

Fiscal and Monetary Policies in Islamic Economics: Contours of an Institutional Framework

SAYYID TAHIR*

Abstract

This paper summarizes salient features of the existing thinking on fiscal and monetary policies in the Islamic economics literature. It outlines institutional framework for these policies from the Islamic economics perspective. The nature and role of government, in the light of the Sharī‘ah principles, are revisited. The general goals for macroeconomic policies are discussed along with separate goals for each of the two policies. The argument is capped with a look at practical considerations in the actual working of both the policies. The following are the main points in the paper. (1) Roles of both the policies shall be complementary in the context of the overall objectives at the state level. (2) Thrust of both policies would be different from that presently recognized. These conclusions are drawn in the context of the government’s role being limited to prudent governance and the society’s economic and distributional concerns being addressed as much as possible without adopting the budgetary channel.

Keywords: Fiscal Policy, Monetary Policy, the Sharī‘ah, Government

JEL classifications: E62, E52, H11.

1. Introduction

Islamic economics project was launched by Muslim economists in 1976 with the holding of the first international conference on the subject in Makkah. The main constituency of this initiative was the Muslims. Speedy development and

* The author is Professor of Economics at the International Islamic University Malaysia.

An earlier version of this paper was presented at the 8th International Conference on Islamic Economics and Finance (19-21 December 2011) held in Doha, Qatar. The author is thankful to anonymous referees of this journal for their useful comments.

quick recognition required focus on issues of practical significance for Muslim countries at that time. Accordingly, economic development, income distribution, poverty and macroeconomic policies were part of the initial research agenda. Fiscal and monetary policies were thus among the subjects that attracted attention of Islamic economists quite early. This happened when contour of the subject of Islamic economics were yet to be defined. Two international seminars on monetary and fiscal economics of Islam were held at Jeddah and Islamabad in 1978 and 1980, respectively. Since then the discourse on these themes coincides with the development of Islamic economics in general.

Fiscal policy works through the government budget in a country. “Government” includes national, provincial/state, county/district and other local governments. However, the literature on fiscal policy generally focuses on fiscal action by the central government. Fiscal policy works through expenditures, taxes and subsidies at the government level. Sometimes public debt also becomes a guiding consideration. Monetary policy is concerned with monetary management by the monetary authority in a country. It revolves around volume of liquidity—purchasing power—in an economy. It works through the volume of money supply (high-powered money) and variations in the rates at which resource-surplus and resource-short units in the economy carry out their exchanges, whether directly with one another or through financial intermediaries.

Traditionally executing authorities for both the policies are different: the treasury, *alias* government, for fiscal policy and the central bank for monetary policy. Linkage between both the policies is recognized in the mainstream economics literature. But that is limited mostly to the case of deficit financing when government expenditure is not tax-financed. In such an instance, the monetary scene is affected by either injection of fresh money supply into the economy or shift of resources from the private sector to the public sector through public borrowing.

Where do the things stand in this regard from the Islamic economics perspective? And, what is the likely line for further research? This study looks into these matters. Organization of the argument is as follows. State of the existing thinking is briefly reviewed in section 2. Survey of the literature reveals gaps in the area of institutional framework for these policies. Accordingly, the issue of institutional framework is dilated upon in section 3. Among other things, this includes nature and role of government in the light of the Shari‘ah principles. In section 4 the goals of macroeconomic policy, in general, and those of fiscal and monetary policies, in particular, are separately discussed. The argument is capped

in section 5 by addressing some practical considerations in the actual working of the two policies. This is followed by some concluding observations in section 6.

2. A Selected Literature Survey

International conferences and seminars have played defining role in the development of literature on Islamic economics. This is more so in the case of the subject of this study. The process of these symposia involves issuance of a call of papers along with identification of topics for research, writing of papers on the approved themes and presentation of the approved papers by the respective authors. The entire exercise is completed in a set time-frame. It is also pertinent to mention that during the formative years of Islamic economics a select group of Islamic economists was involved, either directly or indirectly, in the organization of the said conferences and seminars. All these factors have had great impact on both the direction and the nature of the research effort. Three broad features characterize the work done on the subject of monetary and fiscal policies:

1. Fiscal and monetary policies have been subjects of separate inquiries. The respective Islamic economics literature has, therefore, developed separately for each policy. This, in turn, has had the following result. The argument and the conclusions for both the policies do not rest on common institutional set-up and policy goals.
2. The audience of Islamic economists has generally been the Muslim countries. Therefore, the ground realities and the needs in these countries played a role in their articulation of Islamic economics. They highlighted importance of *zakāh*, prohibition of *ribā* and role of the voluntary sector in the economy (*see below*). However, they did not fully spell out the macroeconomic framework from the Sharī'ah point of view for these policies. That is, institutional framework of the economy, nature and role of government, the policy framework and the goals of macroeconomic policies.
3. Distinction between state and government is not maintained in the discourse.¹

In fact, the positions actually taken are close to those already held in conventional economics. An interesting feature of the existing literature is that in the early stage of development of Islamic economics, fiscal and monetary policies

¹ See, for example, Faridi (1983) and Siddiqi (1996).

were subjects of separate studies. In the late 1980s and early 1990s that some analytical papers were published with the focus on calculating policy multipliers for either one or both the policies.² Likewise, there have been some studies focusing on implications of *zakāh* for an economy.³ The focus of this short survey is on conceptual matters related to fiscal and monetary policies. Accordingly, the said works are excluded from this survey. With the growing interest in Islamic banking and finance, trend of most of the works again turned to analysis of monetary policy alone. In what follows, we separately look at the state of thinking on fiscal and monetary policies.

2.1. *Fiscal Policy*

Faridi (1983, p.28) attributes the following socioeconomic goals at the state level for fiscal policy:

1. Justice and equity
2. Provision of socioeconomic needs of the community or socioeconomic welfare
3. Enhancement of the community's economic resources or economic growth
4. Improvement in the cultural milieu of the society

He contends that Islamic economy would be a three-sector economy consisting of traditional private and public sectors as well as a voluntary sector. He goes on to note that the state (by which he means government) shall perform traditional allocation, stabilization and distribution roles. In his view, *zakāh* and voluntary charity would provide anchors for distributive purposes.

Salama (1983) also assigns stabilization, distribution and regulation goals to fiscal policy. To this extent he is no different from recommendations in the mainstream economics literature. But he also adds a fourth goal: economic growth. He also touches upon revenue and expenditure sides of the Islamic state, and what one might expect for the case of the existing Muslims countries.

Metwally (1983) makes no major addition to the above points. He mainly discusses mechanism for fiscal policy in an Islamic economy and effects of *zakāh* levy on selected macroeconomic aggregates.

² See, for example, Tahir (1989), Mahdi and al-Asaly (1991), Sattar (1991) and M.F. Khan (1996).

³ See, for example, Salama (1982).

Kahf (1983) discusses genesis of an Islamic state, goals of fiscal policy and principles for taxation policy in an Islamic economy.

Siddiqi (1986) focused on public expenditure in Islam. According to his argument, heads of public expenditure from the Islamic point of view will be more or less the same as in any economy in the current age. In a later study, Siddiqi (1993) also presented evidence on public borrowing during the time of the Prophet SAAWS, falling in the period of the first Islamic state, and later Muslim rulers.

Ahmad (1989, 1992) presented a detailed analysis of public finance in Islam. His 1992 paper is a survey of the existing thinking in the area.⁴ The 1989 paper, the more important of the two, contains reviews of (i) basic teachings of Islam with a bearing for the discipline of public finance and (ii) fiscal system in the first Islamic state of Madinah. His conclusion is that many of the issues of public finance had precedence during the time of the Prophet SAAWS and his able successors. The main paper gives an outline for public finances in Islam in the modern age. The most striking proposal in his paper is that the distribution or welfare budget is to be based on *zakāh* and to be maintained separately from the rest of the government budget. He also argues that transfers could be made from the main budget to the *zakāh*-based budget, but not vice versa.

Hasan and Siddiqui (1994) examine the stability implications of equity-based financing of government expenditure in an interest-free economy. They replicate similar exercises for bond-financed government expenditure in an interest-based economy. Their study offers no breakthrough at the conceptual level.

This above review captures most, if not all, of the points in the existing literature related to fiscal policy. It is pertinent to mention that when the above writings were penned, advances in the area of Islamic banking and finance were yet to be made.

2.2. Monetary Policy

In the 1978 seminar in Jeddah, Ariff (1982) and Uzair (1982) made some preliminary observations on the working of monetary policy in an interest-based

⁴ While the publication year is 1992, the paper itself was presented in 1987 at the First International Seminar on Islamic Economics for University Teachers organized at the International Institute of Islamic Economics, Islamabad.

economy, and the possibilities in an interest-free economy. During the same seminar, Ahmad (1982) floated the idea of achieving distributive justice through monetary policy.⁵

Chapra led the discussion on the subject in a series of papers and books published between 1983 and 1996. He initially listed in his 1983 paper the following three goals for monetary policy from the Islamic point of view:

1. Economic well-being with full employment and optimum rate of economic growth,
2. Socioeconomic justice and equitable distribution of income and wealth, and
3. Stability in the value of money

He also discussed sources of monetary expansion and monetary policy instruments. One novel proposal in his paper is earmarking 25% of demand deposits with the banks for advancing interest-free loan to government. This may serve as a sort of proxy for reserve requirements for the respective banks as well as a means for financing government needs in the face of shortage of revenue through taxes or interest-based borrowing. Chapra's 1985 book *Towards a Just Monetary System* greatly expands on these themes.

Chapra (1996) also revisited the subject in his paper on monetary management in an Islamic economy published in *Islamic Economic Studies*. This paper presents the case for monetary management in a comparative perspective. Need fulfillment, optimum growth and full employment and equitable distribution and economic stability are some of the recurring themes in this paper. And, the monetary instruments include, among others, statutory reserve requirements, credit ceilings (in particular, goal-oriented allocation of credit), equity-based instruments, changes in profit-and-loss sharing ratio and moral suasion.

Al-Jarhi (1983) made an early attempt to spell out monetary and financial structure of an interest-free economy, and work out monetary policy details. The players are deemed to be central bank, commercial banks and the treasury, of course, with the private sector in the background. Vital details remain obscured due to the use of broad brush. Quite interestingly, loan-based zero-interest debt

⁵ During this seminar, Siddiqi (1982) discussed the challenges that Islamic economists face on the financial side and the likely form of Islamic banking. He made only a passing reference to monetary policy.

instruments also find a place in his schema. In his view, “neither the required reserve ratio nor the discount rate exist in such an (i.e., interest-free) economy as policy tools” (p.86). In the end, he upholds the monetarists rule for management of money supply.

M.S. Khan (1986, 1992) focused on the financial side of an interest-free economy, and developed a macroeconomic model in order to study the working of monetary policy in such an economy. He observed that non-guarantee of bank deposits will add to the speed of adjustment in an interest-free economy. Apart from this, he found no difference in the working of monetary policy in an interest-free economy as compared with an interest-based economy.

Khan and Mirakhor (1987) gave a flow-of-funds matrix for an Islamic economy in which the central bank provided equity-based support to banks. However, their analytical model rested on conventional interest rate variable relabeled as an *a priori* variable rate of return. It is, therefore, not surprising that they did not find any difference in the role of monetary policy in an Islamic versus a traditional one economy.

The papers by Khan and Mirakhor (1994) and Choudhry and Mirakhor (1997) have reflection of the advances made in Islamic banking and finance in the 1990s. Khan and Mirakhor highlight the *muḍārabah* mode deposit mobilization, and list financing instruments that might be available in the Islamic financial system. They point out that apart from the Islamic banking system there would also be primary, secondary and money markets. There is great semblance between their thinking and what is available in conventional economics. Of course, the instruments like *muḍārabah* and *mushāarakah* certificates are expected to have Sharī‘ah legitimacy. They regard macroeconomic stability, characterized by price stability and viable balance of payments position as the chief goals for monetary policy. As for monetary policy, their conclusion is as follows:

Monetary policy of an Islamic state takes place in a framework in which all conventional tools normally available in a modern economy are at the disposal of the monetary authorities with the exception of the discount rate and other policy tools that involve interest rate. All other tools, namely open market operations (where equity shares rather than bonds are traded) and credit policies, can be as effective in an Islamic system as they are in the conventional Western system. Additionally, the authorities in an Islamic system can utilize reserve requirements and profit-sharing ratios to achieve changes in the stocks of money and credit. (Khan and Mirakhor, 1994, p.19).

Choudhry and Mirakhor (1997) focus on the tools for monetary policy. Their main proposal is use of equity-based government securities with rates of returns based on budgetary surplus for the purpose of monetary management. This study, like the others noted above, does not spell out blueprint of Islamic economy and, therefore, remains silent on the role of monetary policy in Islamization of an economy.

A largely unnoted work in the Islamic economics and finance literature has been *IIIE's Blueprint of Islamic Financial System* (1999). This study explores, among other things, the issue of monetary management of an Islamic economy. It outlines institutional framework for monetary management (including nature and role function of the central bank), instruments available for this purpose and policy choices available to the central bank, in an Islamic economy.

This completes our short survey of the state of thinking on monetary policy. Some other studies also touch on the points relevant for the subject of this inquiry. For example, econometric study of Elhiraika (2004) about monetary policy in Sudan that opted for full elimination of *ribā* from the economy in 1984. Likewise, Iqbal and Khan (2004)'s work on instruments for financing government's budgetary deficit. The points raised in such are only indirectly relevant for the purpose of this study, and are, therefore, not noted here.

In conclusion, the following points sum up the present positions in the field of fiscal and monetary policies in the discipline of Islamic economics. The various positions are not based on proper Islamic institutional framework in order to satisfy the criteria of logic. The objectives of the Sharī'ah, in one way or another, do carry weight in the various positions taken so far. However, the Sharī'ah side of macroeconomic policy is entirely ignored. The Sharī'ah becomes directly relevant when one talks of actually doing something. Here, matters of what can be done, and how become unavoidable. With these remarks, we now proceed to the main aims of this study: the relevant institutional framework for fiscal and monetary policies and the policies themselves.

3. Institutional Framework For Fiscal and Monetary Policies

Islamic economics is about solutions to economic issues of real life on the basis of the Sharī'ah principles. The Sharī'ah perspective implies that the Islamic economic solutions will give the best results in a Sharī'ah-compliant institutional framework. As explained hereunder, this does not limit the applicability of the

Islamic economic solutions. These solutions remain applicable in Islamic as well as other settings, whether in Muslim or in other societies. The Shari‘ah-perspective helps to draw attention to institutional arrangements that are not often appreciated in the academic discourse.

According to the Islamic worldview, this life is a test for man. For the purpose of test, Allah SWT gave man free will and allowed private ownership. This, in turn, implies that people can own property and exchange property rights. How can millions and millions of economic agents do so with their free will? The answer is “through the institution of market”. It is, therefore, safe to conclude that the Shari‘ah prescribes a market-based economy. This conclusion is also confirmed by scores of *Aḥādīth* on forms of transactions and the evidence available for the first Islamic economy during the days of the Prophet SAAWS and his rightly-guided successors.

One may add the following point to the above point about market-based character of Islamic economy. Allah SWT is the Original, the Absolute and the Ultimate Owner of everything that is in the heavens and the earth. This, in turn, implies that when two people enter into exchanges with one another, Allah SWT is always the Third-Party. Thus, His Will also matters in how transactions are to take place. The Divine Will is available to us in the form of general principles governing permissible exchanges as well as detailed rules for the various transactions norms. The former include, among others, free willing consent of all stakeholders, no transaction of a thing on which one does not have a Shari‘ah-recognized claim, no vague elements in contracts, no *qimār* and no *ribā*.—The principle of no *qimār* implies that all exchanges inspired by economic considerations must involve some quid pro quo. And, the principle of no *ribā* requires that all loans, debts and other similar exchanges must be carried out on an equal basis in terms of the relevant units of exchange. With these main restrictions, people may do trading, leasing, partnership-based exchanges, loaning and a host of other exchanges. The list also extends to more complex cases involving many exchanges among several parties, both at a point in time and across time. The possibilities are virtually unlimited. It is easy to imagine the existence of an economy comparable to a modern economy where individuals, businesses and companies exist, and work in a gainful manner for themselves and the others. Market forms would depend on the existence of substitutes for different products and the number of players on the demand and the supply sides.

On the financial plane, the Islamic principles for exchanges will have the following implications. Institutions like banks may exist for economic reasons, but

with the following differences from the contemporary scene. Banks would no more be pure financial intermediaries that borrow short and lend long. They would be economic agents. They would interact with resource-surplus units in two ways. First, they may provide interest-free demand deposits for those seeking security of their money and flexibility in the use of the funds. Second, they would enter into partnership contracts with owners of funds conscious about seeking a return on their money. On the financing side, the restriction of “no interest” will rule out the banks providing credit to their clients who can use it at their discretion. This will force the banks to actually enter into the transaction process at the grassroots level as traders, lessor and partners. To this, one may add that Sharī‘ah-based divisible and tradable financial instruments will add depth to the Islamic money market. This will remove the dichotomy between financing by the banks and its use at the beneficiaries’ end, and, hence that between financial flows and real flows in the economy.⁶

The above recapitulation of Islamic economy would be complete with an addition of its distribution dimension. Islam addresses the problem of distribution at the opportunity, production and inter-temporal stages. Salient features of this scheme are as follows:

1. Everyone has equal right of access to primary means of production like rivers, forests, natural meadows, etc.
2. Contributors to production process are entitled to reward for their respective role. The Sharī‘ah a step further, and grants the poor and destitute a right in the outcome of the process despite their being unable to make a direct contribution.
3. The Sharī‘ah also provides a comprehensive social security system in terms of rights of parents, family and neighbors along with institutional framework and comprehensive legal system all provide an effective enforcement mechanism.
4. Annual *zakāh* on wealth and the Islamic law of inheritance provides additional checks on concentration of wealth.

Zakāh is the main pillar of the Islamic scheme for distribution. The Sharī‘ah prescribes detailed guidelines for its management on a self-financing basis. *Zakāh* plus other social safety nets noted at point 3 form an elaborate Islamic social security system. In the Islamic scheme relies on the individual for both the

⁶ See *IIIE’s Blueprint of Islamic Financial System* (1999), chapter 4 for further details.

initiative and necessary action in order to solving the problems of poverty and economic inequalities. This is a significant departure from the Western model where the welfare issues are addressed by the government, i.e. at the macro level, with the people contributing through taxes. The fiscal implications of the Islamic approach are enormous. They shift the welfare matters off the government budget.

The last piece of our description of the institutional framework is government, the key element and dominant player in any organized society. In order to keep the argument brief, we list the main points on nature and role of government from the Sharīḥ point of view.

First of all, in principle one must distinguish between “government” and “state”. The latter is a geo-legal construct, and is a legal person in the international community. The government, on the other hand, is operational arm of the Sharīḥ and the state as well as representative of the people. In democratic dispensations, government is elected representative of the people. In other settings, the ruler(s) draw their mandate from acceptance of their position from the masses in one form or another.

In its capacity as operational arm of the Sharīḥ and the state, the government is supposed to fulfill all claims of the Sharīḥ on the people (such as collection and distribution of *zakāh*) and to discharge the obligations of the Sharīḥ in favor of the people (like, for example, fulfillment of critical minimum needs of the people should a problem arise due to systemic failure). In its capacity as representative of the people, the matter becomes quite complex. The following points throw further light on this matter.

All *Aḥkām* of the Sharīḥ given in the Qur’an and the Sunnah at the micro level, also apply to government—representative of the individuals. In particular, all prohibitions of the Sharīḥ apply to the government without further ado. For example, the government cannot enter into interest-based transactions. However, in the case of the permissible of the Sharīḥ, the matter is somewhat different. Government’s status as representative of the people implies that it observes neutrality in interpersonal economic matters. This is not just logical but is unambiguously established by refusal of the Prophet SAAWS to impose controls (Al-Tirmidhī, 2007, *Kitāb al-Buyū’*, *Bāb Mā Jā’a fī al-Tas’eer*; Abu Dawūd, 2008, *Kitāb al-Ijārah*, *Bāb al-Tas’eer*). A logical extension of this principle of neutrality is that government may not act as an economic agent in an Islamic milieu. For example, while the government may buy furniture for its needs, it may not be either a manufacturer or seller of furniture because in that event it would be competing

with its own subjects. This point also implies that public sector enterprises, an important source of pressures on government budget, have little place in the Islamic set-up. In addition to not being an economic agent, the government may not automatically tax one group of people against their will and transfer the benefits to another. The Qur'ānic decree requiring free willing consent of people before taking their property (*an-Nisā'* 4:29) necessitates that the taxpayers be provided some economic or Sharī'ah justification for their obligations. Good versus bad considerations alone do not suffice. This limits economic role of government to only the provision of Sharī'ah-justified pure public goods. In all other cases, the teachings of the Sharī'ah require that the cost of government action to be charged to the respective beneficiaries. Any discussion of macroeconomic policy from the Islamic perspective has to reflect on these points.

4. Goals of Macroeconomic Policy from Islamic Economics Perspective

This section is concerned with the goals of macroeconomic policy, in general, and those of fiscal and monetary policies, in particular. The approach here is to spell out what one may regard as general policy objectives from the Islamic economic perspective. The argument is then narrowed to discuss the roles that might be assigned to fiscal and monetary action in an economy.

The general policy objectives are identified hereunder in the context of an Islamic economy. The reference of Islamic economy helps us to provide the Sharī'ah support for these goals. Nevertheless, many of these goals can be policy objectives for any economy in this age.

It is also pertinent to mention that an Islamic state has an ideological context, namely, spreading the message of the God Almighty to everyone, both inside and outside the state. On the practical plane, this ideological perspective also means (1) keeping working of the economy in line with the Sharī'ah dictates for economic activity and (2) Islamization of the economy where it is found to be off the Sharī'ah-prescribed course. Elimination of *ribā* from the financial system through conscious policy action is an example of the latter. In what follows, we do not emphasize this dimension of macroeconomic policy, and limit our argument to the pure economic side of public policy.

4.1. General Policy Objectives at the State Level

The general policy objectives may be divided into primary goals and secondary goals for economic policy at the state level. Both kinds of goals are listed hereunder:

Primary Goals/Objectives at the State Level:

1. Development and preservation of institutional framework for supporting economic and distributional activity⁷
2. Fulfillment of critical minimum needs (fundamental economic rights) of the citizens
3. Maintenance of credible deterrence against external threats
4. Education

Secondary Goals/Objectives at the State Level:

1. Reduction in interregional disparities
2. Integration of economy into the world economy
3. Development of economic infrastructure such as means for communication and transportation
4. Poverty alleviation

Before explaining the rationale for the above goals and their specific meanings, it is pertinent to mention that the above list represents slight departure from the existing views in Islamic economics (*sections 2.1 and 2.2*). All scholars indeed rest their case on the Qur'an, the Sunnah, the practice during the time of the four rightly-guided Caliphs of the Prophet SAAWS and opinions of reputed *fuqahā'* and Islamic scholars.⁸ But the most important source of inspiration has been the practices during the time of the second Rightly-guided Caliph, Sayyidena Omar, may Allah SWT be pleased with him. A point often missed is that during his time the economy was a resource-surplus economy. Sayyidena Omar took all the

⁷ This includes maintenance of law and order and dispensation of justice in order to ensure security of life and property.

⁸ Siddiqi (1983) is a recent example.

initiatives without introducing taxes on the citizenry.⁹ In other words, while forming opinion in the modern age, greater emphasis is to be placed on ground realities, of course, without in any way sacrificing the dictates of the Qur'an and the Sunnah.

The first two goals are absolutely sacrosanct. Development and preservation of the institutional framework and fulfillment of critical minimum needs of the people fall under the natural role of government. Without security of life and property, law and order and justice the state loses its *raison d'être*. These two goals are, therefore, independent of pre-existence of means for doing the needful. In other words, the state's claim on its subjects for arranging the necessary means holds true by default. The provision of necessary means remains the obligation of the citizenry through, of course, taxation.

As for meeting critical minimum needs of the people, the idea springs from the Islamic concept of life as a test for man (*Al-Mulk* 67: 1-2). A meaningful test requires some means for survival and completing the routine of the said test during one's life. Allah SWT has addressed this point in various ways. Some of these are resource endowments of parents at the time of one's birth, one's personal faculties and freedom for owning and exchanging property rights. The Shari'ah also supplements the exchange process with *zakāh* and other social safety-nets. Primary obligation of the state and its operational arm, namely the government, is that the system is in place for doing the needful. However, if systemic failures lead to some lacking critical means for survival, responsibility at the level of Islamic state arises. Of course, in such an event the society has to bear the costs through the government.¹⁰

Maintenance of credible deterrence is mandated by Allah SWT for the Muslims (*al-Anfāl* 8: 60). It is also the need of every society. The only debatable issue may be the extent of such a deterrent. Given that the goal is to keep the hostile external forces at a distance, over-sized armed forces and lavish cantonments and armaments quickly becoming obsolete do not come on the list.

Basic Shari'ah knowledge is right of an individual and obligation of the state. The scope of "education", however, extends to all aspects of practical life. That includes knowledge of humanities, arts, culture, law, science and technology. After

⁹ Sayyidena Omar introduced kharaj (land-tax) and 'ushoor. Kharaj was a levy on state lands made available to the cultivators who stayed outside the fold of Islam after the conquest of their territories. And, 'ushoor were levies on foreign traders seeking to sell their merchandise in the Muslim lands.

¹⁰ Siddiqui (1988) has also discussed this point. The reasoning provided here is different.

the experience of the Muslim societies in the field of education during last 14 centuries, there is hardly any room for further argument. Skilled and polished individuals are not only good for themselves but also for the others. Given the wide gap between needs of the society and the private concerns, it is only natural that the issue of mass education may be addressed at the state level. Effective consultation process between the people, businesses and industry and the government, can help set the priorities and the criteria for meeting financing needs. But, if one is willing to draw lessons from the past, the government ought to spearhead the education agenda.

Among the four secondary goals noted above, several things are noteworthy. Take the case of reduction in inter-regional disparities first. In the present age, most of the countries are like “joint home” of different population groups differing in language, culture and history. Shared interests bring them into one fold but their long-term association is sustained by common concerns. Reduction in inter-regional economic disparities is vital for preserving federal structures and unity of state.

As for integration of economy into the world economy, the case may be argued on economic grounds. But, we rest the matter on the Shari‘ah grounds. The economy during the time of the Prophet SAAWS was an open economy. The same has been true for Muslim states during the past 14 centuries. International trade and mobility of resources provides a natural avenue for getting into contact with the foreigners and spreading the word of Allah SWT to them. Government can work toward opening of the economy through developing economic protocols and agreements, not necessarily through activist fiscal or monetary policies.

Importance of the goal of development of economic infrastructure, hardly needs a comment. As for poverty, the Prophet SAAWS has strongly advised all the believers to seek the refuge of Allah SWT from it. Common concern of all citizens automatically makes as a policy target. In both these cases, however, being policy goals means monitoring and directing or coordinating necessary action in these respects at the government level. It does not necessarily mean action through government budget. Monetary policy instruments may have a role here (*see below*).

In passing, it is notable that the four primary and four secondary goals noted in this section may not be “the” goals of economic policy in the light of the Shari‘ah principles. Some researchers may have other views about logical basis given in this paper. Some may even add to the said list. The argument needs to be dispassionate

and conservative interpretation of the Shari‘ah because of the resource commitments that any goals will ultimately call for.

4.2. *Goals of Fiscal and Monetary Policies*

As noted at the outset, traditionally fiscal policy is seen as the policy that works through the government budget. Thus, it is associated with the role that the government is called upon to perform in its own name in the economy. Monetary policy, on the other hand, is about monetary management—in particular, the volume of liquidity—in the economy by the central bank. Both policies aim at macroeconomic stabilization mainly through demand management. Fiscal policy is routed through public expenditures and taxes, and monetary through private investment in the economy. Fiscal policy also acts as channel for distribution agenda assigned to the government. Government carries a welfare agenda whereby economic support is provided to the have-nots through a tax- transfer mechanism. Islamic economists have not challenged this conventional wisdom.

The discussion in the section 2 of this paper, reveals that the goals of both the policies have separately discussed in the Islamic economics literature. Full employment with price stability is deemed as the chief macroeconomic objective. But the argument is open-ended on other pursuits. In what follows, we review some of the goals for both the policies. The basis for our argument is that from the Islamic economics perspective monetary and fiscal authorities may not necessarily work as independent policies. Where necessary, action on both the fronts may be coordinated in the larger interest of the economy and the society.

To the extent that government is not expected to directly take part in economic activity for the Shari‘ah reasons, fiscal policy will have minimal proactive role. Two arguments supporting this stance are as follows:

1. Government cannot compromise on its neutrality on the economic plane.
2. Government cannot tax one group, whether the existing taxpayers or future generations, and transfer the benefits to another.

The same principle largely applies to monetary policy with reading “central bank” in place of government in the above points.

The traditional goals assigned to these policies are not defensible for the following reasons:

1. Full employment without inflation. First of all, employment is a means to an end, not the end by itself. Secondly, with constraints emerging from the principles of no *ribā* and no *qimār* will have two implications. First, real and financial sectors in the economy will be integrated. And, financial bubbles will not be created that are important cause of inflation and business cycles. Second, economic exchanges beneficial to only one party will be pushed into the background. Both these factors will encourage production and employment, and lessen chances of inflation.
2. Economy is unlikely to carry unmanageable weight of pensions and welfare payments that are an important cause of fiscal deficits and, hence, inflation.

Government can play defining role in determining the economic course of a county. But, given the Sharīʿah constraints, the modus operandi will be short of direct intervention on either the fiscal or the monetary plane.

5. Some Practical Considerations in the Working of the two Policies

At present in the case of government, the ruling elite makes fiscal decisions, the establishment (or, bureaucracy) implements them and the public (whether present or future generations) pick up the price tag. Social contract (constitution), laws, rules and regulations and binding consultative process (in the form of elected bodies in a democratic set-up) seek to ensure orderly working of the system. However, lack of common concerns at the three tiers of fiscal activity, makes the system a recipe for disaster. This problem is partially remedied by the Sharīʿah through the introduction of constraints on the nature and the role of government. These factors have been explained in the preceding sections. In what follows, we take note of some practical matters in the working of fiscal and monetary policies.

One thing should be clear at the outset. The welfare or distribution agenda of society needs to be off the normal government budget. The government's role may be limited to look after *zakāh*-related matters through separate budgetary setup in this regard (Ahmad, 1989). Of course, the government may encourage private initiative for welfare matters through, for example, *waqf* and other institutions.

Taxation warrants specific Sharīʿah justification on a case by case basis. One implication of this principle is that taxation will be mostly earmarked. Closure of the option of interest-Based borrowings will bring forth additional constraints on

fiscal action. This would result in, for example, curtailment of inessential expenditures under the various heads, such as law and order and national defense. A lot of fat from fiscal side of economy is likely to be shed away.

Economic subsidies for promoting economic activity by producers and exporters are difficult to justify on the Shari‘ah grounds. Therefore, they are unlikely to have a place in the Islamic milieu. This ought to remove a big cause of fiscal deficits in a country.

As explained at length in the preceding sections, government’s active role will be brought into line with the natural role for a government. Government may make its economic contribution to the society through off-budget measures.

The following point will merit consideration in the Islamic fiscal set-up. Where government expenditure can be carried out in mutually exclusive ways and all the options do not have identical distributive implications, preference may be given to the way with the implications for reduction income inequality.

As for the monetary side, one expects some radical changes. With the “no interest” restriction, banks will have access to demand deposits raised as interest-free loans to the banks and partnership-based deposits. In the former case, banks may use the available deposits in providing financing in their own names because ownership of the said deposits shall be with them. However, joint ownership of deposits generated through partnership-based modes will have far reaching implications. In principle, with the ownership of the funds belonging to both the depositors and the banks, the latter shall not be in position to do financing transactions (with the available funds) in the banks’ own names. This would place a cap on credit creation as known in the interest-based banking industry. The notion of high-powered money is expected to change.

Notwithstanding the above, monetary authorities may call upon the banks to maintain reserves to back up demand deposits. However, no such requirement may be introduced in lieu of on deposits raised for investment purposes with the prior permission of the monetary authorities. Of course, the goal of limiting (increasing) the banks’ capacity to generate partnership-based deposits may be achieved by increasing (lowering) the contribution by the banks raising the said deposits. Exogenously introduced restrictions on the ratio of profits shared by the banks with their depositors would violate the Shari‘ah principle of no government intervention in bilateral matters.

The foregoing points should not raise alarms. The chief source of increase (decrease) in money supply will be Shari‘ah-justified budgetary deficits (surpluses) and foreign trade surpluses (deficits). If capital markets are perfect, the velocity of circulation of available money supply, along with adjustments generated through international channels, should help meet liquidity needs of the economy. This was partly the case in the early Islamic state. The Prophet SAAWS and his four Rightly-guided successors took no steps on the monetary side of the economy. Money was injected into the system through foreign trade surpluses. An additional source of money was the interested people directly bearing the cost of having their gold and silver minted into dinars and dirhams, respectively, by those who had special dyes for this purpose.

6. Concluding Observations

The existing Islamic economics literature on fiscal and monetary literature came up before development of the thinking on the contours of the Islamic financial system and nature and role of state and government. This paper builds upon the existing thinking in the light of developments on the said matters during the last two decades.

Main messages of this study are two. First, fresh thinking is called for at the systemic level. Many a beneficial changes are possible in the way an economy works and the goals assigned to the policies under reference. Second, there is room for reviewing active role by the government on both economic and distributive planes. The government’s responsibilities should be reduced to only governance. This is what naturally fits with the occupation of “government”. The economic goals of a country may be met through developments on the monetary side — financial engineering — in the light of the Shari‘ah. Even on the monetary side, major role of the respective authority may be largely regulatory.

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