

ISLAMIC PERSPECTIVES ON MONETARY AND FISCAL POLICIES AND THEIR IMPLICATIONS FOR ECONOMIC DEVELOPMENTS

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I. INTRODUCTION

The basic objective of the Islamic code of life is human welfare which, at the national level, the government has been made responsible to supervise and help realize through deliberate policies and efforts. In the economic field, the government is to guarantee basic needs of all the citizens, help and supervise full employment of all the resources, ensure implementation of Islamic norms and values in factor pricing and transfer payments which lead to an equitable distribution of income and wealth, and thus play a positive and important role in economic development of the Islamic economy.

All these involve appropriate economic policies on the part of the government. The two major and broad categories of policy measures at its disposal are the monetary and fiscal policies. Monetary policy refers to the control of the supply of money, its availability, its pricing, and the direction of its use by applying appropriate monetary tools in order to achieve certain policy objectives. On the other hand, fiscal policy refers to the manipulation of the relevant sources of government revenues including taxes and the direction and size of government expenditure by using fiscal tools in order to materialize policy goals of the economy.

This paper deals with the objectives and instruments of monetary and fiscal policies and their implications for economic development. It has five sections. Section 2 discusses the objectives of monetary and fiscal policies of an Islamic economy. The development implications of monetary policy along with its tools are discussed in Section 3. Section 4 deals with the instruments and development implications of fiscal policy. A final section summarises and concludes the paper.

The basic assumptions of the model underlying the paper are as follows. First, the government is committed to establish Islam at all levels and, accordingly it plays its positive and Hisba (supervisory) roles in the economy including the collection and disbursement of zakat. Second, interest is abolished

from the financial system, and the banking transactions are mainly equity based. Third, the economy consists of three sectors, namely, the consumers, the producers and the government, which may again be divided into different sub-sectors. For example, the producers may be of several kinds, including, the Mudaraba participants (sleeping partners by contributing investible surplus) and Musharaka participants (active participants with both capital and entrepreneurship) in the production process. Again each of these sectors may have two sub-sectors: altruistic and non-altruistic. Fourth, the economic agents follow the Islamic ethics of economics and business either voluntarily or involuntarily.¹

II. OBJECTIVES OF MONETARY AND FISCAL POLICIES

To put the discussion in perspective, it seems relevant to outline the broad goals of economic policy of the Islamic government. The basic and fundamental economic policy goal of the government is to establish Islam at all levels within the country, propagate Islam worldwide, and defend the country and the Ummah from enemies. A second policy goal is to help achieve a high level of national economic growth and development which are important for economic well-being of the people and for materializing some of its responsibilities which include the following: to guarantee public welfare by ensuring provision of basic economic needs for each and every citizen of the Islamic economy, to run a disciplined and welfare-oriented administration of the country including ensuring its internal and external deference and the observance of its Hisba role.

A third economic policy goal, which is a corollary of the second policy goal, is the optimum utilization of the resources, both human and material. The fourth policy goal is to create an economic environment of gainful opportunities for smooth and spontaneous functioning of economic activities.

These are the major and permanent policy goals of an Islamic economy. Their satisfaction may require different measures which may also vary in the degrees of importance in time and space. The two important policy measures are, however, monetary and fiscal policies. While various kinds of objectives may be targeted by these policy measures, there are some which are more relevant and important. Furthermore, both monetary and fiscal policies may be used to complement each other in achieving the specific objectives. For example, inflation may be attacked from both fronts, monetary policy and

¹The involuntary practice of Islamic norms is possible because of the government Hisba, role which guarantees adherence to the Islamic norms and value for human welfare.

fiscal policy. Some policies may be more effective in some circumstances, but both policies may be used to hit the same target. Therefore, instead of separating them, the objectives of both monetary and fiscal policies may be discussed simultaneously.

The broad and specific objectives of monetary and fiscal policies are as follows. First, a high level of economic growth consistent with the full and optimum utilization of resources, both human and material. Second, an equitable distribution of income and wealth in the economy without inequalities. Third, controlling high and frequent cyclical fluctuations in the economy which adversely affect economic activities and cause human sufferings. Fourth, maintaining equilibrium in the external balance of payments.

The first two are important components of economic development from an Islamic perspective. The third is not a component of economic development, but is a necessary condition to maintain it. Therefore, the ensuing discussion of the developmental implications of the monetary and fiscal policies concentrates on how monetary policy can help achieve first three objectives. Furthermore, although their objectives are similar and hence discussed together, the development implications of the two categories of policies are addressed separately because their tools are different.

III. INSTRUMENTS OF MONETARY POLICY

An important characteristic of the Islamic economy is the abolition of interest from the financial system. As a result, one of the major instruments of monetary policy in a capitalist economy, i.e. the interest rate, is absent in the Islamic economy. Monetary policy will, therefore, have to depend on other tools. The Islamic economists suggested five alternative and new policy tools. These are profit ratio, lending ratio, demand deposit ratio, refinance ratio and open market operations.² The major instruments of monetary policy are as follows.³

²Although the term "Open Market Operation", is not new, it refers to a quite different, but similar in nature, operations.

³For further details on the tools of monetary policy in an Islamic Economy, please refer to M.N. Siddiqi, *Banking without Interest*, (Leicester: The Islamic Foundation, 1983); M. Umer Chapra, *Towards a Just Monetary System* (Leicester: The Islamic Foundation, 1985); M. Uzair, "Central Banking Operation in an Interest-Free Banking System" in Mohammad Ariff (ed), *Monetary and Fiscal Economics of Islam* (Jeddah: Centre for Research in Islamic Economics, 1982, pp. 211-299.

- (i) *Regulation of the High-Powered Money*: The supply of high-powered money should be consistent with the growth in the real sector of the economy to support the growth process and to avoid high inflation (due to over supply of money) as well as depressionary tendencies (due to shortage of money supply).

The central bank, as the agent of the government of formulated and implement its monetary policy, will determine the size of the optimum growth in the high-powered money and determine its share going to the government free of charge and to other financial institutions (eg. commercial and development banks) on the principle of Mudaraba.

- (ii) *Statutory Reserve Requirement*: This is a requirement from the commercial banks to keep a proportion of deposits as statutory reserves with the central bank. The reserve ratio may be increased or decreased according to the dictates of the monetary policy.
- (iii) *Profit Ratio*: The profit ratio is the ratio which is used for distributing the profits between the bank the entrepreneurs. A high profit share of the entrepreneurs (that is, a low profit share of the banks) will encourage more investment and vice versa. The central bank may choose to regulate this ratio to control bank advances.
- (iv) *Lending Ratio*: This refers to the percentage of demand deposits which a commercial bank will be required to lend to the target groups free of charge (Qard Hasanah) under an Islamic banking system. A higher ratio of lending will reduce the credit creation base of the commercial banks and vice versa.
- (v) *Demand Deposit Ratio*: This is a percentage of the commercial bank demand deposits diverted to the government for financing socially beneficial projects in which commercial financing is not desirable or feasible. Variations in this ratio is expected to affect cyclical fluctuations in the economy by changing credit base of commercial banks and spending ability of the government.
- (vi) *Refinance Ratio*: This ratio may work as the basis of the lender of the last resort function of the Islamic central bank. This involves provision of liquidity to the commercial banks in times of need to the maximum of a percentage of the loans advanced

by them free of charge. In the opinion of this author, the basis of such refinance may also include the amount diverted to the government from the requirement of demand deposit ratio.

- (vii) *Open Market Operations*: In the absence of interest-based bonds and securities, the open market operations may be conducted by the sale and purchase of some equity-based shares as per the dictates of the monetary policy.
- (viii) *Credit Rationing*: The central bank may control the direction and size of loans and equity-based advances to certain sectors of the economy which serve the dual function of selective as well as general credit controls.
- (ix) *Moral Suasion*: The instrument of moral suasion is expected to be more effective in the value-loaded Islamic banking system than its conventional counterparts. Moral persuasion, advice and mutual consultations, will play an important role in policy decisions of the commercial banks with respect to the size, nature and direction of their loans, Murabaha and equity financing.

Developmental Implications of Monetary Policy

The developmental implications of monetary policy may be divided into two broad categories. First, the development effects that are built in the monetary policy of an Islamic economic system which is obtained without deliberate policies towards economic development. Second, the developmental outcome that may be effected by deliberate efforts for development through the manipulation of the instruments of monetary policy.

The first category of effects results from the abolition of interest as an instrument of monetary policy and as a price of capital. A mandatory economic policy in the monetary and financial spheres of the Islamic Government is to prohibit interest from the financial system by banning operation of banking on the basis of interest, and to transfer the whole banking and financial system to one which is totally free from interest. The resulting equity based banking produces two important development effects, namely utilization of investible resources to the full potential and efficiency in the allocation of resources.

Interest limits the amount of investment and, as a consequence, it cannot be carried out to its full potential. For example, if the interest rate is $x\%$ investment from the borrowed fund can be carried out until the marginal

efficiency of capital (MEC) is $x\%$ of the invested fund. Further investment will imply an MEC lower than $x\%$, whereas the interest rate is still $x\%$ and, therefore, further investment will add more to interest cost than to profit.⁴ On the other hand, investment can be carried out under an equity based Islamic banking system until the MEC is zero because the profits will be distributed between the bank and the entrepreneur on the basis of a profit ratio whatever is the size of the MEC. The entrepreneur as well as the bank gets a positive profit until the MEC is zero, because there is no interest cost. Since the MEC diminishes as investment increases, a potential continuation of investment with positive profits until the MEC is zero implies higher investment in the project under consideration. As a result, total investment of all the projects of the economy, which abandons interest as a mandatory economic policy, will be higher than that is possible in an interest-based economy. This will have a positive effect on employment, output, economic growth and, thus, on economic development.⁵

It can be shown that the allocation of resources will also be more efficient and growth-oriented in an economy which prohibits interest as an economic policy. While financing a project, an interest-based bank considers the highest possible credit-worthiness of entrepreneurs subject to a minimally acceptable expected rate of return from the projects, since a higher credit-worthiness increases the probability of getting the principal back along with interest and since the higher expected rate of return of an alternative project does not carry more weight in the financing policy. Because, the bank does not share in higher returns of projects, but rather gets a fixed amount of interest. On the other hand, the interest-free banking system will choose the projects which have the highest expected rates of return subject to a credit-worthiness constraint since its share is directly related to the productivity and profitability of projects. Thus the available investible resources will be channelized to more productive projects and thus the allocation of resources will be more efficient. This will have obvious developmental implications.⁶

⁴It is assumed as usual that the MEC falls as investment increases.

⁵For a digramatic analysis of this, see the present author's "Economic Development in Islam", *Journal of Islamic Economics*, Aug.-Sept. 1987, pp. 35-45; and for a numerical example, see the present author's "Economic Growth in an Islamic Economy: Potentials and Priorities", paper presented at the International Seminar on Islamic Economics held in Kuala Lumpur on 6-9 July 1987.

⁶For more details, see the present author's "Economic Growth in an Islamic Economy: Potentials and Priorities", op. cit.

The abolition of interest is a policy has a favourable effect on the distribution of income with already been considered as an important component of economic development.⁷

For economic growth may add very little to human welfare if the generated income is concentrated among a few rich people. This is effected in an interest-free system through the equity-based provision of investment. The size of the monetary benefits (returns) that are received by the bank and the entrepreneurs vary with the actual size of profits, because those are distributed on the basis of a pre-decided profit ratio. In this distribution mechanism, the entrepreneurs cannot get richer and richer as profits get larger and larger, which is possible under an interest-based financial system since the entrepreneur has to pay a fixed amount (interest) irrespective of the size of profits and can keep the entire residual income. Thus the distribution of profits in the interest-free monetary atmosphere is more equitable.

These development effects are built in the monetary policy of abolishing interest as its instruments as well as the price of capital. These effects are expected without any deliberate development policy of the respective authority. Now let us turn to the development effects of monetary policy that may be achieved through manipulation of its investments.

As mentioned earlier, an objective of monetary policy is to achieve a high level of economic growth. This may be targetted by the use of the instruments of monetary policy. If the central bank allows or requires from the commercial banks to pay a higher percentage of profits to the entrepreneur (changing profit ratio in favour of the entrepreneurs), the latter will be encouraged to increase investment from the bank's financial resources. Alternatively, the central bank may increase the credit base of the commercial banks by reducing (i) the statutory reserve requirements, (ii) the ending ratio and (iii) the demand deposit ratio and by increasing the refinance ratio. As a result, the commercial banks will be willing to dispose of investible resources on easy terms. One way of doing so is to increase the percentage of the entrepreneurs. This is expected to produce a favourable effect on investment and economic development.

Sectoral or regional allocation of resources may be influenced by an appropriate use of the instruments like credit rationing and moral suasion. It may be required from the commercial banks, or they may be persuaded, to advance a particular percentage or amount of financial resources to some well-defined disadvantaged industries, sectors or regions which will help attain

⁷For more details, see the present author's "Economic Development in Islam", op. cit.

a balanced economic development and a more equitable distribution of development across sectors, regions and industries.

The counter-cyclical monetary policy is not expected to be adversely affected because of the elimination of the interest instrument. The cyclical fluctuations may be dealt with by changing the supply of hing-powered money, varying the credit base of commercial banks, altering the ratios of profits, refinancing and lending according to the dictates of monetary policy. The open market operations and the moral suasions may also play an important role in controlling fluctuations in economic activities.

In their efforts to obtain finance for disired industrial expansion, and the consequent economic development, many developping countries have created new financial instituions known as Development Banks which provide finance for the creation and/or expansion of industries. On this score, all Islamic banks are really development banks, which extend equity-based finance and, accordingly, their activities essentially encompass entrepreneurial, managerial and promotional involvement in the enterprises they finance. Thus the Islamic banks will be able to play an important role in the industrialization process of the economies that follow the monetary policy of abolishing interest from the financial system.

A final comment on the stability of the value of money is in order. The Muslim economists tend to strongly recommend to strictly maintain stability in the value of money by using all the instrument of monetary policy as strictly as required. The rationale is that a fall in the value of money causes injustice to those who advance *Qard Hasanah* (loan without any charge), and that inflation causes sufferings to the people and hence the value of money should be kept stable.⁸

The present writer finds it difficult to fully appreciate such a strong position. Mild inflation may well be allowed in a Islamic economy. Prices may be allowed to rise to facilitate achievement of the economic development objective of the Islamic economy, since economic growth and upswings are almost invariably associated with higher prices in the historical experience of the world economies. A tolerable degree of prices rise is not against Islamic norm of economics. If it contradicts Islamic values and if it causes injustice, the prophet of Islam (s.a.w.) would not have allowed prices to increase.⁹

⁸See M. Umer Chapra, "Money and Banking in an Islamic Economy", in Mohammad Ariff (ed.) op. cit., pp. 145-176.

⁹The prophet (S.A.W.) was once asked to fix the prices during inflation, but he refused to do so. See Tirmizi, *Sunan*, Kitab all Buyu'.

Without control in a situation where Qard Hasanah existed in the society, and the question of indexation was also not raised to cure the so called injustice of inflation.

Lending of money or the principle of Qard Hasanah has been declared as lending money to Allah (S.W.T.). Himself, implying that it earns a great pleasure of Allah.¹⁰ This reward is high enough to compensate for waiting time and for the potential loss in the value of money, if any. The loss in the value of money is not, therefore, an injustice, but rather is a natural phenomenon of lending money and a special sacrifice for obtaining reward from Allah (S.W.T). Both Qard Hasanah and inflation existed during the time of the prophet (s.a.w.), but the question of injustice and indexation was not raised.

This applies to advancing of Qard Hasanah by individuals. The phenomenon is however different in applying lending ratio requirement of the commercial banks which deal with others money. There are at least two ways to address the problem. Firstly, the depositors may be required to authorize the banks to lend a percentage of deposits as Qard Hasanah. In this case, the rule of individuals apply to the banks as well. That is, a bank acts as an agent of the individual depositors who receive the reward of the Qard Hasanah and hence bears the risk of any loss in the value of money. Secondly, provisions may be made to reserve a part of the banks' profits before giving dividends in order to compensate for the probable losses in the value of money.

In short, it does not seem to be valid to say that even a mild inflation causes injustice and hence is not allowed in Islam. Instead, inflation should be allowed to take place to the extent that is considered useful to facilitate economic development.

IV. TOOLS OF FISCAL POLICY

An Islamic economy has all the fiscal tools that are available to a contemporary economy, although their application and implications may be different. In addition, it is said to possess as its disposal a novel and unique revenue source which may be utilized to some extent as a tool of fiscal policy.

¹⁰See Al-Qur'an 2:245; 57:11

This is the institution of zakat. The major fiscal instruments of an Islamic economy are as follows:¹¹

- (i) **Taxation:** Most of the Islamic scholars agree that the Islamic state may impose taxes as and when needed for the welfare of the people. There seems to be nothing in the Shari'ah to prohibit imposition of taxes; but rather there is indication that compulsory levies beyond zakat are allowed when the revenues of the state are not adequate to perform its functions. In particular, Islamic personalities like Imam Malik, Ibn Hazm, Abdul Hai Kattani are reported to support taxes to cover the needed expenditure.¹² Besides, all the contemporary writers on Islamic Economics consider tax as an important and permitted tool of fiscal policy of the Islamic economy.¹³ Because, the dynamic role of the state in the changed circumstances assigns multi-dimensional functions to the government including civil administration, internal law and order, external defence, provision of the basic needs to the needy (food, shelter, medicare, education etc.), propagation of Islam. The use of zakat revenues is neither allowed for all of these purposes nor adequate, and hence the Islamic state may impose taxes to raise the needed revenues, which may also be manipulated for the purpose of stabilization and redistribution in an appropriate manner.¹⁴

¹¹For detail analyses on the tools of Fiscal Policy in an Islamic Economy, please refer to F.R. Faridi, "A theory of Fiscal Policy in an Islamic State" in Ziauddin Ahmed, Munawar Iqbal and M. Fashim Khan (eds.), *Fiscal Policy and Resource Allocation in Islam* (Islamabad: Institute of Policy Studies, 1983), pp. 27-45; M.M. Metwaly, "Fiscal Policy in an Islamic Economy", *Ibid*, pp. 59-81; Abidin Ahmed Salomon, "Fiscal Policy of an Islamic State," *Ibid*, pp. 99-118; Monzer Kahf, "Taxation Policy in an Islamic Economy," *Ibid*, pp. 131-153; M.N. Siddiqi "Public Expenditure in an Islamic State" paper presented at the International Seminar on Islamic Economics, held in Kuala Lumpur on 6th.-9th. July 1987.

¹²For this, and for a good survey of the old Islamic literature, supporting or otherwise, the imposition of taxes see Yusuf al-Qardawi, *Fiqh al-Zakat*, Dar al-Irshad, Beirut, 1969, v.2, pp. 964-998.

¹³However, Dr. Monzer Kahf, sees its permission only in specific shariah-defined necessities. See his "Taxation Policy in an Islamic Economy". The opinions of the contemporary writers are available in Ziauddin Ahmed et. al (eds), *Fiscal Policy and Resource Allocation in Islam* (Islamabad): Institute of Policy Studies), 1983.

¹⁴For arguments in favour of taxation in an Islamic economy, see Dr. F.R. Faridi, "A Theory of Fiscal Policy in an Islamic State" in Ziauddin Ahmed et. al (eds), *op. cit.*, pp. 27-45

There is, however, a consensus that the incidence of taxes should be on the rich and must not be on the poor.

(ii) *Government Expenditure*: The government spend a sizeable amount to carry out its functions which has fiscal implications. The size, direction and timing of such spending and the financing sources may be manipulated in order use government expenditure as a fiscal policy instrument for producing the desired developmental, redistributive and stabilizing effects. For example, deficit financing from the central bank borrowing would be more expansionary in effect than from forced borrowing from the rich. If necessary, the government may choose to resort to forced borrowing from the better off population of the society free of charge. In spending, as is well-known, the government may increase or decrease the size of its expenditure depending on the dictated of the fiscal policy. Thus, the fiscal tool of government expenditure along with the alternative financing source is available to an Islamic economy as well.

(iii) *Zakat*: Almost all the Islamic economists consider Zakat as a tool of fiscal policy of the Islamic state. In our view, however, it is not really a fiscal tool in true sens of the terms, although the collection and disbursement of zakat may be manipulated to be consistent with the fiscal dectates so that it does not tend to nullify the desired effects of other fiscal measures.

The nisab and rates of zakat are fixed and cannot be changed in order to achieve other policy objectives. This is an obligatory Ibadah which cannot be left to the will of the people, lest its spatial variations may destroy its identity and purpose. Therefore, the rates of zakat and the conditions of its obligation are considered given which have clearly been elaborated in the Islamic source materials.

The use of a tool as a fiscal measure requires its variation and manipulation to suit the dictates of the fiscal policy. For example, the tax base may be reduced and the tax rates may be increased to fight against inflation, and their changes in the opposite direction will be necessary during recession. Such variations in the base (nisab) and rates of zakat are not allowed, and hence it cannot be treated as a fiscal instrument per se.

At best, zakat may be made to be in consistence with the fiscal policy by, as suggested by Dr. Monzer Kahf, monetization of zakat and controlling the time of its disbursement. For instance, the producers find it difficult to sell their products during recession and hence, as a counter measure, the government may choose to buy goods by the zakat revenues in order to distribute to the needy which will increase effective demand directly without any leakage. This sounds impressive, but a word of caution is in order. In doing so, the zakat authority must buy such items which are needed by those who are eligible to receive zakat in descending order of priority.¹⁵ This implies that the most needy people should get the needed items. Since the marginal propensity to consume of these people is already high, and hence the leakage is low, the anti-deflationary effect of the monetization device of zakat would likely to be small. The second suggestion is to postpone zakat disbursement during inflation and vice versa in recession. This as well has limitations. The poor are the worst affected people during high inflation and, therefore, need immediate financial assistance. The whole objective of the institution of zakat will be destroyed if zakat disbursement is postponed for a long time as anti-inflationary policy.

The zakat does not seem to be an effective tool of fiscal policy in an Islamic economy, although, as will be seen later, its developmental effects seem to be quite promising, which also provides a unique source of revenue for the compulsory social security system of the Islamic economy. Besides, an Islamic state has other commendable sources of revenues which are not discussed here because of their non-relevance for fiscal policy.

Development Implications of Fiscal Policy

Economic development requires allocative efficiency which has a unique dimension in Islamic economics. The satisfaction of marginal conditions may not guarantee efficiency in the allocation of resources because of divergence between private profitability and social priority which has bearing on public welfare and consequently, on economic development from an Islamic perspective. This is reflected in the tax structure of an Islamic economy. Although the fiscal instrument of taxation has an apparent analogy of the

¹⁵For a discussion on the Islamic concept of priorities, see the present author's "Economic Growth in an Islamic Economy: Potentials and Priorities" *op. cit.*

contemporary system, its nature will be different because of the unique value system underlying an Islamic economy. This system has an inherent and inbuilt policy bias towards the disadvantaged bracket of the population to the extent that the better-off people are to be blamed for any suffering of the former. That, those who suffer they suffer because the rich are not carrying out their social responsibilities. Therefore, the state takes the side of the disadvantaged people in its policy measures including fiscal policy. This has several allocative and developmental bearings.

First, the tax structure of the Islamic economy will be such that the incidence of tax is only the rich, and never on the people who are below poverty line. This implies an income tax rather than an indirect tax, preferably with a progressive rate, and heavy excise and import duties on luxuries, and even on the items of comforts if a sizeable percentage of population are deprived of basic needs.

Second, a discriminatory tax policy will prohibit the production of harmful goods and services and penalize the production of the items of lower priority in the hierarchy of needs.¹⁶ In other words, tax incentives will be provided to the industries that produce basic needs, then to those producing the items of comforts, and so on. This will meet an important Islamic criterion of allocative efficiency and of economic development.

Third, the resources mobilized through taxes may be utilized for meeting regular government expenditure and for development purposes. For example, the resources may be diverted, after meeting the essential expenses of the government, to the projects which provide more benefit to the people below poverty line, for instance, the provision of basic needs including food, shelter, medicare, education and so on which contribute to both public welfare as well as productivity. This will also be used to build physical infrastructure and develop human capital in both moral and professional qualities. The tax revenues may also be used for stabilization purposes depending on the dictates of fiscal policy.

A probable objection to the progressive taxation of the rich is the probability of a resulting disincentive effect on their entrepreneurial efforts. A recent thesis of McClallend has probably provided a good answer to such apprehensions.¹⁷ He has demonstrated that it is achievement motivation,

¹⁶For a discussion on the hierarchy of needs, see *Ibid.*

¹⁷David C. McClelland, "The Achievement Motive in Economic Growth", in Peter Kilby (ed.) *Entrepreneurship and Economic Development* (New York: The Free Press, 1971), pp. 109-122.

rather than the profit motive, which activates entrepreneurial pursuits. If this is true to some extent, a fall in the marginal profit rates will not deter further entrepreneurial efforts, since the size of profits is not the driving force in the first place. In addition, any adverse effect of the progressive tax policy, designed to protect and benefit the poor, may be compensated by the emerging entrepreneurship from the presently disadvantaged population as a result of the preferential treatment received from the government.

Fourth, the net effect of the above is transfer of resources from the rich to the poor. This tends to add to the effect of zakat in redistributing resources for a more equitable distribution of income and wealth in the economy.

Although Zakat is not an effective tool of fiscal policy, its bearing on development seems to be impressive. Firstly, Zakat imposes a penalty on hoarding and on idle cash balances. Zakat has to be paid at 2.5% at the end of every year and thus the idle resources will be eaten up at some point of time if these are not invested to grow. Thus Zakat works as a strong disincentive to keep resources idle, and an incentive for investment. Secondly, Zakat is meant for mostly the disadvantaged people of the economy. This will increase the standard of living of the poor, improve their health and skill and thus increase the productivity of the workforce. Thirdly, the institution of zakat increase aggregate demand in a macro-economic sense which should lead to higher investment and economic growth.

There may be two kinds of apprehensions in this context: (1) the modesty effect of Islamic living may destroy the expansionary effect of zakat disbursement; and (2) Zakat disbursement may worsen the inflationary situation, if it is observed to increase effective demand. Our response to the first apprehension is that the modesty effect will not limit consumption expenditure of the lower income bracket, because the principle of a modest living discourages consumption of conspicuous, luxury and snob items which is not applicable to the beneficiaries of Zakat, but rather to the payers of Zakat. The modesty effect of Islamic living will discourage luxurious consumption of the rich and the Zakat will facilitate consumption of basic needs. This will contribute to allocative efficiency in an Islamic sense by encouraging expansionary investment in the socially desirable commodities at the cost of the socially undesirable items.

The second apprehension is also not so strong. Inflation takes place when too much money chases too few goods and services. As a corollary of the above, one may rationally assume that the probability of higher investment in the production of basic needs due to higher aggregate demand in this sub-

sector would increase the supply of these items to meet the increased demand of the Zakat recipients. The higher demand in this sub-sector may not be transmitted to other sub-sectors and hence the inflationary effect is likely to be minimal.

In addition, the equity implication of the institution of Zakat is obvious. The objective of Zakat is to redistribute resources from the better-off people to the lower income bracket of the population. It should be borne in mind that Zakat is not the major distributive mechanism of an Islamic economy, it is rather a corrective device only. The Islamic economy has an inbuilt distributive mechanism in the forms of functional distribution of income which refers to factor pricing based on the principles of justice and scarcity and leads to an equitable distribution of the goods and services right in the process of production.¹⁸ The Zakat is meant to even out the remaining unevenness through transfer payments. However, even if Zakat is supposed to provide the equity service of the corrective nature, it can do the prescribed job efficiently.

Now we move on to the stabilization function of fiscal policy. High cyclical fluctuations adversely affect the environment of trade, commerce and industrial investment, and therefore, a reasonable degree of stability should be targetted by both fiscal and monetary policies. As usual, government expenditure will be reduced during inflation. The difference, however, in the fiscal policy of an Islamic economy in this context is that it would not reduce its expenditure on the lower income bracket as compared to the other sectors. In general, there exist unemployed resources in the economy, and in particular, in the present Muslim countries of the world. These unemployed resources will help the basic needs sector to grow which, as indicated earlier, could not be developed adequately because of the lack of adequate sectoral effective demand. Thus, the supply of basic needs increases with a higher effective demand and, therefore, the inflationary effect of government expenditure on the basic needs sector is not likely to be alarming. If this expectation is reasonably correct, the suggestion of postponing Zakat disbursement during inflation would not be necessary. But, the government should see by a deliberate policy that the basic needs sector is growing and developing as a positive response to a higher effective demand in this sector.

The suggested monetization of Zakat is likely, however, to be more useful during recession. When the goods cannot be sold, the Zakat authority may

¹⁸For further details on factor pricing, see the present author's "Factor Pricing and Income Distribution from an Islamic Perspective", paper presented at the seminar on "Distribution of Income and Wealth in Islam", held in Dhaka on 23rd.-3rd. April, 1987.

arrange to levy such items that are needed by the people in the lower income bracket and disburse goods in kind instead of money. This will have a direct expansionary effect in the economy.

The developing as well as the developed countries often experience a new macro-economic phenomenon of a simultaneous existence of inflation and unemployment, usually termed as stagflation. Zakat revenues may be used to deal with the situation through the supply side policy measures. Zakat resources may be used to establish industries to produce items of basic needs and of high demand which will increase the supply of goods and services as well as job opportunities. The former will have depressing effect on the price level, while the latter will increase employment. The workforce of below poverty line will get priority in employment in these industries and the profits will entirely be distributed among the similiar people preferably in kind in order to produce cumulative supply side effects.

Such use of zakat resources seems to be allowed in Islam. The "Tamleek", transferring ownership to the zakat recipients, does exist in doing what is suggested above as well. Because, in doing so the ownership of a higher amount than the actual zakat revenue will be transferred to the zakat recipients in the form of profits over time. In an Islamic, economy, the zakat payers do not transfer its ownership directly to the recipients, but rather to the state for disbursing it to the needy. Since there is no time constraint in disbursement by the government, there is no harm to invest it to grow as a guardian. In this way, the beneficiaries may receive a continous flow of income instead of getting the zakat amount once for all.

The government of an Islamic state may usefully design a similar programme of spending other welfare funds which may contribute favourably to its efforts for dealing with the problem of stagflation. The monetary policy may also be formulated to produce positive supply side effects for instance, by varying the ratios of the relevant monetary tools to appropriate directions.

V. SUMMARY AND CONCLUDING REMARKS

The paper dicusses Islamic perspectives on monetary and fiscal policies in an Islamic economy and their implications for economic development. The Islamic code of life has the unique characteristics to establish itself through the political institution of a state. This calls for formulation and adoption of deliberate policies encompassing all spheres of human life. Next to the mundane obligation of establishing Islam, both within and without, is the imperative to guarantee welfare of the people which, in economic field, involves assurance

of basic needs to all, provision of a congenial economic environment for achieving full employment of resources, economic development, and so on.

The broad objectives of monetary and fiscal policies are: (1) a high level of economic growth, (2) equity in the distribution of income and wealth, (3) controlling high cyclical fluctuations, and (4) maintaining equilibrium in the external balance of payment. The first three relate directly to economic development and hence are discussed in the paper.

An Islamic economy has a new set of monetary tools including profit ratio, lending ratio, demand deposit ratio, refinance ratio. In addition, the central bank has all the conventional tools at its disposal except for the interest instrument and the tools that involve interest. Although the interest instrument of monetary policy is absent in the Islamic economy, the new tools may well compensate for it to have an effective monetary policy.

The development implications of monetary policy are likely to be quite favourable. The abolition of interest and the introduction of equity based financing helps achieve allocative efficiency, utilization of resources to the full potential and distributive equity. In fact, the institutional setting of Islamic banking presents the concept of development banks by incorporating development elements right in the commercial banking system. These are inbuilt development effects of the Islamic economic system. Besides, the monetary authority may deliberately manipulated the policy instruments to direct the resources towards the sectors possessing higher growth potential and social desirability, and to produce favourable equity effects.

The monetary policy would also be able to counter high cyclical fluctuations in the economy. In this context, it has been argued, as contrary to the most of the writers on Islamic economics, that the strict maintenance of the stability in the value of money is neither a Shari'ah requirement nor necessary. A moderate increase in the value of money and price level would not disturb the principle of justice and will not necessitate indexation.

The Islamic State has all the conventional tools at its disposal, but their application and implications may be different. Although there is some debate on the questions of taxation, the Shari'ah does not seem to prohibit imposition of taxes since it is necessary in the modern context and, therefore, most of the Islamic economists also view it favourably.

In addition, the Islamic state has a unique source of revenue at its disposal which is the institution of Zakat. Most of the writers on Islamic Economics

see it as an effective tool of fiscal policy. To the present author, however, it is not an important fiscal tool, because its base, rates and the heads of disbursement are already determined which cannot be manipulated according to the fiscal dictates of the country. Of course, the institution of Zakat is likely to have appreciable developmental effects. It discourages hoarding, encourages investment, increases effective demand, and so on.

Allocative efficiency has a unique dimension in an Islamic economy. It refers to both productivity and social desirability which is determined by Shari'ah norms and values. This may be achieved by applying appropriate fiscal measures. For instance, the incidence of taxation must be on the rich, the government expenditure would be directed, after meeting regular expenses, to guarantee the basic needs, public welfare, to develop physical and social overhead capital, and also to fight against high cyclical fluctuations in the economy.

A final word about the application and policy goals of fiscal and monetary policies. In this context, we would like to emphasise that the policy measures must be consistent and complementary. This stands in contradiction to the position which tends to assign a few functions to fiscal policy and others to some other policy measures in an independent and segregated way. To us, it is not an either-or problem in the present context, it is rather a problem of consistency and complementarity. The two broad categories of policy measures should simultaneously be used in such a way that one does not destroy the effect of the other, but rather reinforces each other.