the nature functions from those of non-Islamic democracies.

2.1 Goals (Vs. Functions) of Islamic State

Siddiqi distinguished between goals and functions. Those familiar with the modern literature on public finance find this distinction either confusing or overlapping. The confusion rose firstly, because *Siddiqi* did not explain, at the outset, why this distinction was necessary and secondly because, at places, *Siddiqi* mixed up goals and functions and the reader fails to figure out himself the fine distinction that *Siddiqi* wanted to make between the two.

Perhaps by goals, *Siddiqi* meant the goals of an economy that state should aim at to achieve. While aiming at these goals, the state has to perform certain functions. Whereas fulfillment of needs, economic development, full employment etc. may be referred to be the goals, the

achievement of these goals can be said to be attained through allocative distributive and stability function of the state.

Whether there is a need to make such a distinction between goals and functions is not very clear. It may equally be alright to teach only functions of the state and while teaching these functions reference can be made to various goals that each of these functions may help achieve.

It is possible for a function to aim at achieving more than one goals. For example, allocative function may, at the same time, achieve both economic development as well as reduction of income inequality under certain circumstances. Similarly, stability functions may achieve economic development as well as reduction in inflation.

At the undergraduate level, it may be appropriate to make the student fully understand the nature of the various economic functions of an Islamic state. The goals that these functions may possibly achieve may be discussed within the discussion of each function. Description of goals as perceived by *Siddiqi* has no bearing on the teaching of economic functions of state. But putting the student into the controversy of the goals of an Islamic economy and the priorities among them may simply confuse the student in the very beginning which may persist in his mind throughout the course.

Most of the discussants of the Notes, however, raise no objection to making the distinction between goals and functions. Some of the discussants, in fact, made suggested additions to the list suggested by *Siddiqi*.

Abdul Hadi Najjar described social justice to be elaborated in details as one of the goals. *Mohammad Saqr* suggested following additions in the list of the goals:

1. Amelioration of life.
2. Full utilization of resources particularly human resources.
3. Justice in the distribution of wealth and income of individuals.
4. Justice in the distribution of investment and resources among regions.
5. Intertemporal justice in the use of resources.
6. Establishment of economic freedom for the *ummah*.
7. Economic cooperation to enhance economic development of the poorer countries.

Sidiq observed that the goals listed by *Siddiqi* relate to material objectives of economic activities which is not an objective itself. According to *Sadiq*, Islam requires economic gains to be used for the establishment of Islam in this world. In other words, Islam recommends economic pursuits not only for material consumption (need fulfillment), but also for use in the way of Allah. Quaranic verses and traditions would support this position. *Sadiq*, therefore, suggests that one may classify the objectives of economic activities or achievements into two broad groups: (i) material goals and (ii) religious goal. The material goals can be sub-divided into two sub-goals: (a) economic, growth and (b) equity in the distribution of income and wealth. These two sub-goals cover all three of *Siddiqi*'s paper listed above. If growth takes place and its fruits are distributed equitably, everybody will get enough to fulfill basic needs and satisfy comforts depending on the level of economic development brought about by a desired kind of economic growth. The religious goal of economic activity refers to the objective of being able to spend for the cause of Allah.

Mahmoud abu Saud also objected to limiting the discussion of the goals to only those which are directly relevant to economic life as it simply means to follow the capitalistic positivism and thus to depart from the

Islamic perspective. His view in this respect is that Islamic economics is built on transcendence – a normative basis that does not fit in the capitalistic or socialistic positivist paradigms. The “blending” approach of *Siddiqi*, already referred, may run into difficulty when we will try to distinguish between the liberal democracy and the *Shura*. *Abu Saud* also observed that *Siddiqi* did not explain how the decision making would be different, what would be the moral status, why democracy would be more susceptible to the tyranny of majority rule than the *Shura* and whether or not the maximization of benefits guided by self-interest is unacceptable to *shariah*. He regarded *Siddiqi*’s approach as pursuing the “ideal” and assuming that in the Islamic state individuals will always act in conformity with *shariah*, with self-abnegation and philanthropy.

Salama observed that *Siddiqi*, while analyzing the goals, confined himself to goals that are directly relevant to economic life, which though are important, yet we should limit ourselves to the goals that are more relevant to a certain priorities which are achievable given the level of public finance and economic development.

Salama also observed that some specific goals have been mentioned without analyzing how those e.g. basic needs, could be achieved for all human beings, what is meant by such goals as basic needs or economic development, what is the role of the state and what priority should be given to different goals and what is the role of the private sector in achieving those goals. Also *Salama* pointed out that the role of the government has to be clearly identified in the area of inequalities and wealth and income and alongwith the extent to which the government is free to pursue this role and the permissible measure it can take to achieve equitable distribution.

Daraz required *Siddiqi* to mention stability as a goal as well and not merely a function of the state. *Daraz* too suggested that we should get justification for the goals also from the same sources that *Siddiqi* suggested for deriving justification for the functions of Islamic state i.e. the texts or Quran and *sunnah* and *ijtihad*.

Hussain Askri also made similar comment by suggesting stability to be mentioned as a goal and questioning the justification for considering full employment as a goal implied within the three goals described by *Siddiqi*.

Junaid expressed the view that in order to narrow down the variability of interpretations, a good start may be to differentiate between the goals of Islamic and western capitalist systems (as well as those of distribution biased western schools of thoughts like Mills, Marx and the Humanists) and highlight as objectively as possible, the superiority of the Islamic goals.

Hashih is of the view that before describing the economic function and goals of state, a complete explanation should be given with respect to the basic duties of state. He pointed out following two basic duties of state:

1. Promoting basic ingredients in the society that are requested for the establishment of a true Muslim society.
2. Follow Islamic rules and principles in all its dealings with outside world.

2.2 The Islamic Bases of the Functions of State

Siddiqi highlighted three sources for deriving the functions of an Islamic state. These were:

- i) Text of Quran and *sunnah*.
- ii) *Ijtehad* (including *qiyas*, *maslaha* and *istihsan*).
- iii) People (on the principle of *shura* or mutual consultation)

In this context, *Sadiq* observed the following:

We are dealing with a single way of life which is Islam. *Shariah* rules and duties are derived from four major sources (roots). These are the Quran, the *sunnah*, the *ijma* and the *qiyas (ijtihad)*. The *fuqaha* (Islamic jurists) and Islamic scholars term all rules derived from these sources as *shariah* rules irrespective of sources of these rules. They do, however, classify them as *faraid*, *wajibat* and so on.

It is, therefore, more appropriate for a course on economics (and not a book on *shariah*) to list all the functions of an Islamic state under the same title, e.g. the functions of an Islamic state, without classifying them as above, because all are the functions assigned by the *shariah*. One may, however, mention very appropriately the source of each function while describing it.

There should not be any confusion whether “functions assigned by the people”, as the author termed it, is a *shariah* function. He elaborated it as, “It is a matter of convenience and public interest”. It is well-known that human welfare (public interest) is an objectives of *shariah*. Therefore, it is also within the norms of *shariah*.

Siddiqi include in his Notes two separate chapters on the following:

- i) Goals and functions of an Islamic state.
- ii) Fiscal functions.

Under the former chapter *Siddiqi* covers the following sub-sections:

Goals and Functions

- (a) Goals such as fulfillment of basic needs, economic development, check on inequalities etc.
- (b) Functions of an Islamic state, describing the sources from which government may derive its duties.
- (c) Public decision making, with special reference to the principle of *shura*.
- (d) Functions based on texts of Quran and *sunnah* such as law and order, *dawah* enjoining right conduct and forbidding wrong, need fulfillment and other socially obligatory duties (*furud kifaya*).
- (e) Function based on *ijtihad* which may relate to preservation and promotion of various aspects of interest to human life.
- (f) Function assigned by people.
- (g) Public goods and the concept of *fard kifaya*, merit goods etc. and the concept of “free rider”.

Under the latter chapter *Siddiqi* discusses the following:

Fiscal Functions

- (a) Priorities among the
 - functions based on texts from Quran and *sunnah*,
 - functions derived by *ijtihad*,
 - functions assigned by the people,
 - and modern function effected through budgetary policies of the state such as allocation, distribution and stabilization of growth.
- (b) Distribution function.
- (c) Growth function.
- (d) Allocation function.

A clear and detailed understanding of the economic role of state and its justification, of course, is an essential and the first part of the course on public finance. But the way this part has been structured in the Notes, as described above, is extremely confusing. Some discussants specifically drew attention to this aspect.

First of all, the use of the word ‘functions’ in the headings of two different chapters was confusing as pointed out by *Abdul Hamid Junaid*.

According to *Rauf Azhar* the word functions suits to the contents of the chapter on Fiscal Functions and not to the contents discussed in the section on “Functions of an Islamic State”. *Azhar* even considers “Economic Functions” as a more appropriate title as compared to the title “Fiscal Functions”: because some of the governmental economic regulations do not involve finances. He rightly pointed out that the discussion in the chapter on goals and functions of an Islamic state should be integrated with discussion in the chapter on economic functions of the state. Presently, *Siddiqi* has discussed public goods, externalities, *fard kifaya* etc. in the chapter on goals and functions of an Islamic state, whereas they deserve an equal emphasis in the chapter on economic functions as well.

Abdul Hamid Junaid also strongly felt the need of integrating together the two overlapping chapters discussing “Goals and Functions of Islamic State” and “Fiscal Functions”. He also expressed his reservations over the title of the section “Functions of an Islamic State” which was not consistent with the contents discussed in that section. According to him what was discussed in this section did not relate to functions per se.

Though, only a few substantial comments were received from scholars on these chapters dealing with goals and fiscal functions, yet their comments may still be quite helpful from the point of view of presenting this important and primary section of the course to the student. The following sequence of presentation is worth considering while discussing the goals and functions of an Islamic state:

CHAPTER 1:	THEORY OF STATE
CHAPTER 2:	ECONOMIC FUNCTION OF STATE
Section 2.1	Allocation
Section 2.2	Distribution
Section 2.3	Stabilization
Section 2.4	Growth / Development
CHAPTER 3:	PROCESS OF PUBLIC DECISION MAKING
Section 3.1	Justification of Functions Based on Texts of Quran and <i>Sunnah</i> .
Section 3.2	Determining Priorities Among Functions and Principles of <i>Shura</i> .
Section 3.3	Assigned by the People.

In this structure *Siddiqi*'s entire chapter on fiscal functions (except the section on priorities) will be covered in Chapter 2. *Siddiqi*'s discussion on public goods, *fard kifaya*, merit goods concept of free ride etc. Will be referred to in the appropriate sections of Chapter 2. For example, public good and free rider problem will be discussed in section 2.1 on Allocation. *Siddiqi*'s discussion on "goals" will also get distributed in the chapter. For example goals like fulfillment of basic needs and check on income inequalities will come in section 2.2 on Distribution. The discussion on functions in this chapter may be related whatever evidence is available from the Islamic history as suggested by *Abdul Hadi Najjar*.

2.3 Public Decision Making

2.3.1 The Principle of *Shura*

Siddiqi thinks that in a course on public finance it is important to discuss the usefulness of the principle of *shura* as the Islamic mode of public decision making.

There was again a division of opinion on the rationality of including a discussion on this subject in a course on public finance.

Sadiq was of the view that the author had rightly included the matter of public decision making in a course of Public Finance. The role, nature and scope of *Shura* should be elaborately discussed in the present context. Also the distinction between *shura* and the traditional democratic mode of decision making should be clearly explained. It may be better to allocate separate chapter for it. In addition, it may be better to change the place of its discussion in order to avoid any discontinuity between the analysis of the functions of an Islamic state and their detailed discussion under different sub-titles.

On the other hand, there is also the opinion, as given by *Hashim Awad*, according to which there is no reason to discuss them in a course on Public Finance. According to *Awad* what is at issue is the Islamization of academic courses in Public Finance and not the discussion of basic doctrinal issues.

Awad's view, however, may not have weight as the decision making process does have an important place in a course like public finance. What may be disputable would be whether it should be discussed in an undergraduate course or should be postponed until on an advanced level course.

According to *Daraz*, *shura* is not even an independent institution to become a basis for determining functions of an Islamic state. His argument is that, even in *Siddiqi's* own view, *shura* is not a means of discovering what is wrong and what is right. To decide what is wrong and what is right even the *shura* will have to depend on *shariah*.

Sultan Abu Ali apprehended that if mandate is given to the people to assign and task at any time and place to the state then it would mean creating the possibility to extend the role of state beyond reasonable limits.

Some scholars while accepting the principle of *shura*, made suggestions to improve the discussion on the subject. *Raquibuzzaman* emphasized that it should be highlighted that *shura* may not necessarily mean consensus.

Abbas Mirakhor elaborated in more detail on the principle of *shura*. He appreciated the idea to urge the teachers to make a distinction between *shura* and the western understanding of democracy. *Mirakhor* view with respect to this distinction is as below:

“They are treated by many as one and the same. These people assume that the *shura* and majority rule are synonymous. To reach such conclusions requires an enormous leap in logic which is not justifiable. The Quran takes a dim view of majority hence, by implication, their decisions. In numerous places the Quran makes statements such as “But most men know not” [Ch. 12, Verse 68]. This point need emphasis that although the process of *shura* itself is binding the decisions emanating from it are subject to the discretion of the “faithful ruler”. So where as the process of *shura* is part of the immutable laws in the first sphere, many instances from the life of the Prophet (peace be upon him) and the *Khulafa Rashedeen* provide ample

evidence that the “faithful ruler” has the right of veto and this falls in the “secondary laws” sphere were it otherwise, how can one explain the Prophet’s decision on the peace of *Hudaibiya*, for example.”

Mirakhor further observed:

“The other context in which *shura* appears in *Siddiqi*’s Notes is its use as a consultative process within the bureaucratic structure of governmental decision making. Here, I am not certain whether there is any distinction between the *shura* process prescribed and the committee process so notorious an ingredient of bureaucracies. If there is a difference between the two, [the guidelines on teaching this subject] should make it more clear.”

Junaid think that the Notes should show “how *shura* has important bearing on public finance in an Islamic economy *vis a vis* the present democratic mode of social organization show the pros and cons and other intrinsic characteristics of *shura* that makes it more effective in analysis of public finance from Islamic perspective. [The treatment in the Notes is neither] sufficient nor convincing enough unless substantiated by historical or logical examples.”

According to *Junaid*, in the context of explaining the principle of *shura*, “most important will be to explain how public goods would be determined through this principles; should it be a *shura* limited to a few number of population chosen on elite basis or should every one have the chance to reflect his choice or should provision of public goods be decided on certain criteria regardless of *shura*. He also agreed that the process of *shura* should be used to determine priorities. *Shura*, in the view, however, should be constrained by available financial resources and technical know how as to set objectively those priorities.

2.4 Public Goods and *Fard Kifaya*

The discussion on functions of state, of course, requires a discussion on supply of and demand for public goods. *Siddiqi's* Notes suggested that the concept of public goods should be discussed along with the concept of *fard kifaya* particularly because, according to *Siddiqi*, *fard kifaya* also has implications for Free Rider problem. *Siddiqi* emphasized that “an Islamic society in which individuals’ self interest is tempered with care for others and concern for public interest is better equipped to ensure optimum provision of public goods.”

It has already been mentioned that *Abbas Mirakhor* objected to unnecessarily dissociating Islamic economic behaviour from the self-interest and loading it with the care for the society. Argument, reproduced earlier in the original words of *Mirakhor*, however, in spirit does not differ with above argument of *Siddiqi*. Whereas, *Mirakhor* wants to talk only of self interest while considering infinite planning horizon regarding the *akhirah* and including the rewards in the world hereafter also in the self-interest, *Siddiqi* talks of self interest only in the context of this world. While the *akhirah* considerations are translated by him into such phrases as “self interest tempered with care for others and concern for public interest.”

Several suggestions, however, came from various commentators as how to elaborate the concept to *fard kifaya* in a course on public finance.

Junaid suggested a more in-depth discussion with respect to operationalizing and comparing the extent to which the concept can be used in the government sector as well as voluntary private sector. In the context of government sector, the concept of *fard kifaya* can be used in elaborating such functions as technological development which can be done only under government sponsorship.

Sulatan Abu Ali also described that the discussion on the concept of *fard kifaya* needs more elaboration with respect to its role in defining functions of state.

Daraz felt that the concept of public goods and public needs have been mixed up. Public goods, according to him, are produce by government and may or may not be public need. In fact public needs can be fulfilled by private sector production as well. *Daraz* also did not agree with the definition of social needs as it was the definition of Musgrave which, according to *Daraz*, has been widely criticized and has been rejected by majority of experts of public finance.

Hussain Askari pointed out that *Siddiqi's* reference to a public park as a public good is not a good example because exclusion principle is possible to be applied to public parks. This, however, was not a significant point as far as it was clear that *Siddiqi* wanted the teachers to explain that since market fails to provide pure public goods because of the inapplicability of exclusion principle, the society needs a process to arrange the supply of such goods and the concept of *fard kifaya* can provide a motivation to the private sector supply pure public goods.

Raquibuzzaman pointed out that some specific examples were needed to explain merit goods in Islamic perspective and that some and that some guidance was also required as to how free riding can be averted in Islamic perspective. *Siddiqi's* Notes mentioned that “the concept of *fard kifaya* also has implications for the free rider problem. A sense of duty may make the individuals reveal their true preferences in bidding for social goods. Even though, because of non-excludability, partaking in consumption is not made contingent on payment, individuals may pay out of sense of duty.” This elaboration, of course, was far from sufficient to satisfy the reader. *Hussain*

Askari in fact regarded such a discussion unfruitful. *Askari*, though in principle, agrees with the statement yet he thinks that this would be so only in an Islamic society with good and faithful Muslim. In contemporary realities, according to *Askari*, “reliance on such a presence does more than good because it does not reflect facts.”

Salama also has similar feeling with respect to the concept of *fard kifaya*. He observed that *Siddiqi* introduced the concept of *fard kifaya* and tried to extend its application to provision of public goods, but the application of the concept suffered from some shortcomings. Discussion as to what are those public goods which are *fard kifaya*, in what sense should it be *fard kifaya*, was it in the sense of undertaking the duty, or was it in the sense of finance; or was it in both senses, and how equity could be secured in provision and making use of the public goods and could it not lead to free riding. According to *Salama*, the examples that *Siddiqi* gave for *fard kifaya* are even more confusing. In what sense defense is a *fard kifaya*? Should it not be compulsory on all the able bodied persons whether physically or financially? Education could, on the other hand, be *fard kifaya* so that if some pay others may not, even if they are rich?

Salama questioned whether *fard kifaya* can really replace the utilitarian approach. Should it not always be the case that those who benefit most out of a service should pay more for it? Should we not integrate the benefit approach with the ability to pay approach and decide how those public goods should be provided.

The sentence “individual may pay out of sense of duty” (quoted above) was confusing to *Salama* Iso. According to him this definitely does not fall in the area of public finance, as public finance deals with obligations on

individuals to pay for provision of certain public goods, the moral aspect comes in increasing compliance to those public duties.

Abbas Mirakhor reflected more elaborately in this respect:

“Two concepts are pushed to their logical limit: one is (*fard kifaya*) and the other is *shura*. *Fard kifaya* is not, in and of itself, a sufficiently strong counter-argument to the “free rider” problem. Islam does provide the most beautiful counter-argument and that is the extremely intense ideological consensus which Islam, alone among all systems of thought, sacred or profane, is capable of promoting based on the available evidence. Islam also provides a very strong back-up mechanism in enjoining the good and forbidding the evil performed as a *fard ‘ain* (individual duty) by each and every Muslim. [it is sad that one has to see the application of this sacred rule in such places as in the Swiss Constitution rather than in Islamic societies], as it is supposed to be performed.

“This last point needs elaboration since, in my opinion, without it the system will not achieve the “optimality”, in the sense intended for it by Allah. Not only the verse of the Quran but the *sunnah* of our Prophet (peace be upon him) as the life and practice of the *Kuhlafa Rashedeen* and the Companions (May Allah be pleased with them) leave no doubt that this duty is an individual duty [in fact it is the *raison de etre* of all religions, at least those in the Abrahamic tradition, and a duty for all, individually and collectively]. It appears that it was during the reign of Ummayyids and later that this duty was converted into a *fard kifaya* (socially obligatory duty), its scope was limited and it was made essentially a duty of the state. We, as Muslims, have not really understood the meaning, the extent and the power of this all-important duty, This is mechanism and the glue which holds the system together as was intended, otherwise its absence requires a very strong government which cannot be fully justified, under normal circumstances, on

the basis of the Quran, the *sunnah*, and the tradition of the *Khulafa Rashedeen*. There is no denying that the actual working of the system has an individual orientation and the consideration of public interest in neither a negation of this individual orientation nor a logical affirmation of a strong centralized government. If the state is to assume much of individual responsibilities by fiat and not allow the individuals to perform the tests which Allah has instituted for them, and declared in Ayahs such as “He who created death and life that He may try which of you is best in deed” [Quran, Ch. 67, Verse 2] then one of the important instruments of this test, economic behaviour, is nullified. It is true that the state has the power (at the disposal of the faithful ruler) to step in and make corrections but this is derived from its supervisory prerogative under its “enjoining the good and forbidding the evil” obligations much the way it is argued by Ibn Taimiyah.

Sadiq observed following with respect to the discussion on public goods.

“The provision of public goods (and merit goods) is one of the functions of an Islamic state. Because these are important for public welfare which is a *shariah* requirement and hence an Islamic state should provide them. From this it is also clear that the provision of public goods need not be analysed separately, but it is more appropriate to include it in the functions (of state), and more specifically, in what the author termed as the functions assigned by people.”

Sadiq also objected to the statement that the public goods “are essential for human survival and social felicity.” This, according to him, seems to be an over-emphasis of public goods as public goods are important for public convenience, welfare and efficiency, and not essential for human

survival and they are not even included in basic needs, not speaking of survival necessity.

Sadiq also contended that the concepts of market failure, exclusion, externalities etc. are not at all the subjects of public finance and are rather in the micro-economics in the present day teaching programmes.

Sadiq appreciated the concept of *fard kifaya*. However, in the context of an Islamic state and public finance, he pointed out that it refers to the provisions of the items of common interest. If they are not provided privately (by anybody other than the state), the state should provide them. From this it is clear that this is a special form of public goods, or is included in the provision of welfare items. Therefore, according to *Sadiq*, this also does not need discussion under a different heading and it can conveniently be included elsewhere.

Salama also made elaborate comments on the discussion on the concept of public goods. According to him, *Siddiqi*, started without proper follow up drawing on Islamic public goods theory. Perhaps a second look on the paper will take care of this point and he could spell out clearly those public goods which the state has to provide and how these should be financed and those public goods that are obligatory by *qiyas* and how they should be provided and how they should be financed and at what levels of government, central of federal regional or municipal. The third function which involves some public goods which could be determined by standard principles of public goods provision and how they could be provided by the principle of *shura* should be explained.

“We have therefore to decide which public goods should be decided by *shura* and how such goods should be financed and at what levels of government.”

Siddiqi is asked by *Salama* to spell out some standard rules as to how public goods should be provided. *Salama* thinks that *Siddiqi* is of the opinion of assigning a greater role to the government as he spelled this in some other parts as well but he left the issue of the optimal government role without proper analysis. Government role in *Salama*'s view should be limited to certain specific areas and should accordingly not exceed them. Accordingly it is advisable that each public good should be defined as to how it could be financed and the tax policy should be integrated with how public goods should be provided. Social security, for example, could be financed differently while other public goods like roads and bridges could be financed differently and so on.

Adil desired that the subject of public goods and services should be discussed in more detail in the course of public finance because they have significance in connection with supply of public needs and hence determine public production.

CHAPTER 3

FISCAL FUNCTIONS

3.1 Priorities

Siddiqi Notes suggested that after a general discussion on the goals and functions of state and their justification from Islamic point of view, the teacher then should explain the economics of these functions of state in the modern economic jargon, focusing on allocation, distribution, stabilization and growth effects.

According to *Siddiqi* the teacher should first explain the priorities among these functions, if they turn out to be conflicting and trade off becomes inevitable. In *Siddiqi's* views, distribution and stabilization may generally get priority over growth and allocation functions. After discussing the priorities, these functions can be discussed keeping an Islamic perspective in view.

Sultan Abu Ali agreed with *Siddiqi* on the question of priority as topic for discussion in the course. He rather suggested that this topic needs to be discussed in more detail particularly with respect to the trade off between equity and growth and whether, in case of conflict, equity should always get the priority.

Junaid also took the point of trade off in equity and efficiency. He observed that “we have to be clear when and under what circumstance the equity consideration should be traded off with efficiency considerations. To say that equity be given priority and then to mention the possibility of reversing the order is very misleading unless qualified by specific conditions. The teachers need to know more than is suggested here

especially whether Islamic perspective would change the present trend of development approach that emphasize basic needs rather than growth.”

Hashim Awad was of the view that “the author points out an important difference between Islamic and conventional fiscal systems on the priorities assigned to such goals as equity, stabilization and development. Can it be said that in an Islamic state fiscal policies will show the current obsession in the West with stabilization (internal and external) at the expense of growth, employment and equity? If not, the reasons for the difference in prioritization should be elaborated.”

On the question of priorities, *Sadiq* observed that “there is no disagreement on the importance of distributive justice and stabilization. However, growth oriented functions are not “may be necessary”, rather they “are necessary” since we are dealing with the present reality of the developing Muslim countries.

The conflict between growth and equity is important. A wide body of literature is available on this subject. Those policies which help accelerate growth disturb the achievement of greater equity. Given the starving level of poverty in the developing Muslim countries, growth seems to have higher priority than equity subject to the constraint of a minimally acceptable distributive justice.

According to *Sadiq*, “discussion of priorities does not seem to need a separate section. It may will be included in a section on the objectives of fiscal policy which does not appear at present.”

On the matter of fiscal functions as a whole, *Sadiq* gives a different view. According to him “analysis of fiscal functions should start with the discussion on the objectives of fiscal policy. The sequence may be as follows:

1. Objectives of fiscal policy.
2. Functions of fiscal policy.
3. Instruments of fiscal policy.

While the objectives of fiscal policy may be many, they can be classified broadly into three categories:

1. Economic growth.
2. Equity in the distribution of income and wealth.
3. Stabilization.

After this, the functions of fiscal policy can be mentioned which should correspond to the objectives. For example, the functions related to growth objectives include the following:

1. Allocation.
2. Environment and incentive for private investment.
3. Public Investment.

Similarly, functions related to equity and stabilization functions can be mentioned.”

Abbas Mirakhor observed that the “discussion on fiscal functions would be clearer if reference is made to principles and rules derived from the Quran and *sunnah* (the part which relates to the ruling of the Prophet (peace be upon him) as the ruler and secondary rules. Again the discussion of martyr Baqir al Sadr in *Iqtisaduna* could be very helpful here.”

Abbas Mirakhor also suggested that “some further and more detailed arguments are needed to clarify Islam’s position on governmental budgets

[at least the part about which there is available evidence from *sunnah* and the behavior of the *Khulafa Rashedeen*. A budget may be balanced or have surplus or deficit. We know from the life of the Prophet (there is at least one *hadith* which is related on the authority of Aisha, mother of all Muslims, May Allah be pleased with her, we know that he (peace be upon him) did not rest until any surplus left in the budget was spent. Similar behavior was observed in case of three of the Khulafa (Abu Bakr, Umar and Ali, May Allah be pleased with them) in quickly disposing surpluses [in fact we have evidence to believe that the first check in history was issued by Umar bin al Khattab when the revenues of *Bayt al Mal* could not be disposed of quickly]. So half of the formula for a balanced budget requirements is demonstrated. What is not certain is how was the deficit dealt with. But even on the basis of the available evidence, are we justified in suggesting that a balanced budget is to be preferred?"

3.2 Distribution Function

Siddiqi, giving a priority to this function, advised that it should be discussed with respect to the distributive implications of taxes and transfers as well. *Sadiq*, however, observed that *Siddiqi*'s treatment of this function was far from sufficient particularly from the point of view of its Islamic contents. According to *Sadiq* "since Islam gives high priority to distributive justice, it is important to indicate how does Islam intend to realize this objective. What are the distributive measures specific to Islam, how they are superior to the traditional measures and what are transfers.

It seems that even the traditional distributive measures are not fully included. For example, intersectoral, inter-regional and inter-group allocation policy is an effective fiscal measure for wider distribution of income and wealth in the economy. These measures may also be included. In addition, Islam emphasizes heavily on realizing distributive justice through transfers. It will be useful to indicate them."

3.3 Growth Function

Siddiqi suggested to discuss growth function also “as an independent function and not as a corollary of “allocation” and stabilization functions”. *Sadiq* agreed and regarded that growth function was better addressed in the Notes which included most of the traditional growth measures along with some Islamic ones. He, however, drew attention to following two additional traditional measures:

1. public investment in bulky and risky areas for disinvestment once the projects turn out profitable and
2. attract private investment in large industries by buying major shares by the public sector.

Besides, he suggested, it would be better to spell out appropriate growth measures of an Islamic state.

Salama, however, suggested that while discussing the growth function it would be preferable if the functions of growth and development are separated as some functions discussed under growth function fell more in the development aspect rather than growth. Similarly, the emphasis on profit sharing, according to *Salama*, may be relevant for growth but development effect can hardly be achieved through profitable institutions. *Salama* also observed that some factors most important to economic growth are ignored in the analysis, for example, the role of fiscal policy in affecting private incentives and how it could be conducive to economic growth. Problems of foreign borrowing and how it could be provided and how it could be serviced. Implications of development efforts on external balance should be spelled out. In the context of development strategies and how they should be chosen and their effect on fiscal policy has also been ignored, in view of *Salama*.

Sultan Abu Ali suggested that the discussion on growth function should concentrate more on development aspect rather than limiting it to the concept of growth as applicable to industrialized nations. Thus the section of growth function, according to *Abu Ali*, should include discussion on the concept of quality of life and development in the context of the developing countries.

3.4 Allocation Function

Sadiq suggested to discuss the problem of the allocation of resources between private and public goods and their efficiency aspects and emphasized two criteria (1) satisfaction of marginal efficiency condition and (2) balancing advantages against disadvantages of transferring resources from one side to the other. *Sadiq* also suggested that the second method is more practical.

In this context, *Sadiq* pointed out that the function has two major objectives in view and not merely efficiency (as indicated in the Notes). The two objectives are:

1. Efficiency (growth)
2. Equity (distributive justice)

In addition, *Sadiq* observed the problem of allocation is not only between private and public goods, but it is also among several alternatives. The major ones are as follows:

1. Allocation between agricultural (traditional) and manufacturing (modern) sectors.
2. Allocation between formal and informal sectors.
3. Allocation between necessities and comforts.
4. Allocation between private and public goods.

Sadiq agreed that *Siddiqi* had rightly said that marginal conditions were less practical for policy decision and therefore some pragmatic techniques should be devised to measure advantages against disadvantages. This aspect should not, however, be addressed in details in a course of Public Finance.

Iraj Toutanchian was of the view that “allocation function has been discussed in highly hypothetical formulations. We must recognise the fact that efficiency is not a complete criterion in general equilibrium because it ignores the indirect effects that one good’s allocation has upon the prices and quantities of other goods.

3.5 Stabilization Function

Saddiqi suggested to discuss in this section the contemporary problem of stagflation faced by the developed countries. He suggested to deal it with Keynesian expansionary and contractionary fiscal policies and viewed that those policies were not responsive in agrarian economics.

Sadiq was of the view that, in this sub-section, the stabilization related problem of developing Muslim countries should be indicated which may include stagflation as well which is also a problem of developing countries. *Sadiq* agrees that Keynesian measures might be less responsive. Yet he thinks that they might not be responsive in developing countries. *Sadiq* thought it desirable to suggest some stabilization policies for developing countries from even traditional sources.

In addition, *Sadiq* also suggested the inclusion of a discussion on the stabilizing efficiency of an Islamic economy will be very useful. Some Islamic economists tend to suggest that an Islamic economy will be more

stable. Are they right? If yes, how? Some discussion of such questions might be appropriate.

Salama required that more emphasis had to be paid to the role of economic stabilization on the value of currency if it was to be kept stable. Also more work, in his view, was needed to see how fiscal policy could achieve this goal and whether this should take the shape of discretionary policy changes or automatic stabilizers or a mixture of two and how monetary policy could be effective as a mix in countries where a large volume of finance is handled outside the banking system.

Iraj was of the view that stagflation is a capitalist countries phenomenon and is a result of long implementation of capitalistic principles. Its extension to Islamic countries whose problems shall be solved through *shariah* is questionable. “Since at least one method of labour remuneration is accepted to be tied to an appropriate index of the firms performance (as the author himself proposes such a scheme) makes the discussion of stagflation out of context. This solution to a capitalist system proposed by Martin L. Weitzman in his book “The Share-Economy – Conquering Stagflation” has received wide acceptance among economists.

Siddiqi, in fact, did not seem to explicitly make this suggestion. The discussant has implied this suggestion on the part of the author probably for the following phrase used by the author

“..... an economy where profit-sharing is the dominant mode of contract both in the financial sector and in the labour market”.

According to *Siddiqi*'s position, that part of labour which is working as *mudaraba* may have implications for stagflation, as pointed by the discussant, but this phrase perhaps may not be reflecting what discussant

has implied that “labour remuneration will be tied to an appropriate index of the firm’s performance.”

Junaid wondered that if “Keynesian models are not applicable in developing Muslim countries – what is the alternative?”

Sultan Abu Ali suggested that the stabilization function needed to be discussed more objectively. According to him, the suggestion that simple macroeconomics of income determination to explain rate of taxes should be taught at this stage where stabilization function is being discussed, is questionable. Since public finance course usually comes after the course in macroeconomics, there is, therefore, no need for repetition.

Daraz, on the other hand suggested that stabilization policies could not be taught at this level of the course. *Daraz* also maintained that *Siddiqi* did not point out any thing new in the fiscal functions. They have all been discussed in conventional framework. Some of them have been abandoned even in the conventional framework.

Ras’ view was that the discussion does not refer to any Islamic context in it.

3.6 Fiscal-Monetary Mix

Siddiqi suggested, in this context, that students, must, first be educated with respect to the scope of monetary policy in an interest-based system and the teacher then may elaborate the replacement of interest by profit-sharing in an Islamic economy.

Sultan Abu Ali, however, objected to teaching interest-based system in this course.

CHAPTER 4

CATEGORIES OF PUBLIC EXPENDITURE

Siddiqi suggested to clarify public expenditure of an Islamic economy into three categories namely:

- a) Expenditures on tasks ordained by *shariah*.
- b) Expenditures necessary in the light of *shariah* in the present circumstance.
- c) Expenditures necessitated by tasks assigned to state by the people.

An opinion was expressed by some discussants that such a categorisation would neither be necessary nor it be made mutually exclusive. *Daraz* regarded the three categories overlapping and serving no purpose. *Ras'* elaborate comments already mentioned in Section 2 relating to the theory of state apply here also.

CHAPTER 5

SOURCE OF PUBLIC REVENUE

Siddiqi divided the sources of public revenue into two categories: a) public property; b) withdrawals from the private sector. The second category, according to *Sadiq*, is so wide that the analysis may become confusing to the undergraduate students. He suggested that a more convenient classification could be as follows:

1. Public property and enterprises.
2. *Zakat*.
3. Taxes.
4. Charges and fees.

Abu Saud made several observations on the way *Siddiqi* has suggested to deal with the subject of public property in the course on public of finance.

Abu Saud commented that he was “not aware of any *Quranic* of Prophetic text that relates the ownership of an natural resources to the state on a permanent basis as alleged in (*Siddiqi*’s) Notes.” Granted that all beings belong to God, and that the “state” represents the *ummah*. But according to *Abu Saud* this is not enough to validate the “allegation” made by *Siddiqi*.

Abu Saud also pointed out that the statement “the early Islamic revenue category of *kharaj* emanated from public property in the form of rent” was not an accurate statement as *kharaj* was a tax and *not* a rent. It was imposed on the non-Muslim non-combatant landlords living in a vanquished territory. (see *Al-Kharaj*, by Yahya Ibn Adam).

Regarding the pricing of the public sector products, *Abu Saud* observed that it was of little importance to relate the price to the “marginal cost”. Most of such products are of special nature as indicated in the essay, and the government sells them either at cost, or above or under it, according to the nature and utilization of the product. According to *Abu Saud* there is no ‘marginality’ there.

He also objected to the statement of *Siddiqi* that “it is also open for an Islamic state to mobilize public savings on a profit-sharing basis for investment in public sector”. He wondered how that could be done!! He was of the view that the state would not be producing goods that the private sector could produce (unless in exceptional cases) and that its productive activities would mainly be unprofitable. To mobilize savings, one has to offer the savers a reasonable tempting return. In this case, a part of the profits realized from the public products. The difficulty according to *Abu Saud* arises from the nature of these products, even if they are economically profitable, and the short-term savings requirements. It seemed to *Abu Saud* that *Siddiqi* was assuming that the Islamic government would be undertaking some productive projects which would yield in the short run competitive rates of profit and *Abu Saud* did not agree with that at all.

When discussing sources of public revenue, the writer of the Notes went into details without formulating any opinion on the optimal revenue structure that meets the standards of *shariah* and how the tax structure should look like, with more emphasis for example on indirect taxes or direct taxes or non tax revenue and how this should suit the conditions that prevail in a certain country; those endowed with natural resources; those which are federal; and the level of development etc.

Siddiqi's position on a wider role for the government in that it can manage agricultural farms and fisheries as well, however, was not seen favourably by *Salama* as this runs in conflict with what *Siddiqi* himself who had asserted that the complexity of bureaucratic decision making has proved as failure even in the most socialist countries. *Salama* wondered, whether it was not better to design an optimal revenue structure that would cater for an optimal size of public activities.”

5.1 Public Property as a Source of Revenue

Siddiqi advised the teacher of this course to explain *shariah* provisions in this respect particularly those relating to natural resources not already in private ownership. He also advised to teach public sector pricing as well as policies to achieve optimum mix of public goods private goods and mixed public goods.

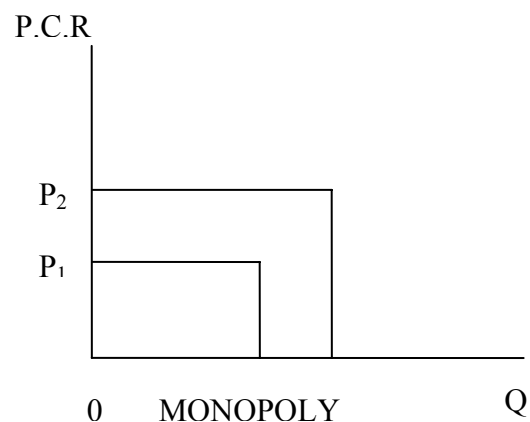
Sultan Abu Ali, however, was of the view that the discussion on public sector pricing policy might be out of context in a course on public finance at the proposed level.

In the context of the principle of avoiding waste in the use of public property, *Iraj Toutanchian* observed that “in order to give the right impression to the students, it must be given a definition and a criterion to measure it. It may seem apparent that this principle is rooted in another general principle by which society has the right to fully utilize all goods produced in that society. Since Islam does not approve of absolute ownership of personal property, society, therefore, has indirect claim over individual property. To waste a personal property is equivalent to destroying a potential utility which could have otherwise been utilized by someone else.

Regarding pricing policy, *Iraj Toutanchian* pointed out the following:

Government frequently underprice their services either because of the influence of pressure groups or as a matter of philosophy. But in Islamic state, the pricing policy can be expected to be only influenced by the philosophy of a state. To make services available either free or at very low charges may emanate from the desire of the politicians to assure maximum use by the public. But it should be kept in mind that underpricing not only results into deficit in the budget but also hinders a proper modernization program. A solution must be found for the problem involved.”

“The suggested pricing policy of the public enterprises is less clear. What is the rationale of a mark up pricing over marginal cost? We need to refer to market structure for this. If a good is provided entirely by the public sector, it is a monopoly. Otherwise it may be one of the following: oligopoly, monopolistic competition or perfect competition. Let us consider the case of a monopoly which is a likely case in public enterprises.



A price, P equal to OP_1 or MC pricing with mark up such that $P < OP_2$ will mean losses in the industry. So the price has to be $P \geq OP_2$ which implies an average-cost pricing with zero or positive mark up.

“And it is not clear why we must follow marginal cost industry to cover the losses from taxes. A commercial public enterprise must be made economically viable. And it involves the provision of some utility services, then one does not have to make reference at all to MC or AC.”

Daraz pointed out that *Siddiqi*'s suggested discussion is not very different from what has been discussed in secular economics. According to *Daraz*, *Siddiqi* has discussed, in fact, some old principles which have been dismissed by modern experts of public finance. Saying that *zakah* is a tax earmarked for specific expenditure has also been regarded as incorrect by *Daraz*. According to *Daraz*, *zakah* has been specified to be spent on 8 heads without earmarking.

Similar view was expressed by *Sultan Abu Ali* on the issue of earmarking *zakah* as mentioned in the Quran is very general and cover all categories. *Abu Ali* instead suggested that while discussing the concept of earmarking, it might be useful to discuss also the concept of fungibility of funds.

5.2 Shariah Justification of Taxes

In connection with *Siddiqi*'s discussion on *shariah* relevance to taxes, *Iraj Toutanchian* observed “*Siddiqi* has quite consciously taken up the issue of proper and inevitable link between Muslim jurists on one side and Muslim economists on the other and has made distinction between the tasks of these two groups quite carefully. It should be clear at this stage it is not only the *shariah* that has arguments on *maslaha* but economists do as well. On the basis of predictive power of theories, Muslim economists can mark the consequences of specific policy (whether “good” or “bad”) clear to jurists. If a policy to be taken leads to economically “bad” results it should be pointed out to jurists to help them reconsider what was marked *maslaha* or

mafsadah. In other words, the tasks of jurists and economists are mutually interdependent, and this is really what is meant by dynamism of our *ijtihad*.

Junaid did not like too much emphasis on secular consideration on the choice of taxes. According to him, such an emphasis simply means to nullify the need of having a public finance course where taxes rather than *zakah* are needed to be offered as a main source of revenue! Also statements referring to ‘*suitable tax*’ structure referred to in the Notes required more clarification according to *Junaid*.

5.3 Withdrawals from Private Sector

Siddiqi suggested a discussion of the impact of resources withdrawn from private sector in various forms including those on profit-sharing.

Salama appreciated the idea of raising funds on profit-sharing or loans for productive venues in the public sector, though, he suggested that it is very important that the term “productive” be defined precisely. If by productive he means profitable then much ventures will not be producing public goods and they should be left, in the view of *Salama*, to private enterprise. Even where economies of scale prevail public ownership could take the form of public companies owned completely by the private sector or as joint ventures between the private and public sectors.

Salama also pointed out the confusion in the use of the term “substitution effect” in the context that the individual taxes can change tax liability by changing behaviour. This definition according to *Salama*, may confuse the student as substitution effect is limited to the substitution between labour and work. He may change his tax liability through other means as well; such as evasion and avoidance. The paper also did not address itself extensively to the issue of incentive effects.

Salama did not agree also with *Siddiq*'s idea that number of exemptions and allowances which make it possible for moonlighting. *Salama* suggested that it must be explained that allowances and exemptions are integral part in any tax system which is to achieve the goals that *Siddiqi* already outlined for fiscal policy in his own Notes. Evasion of tax is a problem especially in less developing countries and it is not possible to prevent it completely as some incomes may not be easy to detect. Tax avoidance is always possible especially with moonlighting.

Salama expressed his disagreement also when *Siddiqi* stated that local government and state governments collect indirect taxes as this may be in some countries applying special forms of indirect taxes but not in majority of countries where indirect taxes imposed at the importation level or at an earlier level of production or distribution are always collected centrally.

CHAPTER 6

TAXES AND THEIR IMPACT

Siddiqi suggested a separate section on this subject and advise to start this section with a survey of various forms of contemporary taxes in the context of their cost and benefits from the point of view of their implications for an Islamic state.

Salama suggested that such a survey would require spelling out clearly the criteria with which the implications could be assessed as costs or benefits. These criteria should cover all aspects such as equity, economic, administrative etc.

In this context *Abu Saud* observed that the theory of cost-benefit analysis in relation to “*maslaha* and *mafsadah*” was very vague and did not really help in justifying a tax. According to *Abu Saud*, the application of this criterion we would be defending on two contradictory elements. *Abu Saud* preferred to use the principle of “*public need*” irrespective of the cost-benefit analysis.

6.1 Zakah Versus Income and Wealth Tax

Siddiqi point out that application of *zakah* in contemporary economy may raise several issues particularly when it is applied in the presence of income tax. *Abu Saud*, however, felt that the discussion of issues in *Siddiqi*'s Notes is not profound enough. He drew the attention towards his own book “*Contemporary Fiqh of Zakat*” which is his view would be quite helpful in elucidating some of the *zakah* complexities inherent in our *fiqh* legacy.

Sadiq agreed that *zakah* should be tax deductible in the context of income taxation and also that *zakah* may be used to finance education, health etc. *Sadiq*, however, wondered that if *zakah* is used in education and health in general, the beneficiaries may be both rich and the poor which may not be in line with the uses of *zakah* as laid down in Quran and *sunnah*. This observation from *Sadiq*, in any case, is based on the misunderstanding of the *Siddiqi*'s position on the issue. There is no doubt a debate between economists and *fiqh* scholars whether *zakah* can be used for the social welfare projects. While economists would like to use *zakah* funds for any social welfare projects which are generally meant to meet the needs of poor people, *fiqh* scholars have been strict in their position that whatever be the use of *zakah* the conditions of *tamleek* and utilization by poor must be met. *Siddiqi* did not take the position of indiscriminate use of *zakah* funds. He simply mentioned that "in so far as the *zakah* revenue is going to finance activities financed in conventional economies by income tax (e.g. defense, education, health etc.) the decrease in the yield of income tax due to deduction for *zakah* will not affect the financial position of the state."

Some objections have been made on some of the issues mentioned in the context of secular analysis of contemporary taxes. *Daraz*, for example, pointed out that most of the properties of income tax and other direct taxes discussed by *Siddiqi*, have been rejected by modern economists. *Daraz* specifically pointed out that *Siddiqi*'s position that income tax cannot be shifted has been proved to be wrong. (There seems to be a misunderstanding on this point. What *Siddiqi* has been referring to is the need of survey of the contemporary thinking on various taxes without taking any a priori position in favour or against any of these taxes).

Daraz also objected to the notion that sales and excise taxes may increase price level and reduce production. According to *Daraz* these results have been proved, in theory, to be untrue. The effect on price on account of these taxes depends, according to *Daraz*, on the possibility of shifting or not shifting the burden.

Abbas Mirakhor gave elaborate views on the relationship between *zakah* and taxes. His view is the following:

“On the relationship between *zakah* and other taxes, it is indeed important to note that *zakah* belongs to the core sphere, its primary reason being to cleanse the earnings of Muslims. But *zakah*, as operationally defined 2.5 percent, is the lowest limit there being no upper limit to what a Muslim should *give* of his earnings. After all he does not really own any of it since Allah all he does not really own any of it since Allah says: “give them something yourselves out of the means which Allah has given to you” [Quran, Ch. 24, Verse 33]. But a distinction has to be made between what Allah says that a Muslim must *give* and what He has authorized an Islamic state to *take*. I realize that my views here are converging to those of Brother Monzer Kahf’s [and by the way I feel his views have not received a fair treatment by the rest of us] but my problem is more fundamental. One may properly argue that an Islamic state is the Khalifa of the Prophet (peace be upon him) and it is empowered to do what it sees fit under the contention of the faithful ruler and with the domains of public interest but the question arises as to whether this is also justifiably applicable to *taking*, under all circumstances not only under exceptional instances such as *Jihad*, or Muslim’s earnings? The second question is whether or not there is a limit on how much it can take.

On the first question let us consider the life of the Prophet (peace be upon him). Here is a being about whom Allah has said that he is “closer to the believers than their own selves” [Quran, Ch. 3, Verse 6] now assuming that our lives are more valued than our belongings the statement also covers our properties. Hence, he (peace be upon him) had the power to make any kind of intervention in the properties of Muslims for purposes of public interest in the name of the poor of Medina, who were, relatively speaking not any better off than the poor of our days. But he (peace be upon him) chose not to do so and resorted to ‘enjoining the good and forbidding the evil’ instead and the Muslims responded. Is any Muslim state justified in taking, greater power over the properties of Muslims than the Prophet (peace be upon him). Then, also, what are we to do with the tradition “people have authority over their properties”?

“Now if it is determined that there is no validity to the above argument and the faithful ruler has the right to impose duties other than *zakah* (with which I would have no arguments barring the above), then there is a further question; should the state consider imposition of taxes whose structures (and therefore their income and substitution effects) are materially different from *zakah*? The reason such questions are raised is because, the principle and rules include only *zakah*. The question is why did Allah (*Subhanah wa ta'ala*) and his Prophet (peace be upon him) choose this particular form of taxation. Did they not (and I seek Allah’s forgiveness when I say so) know of other form of taxation? At a minimum, we know that the Persian and the Byzantine Empire imposed a variety of taxation and one need not go very far to argue that the Prophet (peace be upon him) knew about them but did not choose a similar structure of taxes for *zakah* even though he (peace be upon him) could have since, the Quran does not specify the structure of *zakah*. Yet he (peace be upon him) chose to structure it differently. Just as he refused (according to some accounts) to allow minting of peculiarly Muslim

coins and chose to continue to use the coins of other countries. [This last point has enormous implications but that is another matter]. Why did the Prophet (peace be upon him) choose this particular structure? *There must be something special about zakah*: Unfortunately very little has been done to determine the economic properties of *zakah*, but our priors tell us that it has distributional properties which address themselves to a central concern of Islam: concentration of wealth, since with concentration of wealth comes concentration of political power and with it, as the Quran so early points out, corruption on earth. Its other properties, such as its low substitution effect relative to other forms of taxation, have enormous implication for income-employment-price configuration particularly in conjunction with the implication for investment which the absence of interest rate holds. Now, the *question* is: Why not organize the structure of taxes, over and above *zakah*, so that they would (tax system as a whole) preserve the properties of *zakah*?

"I realize that this point can be misunderstood since it may be construed to mean the changing of the *zakah* rate which is not permissible. But let us consider, for a moment, the implications of imposing any other taxes with different structures than *zakah* rate. Take the imposition of income taxes, can we not have a functional relationship between income and wealth so that tax on one is a tax on the other and can we not derive effects on rates of taxation of these two? The difference is that all other taxes have structures with implications for economic behavior different from *zakah* while the *zakah*-type additional taxes will preserve the reasons (as yet to be discovered) for which Allah find His Prophet (peace be upon him) imposed *zakah*. [Since we are on the subject of *zakah* I am not totally convinced that the effects of *zakah* on all types of commodities will be uniform. I suspect that if the *zakah* as it was constituted originally on the 9 commodities, is calculated for different commodities the effect will be different for gold and silver (direct wealth) and say, sheep (means of economic development) and

camels (both capital goods and means of wealth). This would make for an interesting student research paper.]”

6.2 Payroll Tax

Siddiqi suggested that in Islamic economy, the payroll tax and the corresponding social security benefits may be integrated with *zakah* and its benefits with a provision that those who are too poor to be liable to *zakah* should also be exempt from the payroll tax. *Iraj Tontanchian*, however, did not appreciate the idea. According to him, “The choice of the terminology is rather misleading. The confusion originates from the following two points. First, payroll tax is customarily a tax levied on all wage-salary earners and the employer is obliged to deduct appropriate tax from the earnings of those enlisted on payrolls and reimburse them to the treasury. Such tax liability is only the responsibility of the earner and no one else's. Second, these revenues these revenues collected by the treasury has nothing to do with the coverage of insurance schemes ordinarily designed to cover unemployment, old-age and survivor, hospital, disability and the like insurance policies. Hence, it is suggested that the title be changed to “Social Insurance” in order to make correspondence between the title and its content. This type of insurance exists in the U.S. with exactly the same title as suggested and the same coverage as outlined.”

In this respect, *Junaid* drew attention to the fact that “another source of public expenditure quite akin to the payroll tax is the employer-employee provident fund which is used for pensions and retirement benefits and where the funds are invested and used as fiscal and monetary tools.”

Sultan Abu Ali also felt that the treatment of payroll tax by *Siddiqi*, in Islamic perspective has confused the concept with the social security scheme.

Abu Saud observed that “it is not correct to integrate he payroll with *zakah* because *zakah* must be spent in specified avenues, while the payroll tax is part of the public revenue.”

Ras, however, raised the usual controversy between economists and *shariah* scholars in the issue. Whereas economists are of the view that all forms of wealth should be adequately taxed to rationalize and integrate the imposing of *zakah* in the existing fiscal structure, the *shariah* scholars are of the view that *zakah* provides no analogy for imposing tax on other forms of wealth not subjected to *zakah* by *nusoos*.

Ras also objects to *Siddiqi's* position that *shariah* neither recommends nor prohibits imposing additional taxes. According to *Ras'*, *Siddiqi* is taking a position imposing tax on wealth is *mobah* (permissible). *Ras* thinks, this position is wrong. He quotes the tradition from Prophet (pence be upon him) which prohibits for every one the wealth and blood of the others.

Hashish raised the usual objection that *zakah* cannot be treated as tax, nor it can be utilized as an instrument mobilized resources. He also did not agree with *Siddiqi* that *zakah* payers should be exempted from income tax to the extent that they pay *zakah* because the two levies have entirely different objectives.

6.3 Sales Tax

Siddiqi expressed the view that the idea of imposing sales tax with the sole purpose of raising revenue is not favoured by Islamic economists, though it may be used for a variety of specific purposes. According to *Siddiqi*, the decisive factor in the Islamic context is need and for which a modern economy may be considering a general of specific sales tax. The

shariah, according to *Siddiqi*, has not barred such taxes though it did not prescribe them either.

Sultan Abu Ali observed that “the idea of imposing sales tax with the sole purpose of raising revenue is not favoured by Islamic economists” needed to be explained. Why this is so, if it is true? The same question was raised by *Junaid* and *Salama* as well. *Salama* even pointed out that sometimes revenue raising is an important goal which may require imposing tax on the consumption of inelastic goods.

6.4 Taxation at Local and State Level

Siddiqi emphasized the need of imposing local taxes particularly for providing some local public goods. *Abbas Mirakhor* appreciated the point and elaborated that “this is an important issue which relates to the delegation of authority to the local government. Here the policies of the Prophet (peace be upon him) in Yemen for example, or in case of governance of local tribes in the peninsular Arabia as well as cities there, are extremely instructive. The policies of the Khulafa vis-a-vis Sawad, Egypt and Syria are all pertinent and helpful. Unfortunately, very little useful research exists vis-à-vis economic policies in these instances; although substantial amount of early writings are available. From the available evidence it would be safe to say that a greater autonomy was invested in local governments than is the case in *any* present day Muslim society.”

6.5 Other Taxes

Sadiq did not agree with *Siddiqi* that consumption expenditure is an alternative to income tax. According to *Sadiq* there two are not necessarily alternatives of each other. In many countries, both of them are used simultaneously.

Sadiq, however, agreed with *Siddiqi* that the burden of a general sales tax is borne by the factor owners and the consumers, though in many occasions a part of the burden is also borne by the sellers.

As for the death duty, *Abu Saud* failed to find any text prohibiting the imposition of a death duty. The tax here is imposed on the estate before distribution and has nothing to do with its partition. The say that such a tax is “not permissible” needs a textual prohibition. To judge such a tax as not practical or even inequitable is something different.

On optimal taxation in Islam, *Abbas Mirakhor* is of the view that there is a need for specific criteria against which “optimality” may be judged in an Islamic context. Whatever that criteria may turn out to be, it is safe to assume that it will be different from that in other systems.

Siddiqi's general view, however was that all prevalent forms of taxes should be studied on their own merit as a possibility for an Islamic state. He particularly referred to income tax, corporation tax, capital gains tax, expenditure tax, wealth or property tax, death duty, inheritance tax, gift tax, payroll tax, sales tax, excise tax etc.

6.6 Economic Impact of Zakah

Sadiq appreciated the discussion by *Siddiqi* on the subject. According to *Sadiq* “this topic would be very much relevant for the course and it will be extremely useful to elaborate on the economic impact of *zakah* in great details, because literature on the impact of taxes (which is described greater details) is readily available, but that on economic impact of *zakah* is not. In particular, this is less accessible to the teachers at different universities.

Abbas Mirakhor suggested that discussion on *zakah* should not convey a message “that *zakah* is the only right the poor have in the wealth of the rich. It must be made clear that, first, there is more than *zakah* which must be transferred by the rich to the poor and, secondly, that that these amounts is not transferred to the poor because they are poor but because of their original property rights claim which Allah has given them on the resources of the society but which for a variety of reasons, they have been unable to utilize. The mere fact of their inability to take advantage of these resources does not negate their original rights. So when they are paid *zakah*, and more, they are remunerated for their property rights claims.”

Iraj Toutanchian made the following point:

“There is another advantage of *zakan*, besides the ones mentioned by *Siddiqi*. *UShr* (or *khoms*) which is proportionate in rates over that of other taxes which may help the instructor to embark upon, as follows: On the one-hand, the dead weight tax loss results in changes of private decisions at the margin. On the other hand, average rates determine the total revenue. Thus a tax causes less dead-weight tax loss per unit of currency of revenue if its average rate is high but the margin rate is low. But at the same time in order to minimize the dead-weight tax loss it is advised to maintain high average rates of taxation with low marginal rates. The extreme form of such tax is a head tax, but *zakah* (and *khoms*) also account for such a merit. It is, moreover, worthwhile to mention that the principle of minimizing dead-weight tax loss runs counter to equity objectives.

Raquibuz Zaman was of the view that it is not desirable to rearrange the priorities of distribution of *zakah* funds. In the holy Quran, the order is *fuqara*, *masakeen*, *ameleen alaih*, *muallafat al quloob*, *fi riqab*, *gharemeen*, *fi sabeelillah* and *ibn al asabee1*. Thus the emphasis should be on need fulfillment first and defence second. *Siddiqi* emphasized the need of

classifying assets into certain categories while explaining coverage of *zakah* to students of economics.

Some scholars, however, had reservations on using such a classification for explaining coverage of *zakah*. *Saqr* is one such scholar who raised this objection. The point is well taken in view of the *fiqh* controversies of the zakatability of some of the assets of modern times. The need for such a classification for the students of economics, however, cannot be over emphasized. Some classification has to be used by the teacher. In view of the existing controversies, the teacher, however, may qualify his classification in all respects so that it is presented without creating any confusion or conflict with existing *fiqh*.

6.7 Progressivity of *Ushr*

While elaborating on the economies of *zakah*, *Siddiqi* pointed out that “it is necessary in the context of *ushr* to dispel the misconception that being a proportional levy it tends to be regressive.” *Junaid*, however, observed that some times it may be difficult to dispel such a claim. He gives the example of an agriculturally based economy.

“Where the main source of GNP is agricultural production, the following may occur:

- (a) Distribution of land ownership is very skewed.
- (b) The tenorial system is a mixture of owner operator, pure tenants or the mixed type with % of land rented to total acreage varies.
- (c) Tenants have smaller plots than owners.

Then how can a teacher counter the proposition that *ushr* is regressive and not progressive?

CHAPTER 7

MACROECONOMIC ANALYSIS

Siddiqi suggested that the macroeconomic effects of fiscal policy should be taught in the framework of a macro model as it is done in the conventional economics. He suggested that a conventional macro model should be suitably modified to reflect the model of an Islamic economy by incorporating the concept of profit-sharing in the financial and labour market. The stabilization effects of fiscal policy then should be traced within this model. *Siddiqi's* suggestion to use a Keynesian model for this purpose however attracted substantial criticism. According to *Saqr*, Keynesian analysis can suitably be applied only to industrial economies and the students should be warned that its application for developing economies may yield opposite results.

With respect to incorporating the profit-sharing concept in the macro model, *Irai Toutanchian* observed that “since the rate of profit plays an important role in the analysis of the issues involved in this section, the instructor shall be quite clear as to what is meant by that. There is not one single definition for the rate of profit; for example it can be defined either as the ratio of profit share in national income to the value of capital stock or the ratio of profit share in national income to the savings deposits. As is quite clear, depending on which one of the above two definitions is chosen, it has different implication. But it is for sure that aggregate data should be used, no matter which one is chosen, and not each firm or industry’s data as such,” *Abu Saud* also said that it had been very controversial to talk about low interest rates tied with a depression: less production and less unemployment. It may be right to refer to the irregularity of “stagflation” and the uncertainty of the effect of the classic monetary policies. What is needed is how to refer to the “Islamic” system. Is there anything in our *shariah* that

would spare us the “capitalistic” hectic courses and instability? Is the “profit-sharing” system the panacea of all such ailments?

Abu Saud also objected to what he called *Siddiqi*’s favourable tendency to “create money”. He warned that it is very dangerous to resort to this method in the hope of heating or boosting the economy, especially in an underdeveloped one. He also did not favour the idea of not creating money “for financing public expenditure”. He found it difficult to justify such a position.

Abu Saud also observed that to accept investment certificates in public-owned projects would be speculative, if not mere waster. Governments should not go into competitive ventures nor into monopolistic projects. In both cases the result would be negatively affecting the general welfare.

Sadiq commented as below:

“It is better for a clear understanding of the undergraduate students to deal with anti-inflationary fiscal policy and fiscal policy for full employment under separate sections or sub-sections. Too much attention is given here in the relative effectiveness of monetary and fiscal policies which should be a concluding remark only. In addition the teachers are advised to examine the core and some latest. developments in macro-economics like the fiscalist-monetarist debate, .rational expectation, stagflation, supply side economics and so on. Examination of these topics will need coverage of the topics of advanced macroeconomics in an undergraduate course on public finance.

In addition, the suggested measures of stabilization policy (e.g. manipulating effective demand) refer more to the development countries. It will be more appropriate to deal with inflation, unemployment and stagflation separately in the context of fiscal policies that are appropriate for developing countries.

Further, how to incorporate fiscal policy in a sharing economy deserves more elaboration since this is less known to the teachers and very appropriate for the course. The same point was emphasized by others particularly by *Ras*.

While elaborating on how to discuss macroeconomics of fiscal policy in Islamic framework, *Siddiqi* claimed that stagflation could be handled more effectively in a profit-sharing based economy. *Raquibuz Zaman* and *Junaid* both doubted the validity of such a claim unless *Siddiqi* could substantiate it.

7.1 Deficit Financing and Economic Development

Junaid appreciated the need for a new approach to public finance in the context of economic development as emphasized by *Siddiqi*. He, however, desired more elaboration on how fiscal policy could be used for economic development. According to *Junaid* deficit financing is neither the only nor the last way to contribute to national output.

Saqr also held the same view. While appreciating the idea of using public finance for economic development, he wondered what instruments of public finance can be used for economic development. Similarly, while appreciating *Siddiqi's* view that money creation should never be used for financing such public expenditure as does not result in any addition to marketable good and services. *Saqr* wondered about the practicability of this suggestion as sometimes it becomes inevitable, for example for military purposes.

Abu Ali suggested that necessary conditions should be developed for justifying resort to deficit financing e.g.

- i) Existence idle capacity.
- ii) Elasticity of productive sectors to demand increase.

With respect to creation of new money, *Iraj Toutaunchian* commented as below:

“When the author speaks of the creation of new money it seems as if there is consensus among Muslim economists about the definition functions of money. Although few papers have been written on the subject without going thoroughly into it, my idea is that we have not reached a conclusive point; to me there is more left to be deeply investigated. Banking have involved over long period of time and functions of money have followed suit accordingly. Money today in non-socialist countries suit the capitalistic type of banking systems. Islamic banking system requires its own money to function correspondingly. It is clear, at least to me, that Islamic banking system can not function with capitalistically defined type of money. To accept the role of capitalistically defined money for Islamic banking *may* make the system run into similar problems as those countries have. Capitalist systems have run into new problems from the time money has taken up its new function as store of value added its two primary functions as medium of exchange and standard of economic values.”

Commenting on the development priorities discussed by *Siddiqi, Raquibuz Zaman* commented “the priorities for development cited here are the ones most development plans of the LDC’s including the Muslim countries, call for. Their failure to achieve such goals are principally due to the absence of accountability of the government and the institutions that handle economic development. Changing the ideological slogans is not the

solution. The solution lies in making all accountable for their actions. Without this, a program of free lunch in the school will mean enrichment of the pockets of bureaucrats and very little lunch, if any, for the children.

7.2 Alternative of Public Debt

The concept of “profit-sharing” as the chief instrument of mobilizing private savings for investment in the public sector (rather than relying on public borrowing) suggested by *Siddiqi* was considered by *Sultan Abu Ali* as a far fetched possibility because most public activities are not profitable or have direct pecuniary benefits. According to *Abu Ali*, productive public sector activities should be a subject of an independent course on “the economics of public enterprise” and should be a part of the course on public finance.”

Saqr found it conflicting that *Siddiqi* at one place disfavours deficit financing and at another place allows borrowing from central bank. *Saqr*, however, finds it justified to allow room for public borrowing whenever need (*maslaha*) requires it.

Rauf Azhar is of the view that the case for debt financing in the conventional sense of the term cannot be justified in Islamic economics; unless, of course, debt is incurred without any interest liability in which case it, becomes *qard-e-hasan* (an exceptional case, which cannot form the basis of a theoretical premise). He thus agrees with *Siddiqi* to rely more on equity financing than on debt financing.

Rauf Azhar also pointed out that deficit financing by bond issue (borrowing from public) is ignored which, of course, does have different connotations than simple borrowing from central bank – it primarily leads to crowding out. Bond financing is indeed un-Islamic and if it is explicitly

rejected – which the paper does not seem to do – then only money creation or simple borrowing from central bank can be justified.

Salama, though agreed in principle with the need to create money, yet he suggested that creation of money should be within a tolerable level and this should be decided adding to the level of economic activity, the balance of payment position and availability of other sources is preferable to inflationary finance i.e. tax sources are better than borrowing; and borrowing is better than deficit financing except under economic recession in advanced countries.

Salama however, wondered why money creation has been emphasized in the form of borrowing from central bank as there is no other form of money creation. Any new money created by the central bank is lent either to the public sector in return of government securities with certain maturity or to the private sector in return of commercial bills. There is no other way, according to *Salama*. It is just the case that the government may continue default and go on creating new debt.

Sultan Abu Ali was of the view that, in Islamic context, it is preferable to suggest to keep public debt to the minimum as it enables the government to live on standards exceeding their means.

7.3 Foreign Capital

Siddiqi suggested foreign capital to be invited on profit-loss sharing basis. *Iraj Toutounchian*, however, suggested that “the instructor should be advised to note that such a proposal can follow only when Islamic countries’ currencies are rightfully valued compared to foreign currencies, whereas there are evidences that Muslim countries have over valued currencies.”

Toutouchian also observed that “to replace foreign (interest bearing) loans by foreign equity capital has some important political implications when legal aspects of this scheme is considered. As a result, the problem remains as a controversial issue.”

Siddiqi used the term “foreign debt” to refer to the profit-sharing foreign capital. *Rauf Azhar*, in this respect, observed that though equity participation is allowed, yet the foreign ownership could not be labeled as foreign debt. “If foreign debt is being considered with reference to *morabaha*, it should be made explicit and then a ,similar arrangement could not be ruled out in the case of internal financing.” *Abu Ali* also objected to the use of the term debt to signify non-interest bearing capital.

Salama suggested that it is advisable that modern literature on debt crisis and its implications and ramifications internationally and to developing countries should be highlighted and included as part of the course.

Saqr did not consider it reasonable for an Islamic country to invite capital from non-Muslim countries on profit-sharing basis.

Raquibuz Zaman observed that “rates of return on equity capital in LDC’s have not been sufficient to offset the risks inherent in such investments. Why, then should anyone be interested in investing in these countries when they can earn better returns in the developed countries of the West.”

CHAPTER 8

INTERNATIONAL ASPECTS OF PUBLIC FINANCE

Siddiqi suggested that this course should also discuss interdependence of economic particularly with reference GATT type organization, the role of exchange rate and tariffs and the implications of international jurisdictions.

Sultan Abu Ali suggested that the issue of double taxation is also an important international aspect of public finance and should be included in the course as a separate topic. He also suggested to include “effects of budget deficit on the relative exchange rate as an independent topic. He, however, disagreed to discuss such organizations as GATT in this course because according to him, such discussion is usually relevant for a course on international trade.

CHAPTER 9

GENERAL REMARKS ON THE NOTES

Several discussants, while appreciating the effort, made general and often critical remarks also on the Notes prepared by *Siddiqi*. *Sultan Abu Ali* suggested that these guidelines need to be presented in the framework of a definite number of credit-hours (i.e. one term of two-terms). He also mentioned that if contemporary principles and Islamic injunctions relating to public finance have to be explained simultaneously then the way the transition could be achieved also needs to be explained more explicitly. *Sultan Abu Ali* also warned that sweeping statements should be avoided while relating Islamic injunctions to certain principles whose validity may be doubtful or debatable.

Hossein Askari regarded the Notes too general to be truly useful.

Abbas Mirakhor observed the following:

“At this stage of the development of a body of knowledge called “Islamic Economics”. [they have some disturbing objections to the use of this term and prefer, even if one has to render it into English as *Iqtisad* to distinguish it from economic, for I believe economics and *Iqtisad* share nothing in common. One has its basis in the “profane” the other in the “sacred” and putting an “Islamic” prefix in front of “Economics” serves only to confuse, witness attempts at arriving at a definition of “Islamic Economics”], the teachers should keep in mind certain facts and factors while teaching a course in public finance in an “Islamic Perspective”. The first is that this material will be taught to a generation of Muslims who will, Insha Allah, comprise the future Muslim thinkers, scholars, and public servants. This generation will be the most intellectually-taxed generation among all Muslims, past and future, for they will not only face enormous

opportunities for the spread of Islam but also the most difficult challenges. It now appears that the intellectual legacy, in dealing with the economics problems facing Muslim *ummah*, which the present generation will leave the next will be modest. So it is the next generation which must show a great deal of originality, ingenuity, and imagination in developing a properly Islamic paradigm for “Islamic Economics”. For this reason it is important that they know what has been done so far, and what needs to be done in the future. They must know that the present generation of economist will push the frontiers of borrowing from the Western economic tradition to its limits and when the time comes for the next generation to take over it will have to work backward to strengthen the foundation of *Iqtisad*. To do this they have, thank to Allah, a millennia of work by Muslim scholars, *ulema*, *fuqaha*, ethicists, philosophers and mystics to plow through and to combine their findings with the methods (and only methods) of modern economic analysis to not only formulate a truly Islamic paradigm for *Iqtisad* but also find uniquely Islamic solutions to the problem faced by the *ummah*. They can wait for the *ulema* to become economists, this expectation is not only unrealistic it leads to a waste of time which could be used more productively. They, i.e., the next generation, themselves must go through the original materials beginning with earliest *tafsir* of the Quran and *ahadith* to *Al-Kindi*, *Al-Farabi* down to the writing of the present day *ulema*. A cursory look at just a few works of 11-13th century (AD) Muslim scholars yields such enormous harvest that there can be no doubt that, through the *harakah* of Allah, there is much to be gained from such an exercise.

“Finally, attempts must be made to make the generation understand that they must free themselves of the suffocating generation prejudices which had gripped the present generation of Muslim economists. These counterproductive attitudes have led to a paradox where a piece of article by a Muslim scholar quotes profusely from the works of the non-Muslim but

refuses to acknowledge relevant sources by other Muslims because they belong to a different school of thought.”

Abu Saud made following general remarks on the Notes:

“On many occasions where the Notes raised some problematic issues they gave general “easy” answers. For instance, when the Notes dealt with the problem of priorities, they mentioned “the priority Islam attaches to distributive justice. . . .” Yet, “it does not preclude the possibility that proper allocations and growth oriented measures may be necessary....” At the same time, stabilization and growth must be keenly observed. The catch is how to strike the balance among the four factors?

“Again, when the Notes referred to the key industries in developing countries as failure, they did not advise whether such failure was due to the wrong concept or to the inefficient administration, or to both”?

“Everybody agrees and wishes that “fiscal policy is to be directed at maintaining price stability with low levels of unemployment in the domestic economy and a sound balance of payments positions”. The issue is that in capitalistic countries, this is extremely difficult to realize. Has Islam a solution to this problem. Besides, if the (Keynesian) fiscal policies do not apply to the predominantly agricultural countries, what would be the alternative? And how does the principle of *maslaha* function in safeguarding the budgetary deficit financing? I am afraid such references are more evasive than explanatory?

The same ambiguous reference is repeated when you alluded that the *shura* will solve the problem of deciding what is publicly or privately produced. How does this happen and why does the democratic system fail in this respect. Definitely the moral element of self-interest of self-abnegation cannot be the answer to the question.

NEED FOR REFERENCES

Several discussants pointed out that a list of references should be a part of the Notes on how to teach the course of public finance. The concern is genuine. The objective of the Notes is to guide and help a teacher of the course. The help will be incomplete if the teacher not guided to the references that he should consult to organize his teaching on the lines suggested by *Siddiqi*. It has been specifically pointed out by *Raquibuz Zaman* and *Hossein Askari* that *Siddiqi* himself mentions at several places in his Notes that the teacher should refer to recent views of Islamic economists on particular subjects but he gives no references or detailed bibliography on any of these issues. *Raquibuz Zaman* was of the view that not too many of the works on Islamic economics currently available in the market can be termed factually correct as far as *shariah* is concerned. He suggested that some related references should be sighed for each section so that the teacher can consult them to appraise himself/herself of the relevant issues and their varied interpretations while avoiding misleading and erroneous information.

The Notes how to teach should definitely guide to the resources to be consulted by the teacher. *Sadiq* also desired the author to provide relevant references for each section of the Notes. In fact, it is a well-established and fruitful tradition.

Abbas Mirakhor observed that “it is of utmost importance that a work by someone such as by *Siddiqi* who is the most qualified scholar in the field, should have suggested a list of references.

CONCLUSION

The Notes by *Siddiqi* and the discussion of various scholars of Islamic Economics on these Notes, summarized herewith, is definitely a new milestone not only in the way of developing a course on “Public finance in Islamic Perspective” but also in the way of scientific development of various aspects of the discipline which is known as Islamic Economics.

The discussion presented here is particularly very valuable with respect to some very fundamental issues of Islamic Economics. Discussion on the “Theory of state” is one example. The quality of discussion motivated by *Siddiqi*’s Notes on such issues in itself can be treated as an original contribution of the Notes, which has a potential of opening a floodgate of new ideas and research on the subject, once these views are made public.

The discussion summarized in this paper can be seen to be having two dimensions. One, making the suggestion how to improve upon teaching the subject of Public Finance in Islamic perspective as perceived by *Siddiqi* and two, debating on certain specific opinion, assertion or statement made by *Siddiqi*. Both dimension are useful while the first dimension helps developing a good course on Public Finance for an institution teaching Islamic economics, the other provides a rich stock of topics and ideas for students and researchers involved or interested to involve in pursuing research in Islamic Economics.

NOTES AND REFERENCES

1. “Notes” with capital ‘N’ in this will refer to Siddiqi’s “Some Notes on Teaching Economics in Islamic Perspective: Public Finance”.
2. The comments/suggestions received on the Notes prepared by Siddiqi can be distinguished into
 - (a) comments/suggestions having a direct or indirect bearing on teaching of public finance;
 - (b) comments/suggestions having no bearing on teaching public finance (such as editorial comments).

This paper analyses and summarizes only the former type of comments and suggestions.

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