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Theory of Fiscal Policy in an Islamic State

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Introduction

The present study seeks to attempt a theoretical exposition of the fiscal dynamics of an Islamic economy. In view of the absence of any empirical base in the modern world, the exposition relies heavily on the following techniques of analysis:

i. The norms and values that are relevant to and direct the economic aspects of individual and collective behavior in an Islamic society have been spelt out in terms of their likely impact on the allocation, distribution and stabilization branches of public economics.

ii. The behavior of an Islamic economic system in the past has been taken as the datum for theoretical projection in the future.
In other words. the total absence of any empirical base in the modern Muslim societies has been partly compensated for by a selective adoption of past Islamic societies as the sample.

The use of the latter technique could render the whole analysis anachronistic. But this has been avoided through the complex device of introducing significant elements of current economic systems and integrating them, as far as possible, with an Islamic economy. This has helped us to visualize the future working of an Islamic economic system. The main elements of this theory may be summarized as follows:

i. An Islamic economy has been characterized as a three sector economy, namely the private sector with profit, the voluntary sector and the public sector. The three sectors working in conjunction furnish the institutional framework of an Islamic economy.

ii. *Zakah* provides the base of the fiscal system and defines its scope of operation within the general institutional framework of the Islamic economy.

iii. The allocation, distribution and stabilization functions of an Islamic economy are processed and implemented through all these sectors jointly.

iv. The public sector's role is minimal but crucial in so far as it operates continuously to ensure an optimal allocation of the community's resources, rectifies sub-optimal distribution of incomes. and introduces an element of stability.

Is a Fiscal Policy Possible in an Islamic State?

It has been argued by some Islamic theorists that a fiscal system beyond what is defined by *zakah* is un-Islamic. The argument relies on the sanctity of private property recognized by Islamic *Shari'ah* and contends that any compulsory government charge on private property is patently unjust. Since taxes constitute the core of modern fiscal policies an Islamic fiscal policy is a contradiction in terms. A refutation of this assertion may be briefly stated in a few paragraphs.

The socio-economic policy goals of an Islamic state are as follows:

1. Justice or equity
2. Provision of the socio-economic needs of the community or socio-economic welfare.
3. Enhancement of the community's economic resources or economic growth.
4. Improvement in the cultural mileu of the community.

These policy goals have been derived from the Qur'an and *Sunnah* and implemented in the simple socio-economic system prevalent during the Prophet's (PBUH) lifetime and during the caliphate. Later, as the Islamic society became more complex, Islamic thinkers such as Al Ghazzali, Abu 'Ubaid, Abu Yusuf, Ibn Taymiyyah, AlShatibi[(1)] and others dealt with these policy goals and their implications and also suggested appropriate devices for their attainment. Recent additions to this literature are extremely valuable in view of their contemporary relevance and modern exposition.[(2)] We can take them as given and envisage the path along which the fiscal mechanism in an Islamic state is likely to operate.

It may be correctly argued that *zakah* is the most important fiscal and distributive mechanism of an Islamic economy. But as pointed out subsequently, *zakah* may generate certain incidental effects on the economy, which can be redressed only by an appropriate mechanism of secular levies. For instance, a situation may arise where *zakah* levies may lead to such a diversion of resources that is not desirable from the point of view of general goal of a Muslim society. To prevent this, an appropriate fiscal device may be required. Moreover. the policy goal of an Islamic society to alleviate poverty, may in certain situations, necessitate the imposition of subsidiary welfare levies.

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(1) References to their works are given at the end of this paper.
(2) See for instance Al-Qardawi, Abu-Sa'ud; Al-Siba'i. 1960; Qutub, and Siddiqi, 1968.

The argument that *zakah* receipt may sometimes fall short of resource requirements for welfare expenditure has been recognized by the *Qur'an* itself in as much as it has exhorted the Muslims to expend voluntarily a part of their resources. In addition, many Islamic thinkers have also taken note of it, as discussed in the following paragraphs. Although such situations may not ordinarily arise, they are nevertheless important in the context of an Islamic country today. where the phenomenon of mass poverty co-existing with a relatively small number of wealthy people may call for additional mobilization of resources. Moreover, equitable distribution of income in a situation where exogenous developments have led to an unprecedented rapid accumulation of personal incomes, may not be wholly attainable through *zakah* levies alone. In such a situation *zakah* may be interpreted as the minimum rather than the maximum effort to alter the situation. But it seems probable, on the basis of evidence recorded in early Islamic literature, that a compulsory additional charge on such extraordinary income is permissible under Islamic law.[3]

The allocation function of the Islamic economy may also require an appropriately devised tax system. An optimal allocation of the community's resources as between different sectors of the economy and within each sector is likely to call for a tax policy geared to this need. Similarly, the allocation of resources along the temporal and spatial scale requires a judicious use of tax policy together with monetary policy and other regulatory measures. Economic welfare of the Islamic community may involve a more appropriate time and spatial allocation of its resources. The intertemporal allocation of scarce resources or their conservation in the interest of the Islamic collectivity through state conscription or public management has been alluded to in the Qur'an.[4]

The verses regarding *fay'* have specifically laid down an equitable intertemporal allocation of the *fay'* proceeds. Although initially all such proceeds were distributed to members of the then present generation Hazrat `Umar changed this policy in respect of the distribution of the conquered lands of Iraq and Egypt.[5] These lands were retained by the state not only to prevent concentration of wealth but also in the interests of future generations.[6]

An Islamic state may require additional mobilization of tax resources to (a) regulate price movements. The general concern of *Shari'ah* in this respect is reflected in its prohibition of speculative hoarding of essential goods, although specific instructions in regard to control of prices are absent for obvious reasons; and (b) to provide such goods as are imperative for the welfare of the society and cannot be left to the private enterprise. That the Islamic state is entitled to additional mobilization of resources, through *ad hoc* levies or other methods when the conventional resources of the state exchequers are not able to meet emergency requirements has been ably argued by

(3) See for instance, Ibn Taymiyyah, Abu Yusuf and Abu 'Ubaid.

(4) "And the harvest that ye reap, ye shall leave them in the ear except a little, of which ye shall eat. Then will come after that (period) seven dreadful (years) which will devour what ye shall have laid by in advance of them. (All) except a little which ye shall have (specially) guarded. Then will come after that (period) in which people will have abundant water, in which they will press" (wine and oil). (Al-Quran 12:47-49).

(5) For a brilliant exposition of the entire gamut of this issue. See Siddiqi (1968) and Al Sadr.

(6) Abu 'Ubaid:. p. 59. Mu'az is reported to have argued thus: "Then will come after them people who will defend Islam (to the best of their ability) und will find nothing. So consider the stand that suits the first and the last of them".

classical Islamic thinkers. During *`am al-ramadah* (the year of Famine) Hazrat `Umar is reported to have underlined the fiscal power of an Islamic state clearly.[7]

In a different context Ibn Hazm has also recognised the compulsive economic power of the Islamic state in extraordinary situations.[8]

System Constraints on Taxation

The above analysis highlights the usefulness and necessity of a tax system to serve the socio-economic objectives of an Islamic state. An attempt has also been made to prove that it is permissible for the Islamic state to conscript resources to meet its ordinary and welfare expenditure. It will be argued, however, in the succeeding paragraphs. that there are certain in-built constraints in the Islamic socio-political organisation that prescribe the permissibility frontiers of taxation by the Islamic state. The limitation lies in the ideological-cum-moral parameters of an Islamic society and is applicable to normal conditions only. It is these parameters which point to an optimum level of taxation which, if exceeded, results in the diminution of aggregate socio economic welfare of an Islamic society.

The permissibility frontiers of taxation envisaged here are not quantifiable. Nor is the optimum level translatable in terms of certain universally valid magnitudes. Abstracted from its quantitative implications the optimum level may be derived from two characteristically unique in-built system constraints of the Islamic economy. In the first place, the Islamic taxation policy will be so designed as to compensate or supplement the "resource gap" arising out or incidental to *zakah* and *sadaqat*. It will not be an independent variable but a derived one. Its dynamic will operate within the outer limits set by *zakah* and voluntary contributions to the aggregate socio-economic welfare of the community. The Islamic taxation system will be an adjustment to the resources flow originating in these sources. An assessment of the "resource gap" thus left uncovered compared to the overall fiscal needs of the public authorities, given the socio-economic goals of the community and its stage of economic development will determine the quantitative aspect of the tax effort. and as a corollary thereof its structure and rates. It will define the assessment base of direct taxation in so far as the equity and ability to pay considerations intrinsic to *zakah* levies are not negatived through a thoughtlessly conceived system of secular levies.

In the second place, Islamic tax system will be so structured as to fill in the "objective gaps" indicated by, or incidental to *zakah*. It will serve to promote primarily the same ends for which *zakah* has been levied. If certain aspects of the economic impact of *zakah* tend to frustrate the general design of the *Shari'ah* and act to the detriment of economic growth Islamic tax policy will be accordingly adjusted. For instance, if in full employment, or in comparatively rigid supply conditions. the transfer of resources exerts an upward pressure on the price level. taxation policy will be suitably adjusted to arrest the price spiral. Or if *zakah* levies cause a sudden diversion of resources from savings to overspending, or from investment in *zakat*-able to *zakah*-free economic activities whose overall impact on the economy is likely to be detrimental to

(7) See Mohammad Ibn Sa'd: *Tabaqat*, Vol. III, p.317.
(8) Sec Ibn Hazm: *Al-Muhalla*, Vol. VI, p. 156.

general welfare of the Islamic community, tax policy will have to be readjusted. Similarly, any difference in the burden of *zakah* incidental to the rates applicable on varying forms of wealth-saving may result in an unbalanced intersectoral allocation of the community's resources, say, between agriculture and manufacturing, the tax policy will have to take due account of it in so far as this Unbalancing effect runs counter to the overall objectives of an Islamic society. On the other hand, if certain development in the economy tend to frustrate the ultimate objectives of. *zakah*, taxes will be used to arrest or control them. A general inflationary rise in prices may he a case in point. as it releases forces that tend to increase the income disparities and distort the flow of resources.

This analysis. however, does not make the assertion that Islamic taxation policy will be a `residual' exercise only. It does maintain, however, that it will be primarily a `compensatory' policy or one that is complementary to *zakah*. It will be clear as we proceed through this analysis that the Islamic taxation policy will nevertheless be an effective allocative and distributive device pivoted to the central Islamic levy *zakah*. Somewhere it will appear to enjoy a comparatively freer hand. Even so, the general system constraint can never be lost sight of.

It may be argued, however, that the "resource gap" concept is inadequate for the dynamics of a modern economy that involves a much wider scale of governmental economic activities which need financing on such a large-scale that render the "resource gap" formula derived from *zakah* impracticable. But this objection is not so formidable as it appears to be. In the first place, development finance depends only partly on taxation. The bulk of finance for public investment has traditionally come from non-fiscal sources of budgetary receipts, such as public borrowing, both internal and external, money creation and income from economic activities of the state. In the second place, aggregate public expenditure in an Islamic society will necessarily tend to decline for many reasons. For one thing, an Islamic administration will be a less-expensive one in view of its distinctive cultural milieu. Secondly, it will depend, to a large extent, on private initiative for development. Thirdly, a sizable part of its welfare expenditure, will be met out of *zakah*. Thus taxation will surely decline in importance, as a means of public budgeting.

Another significant system constraint on taxation policy derives from the distinctive nature of the Islamic economy Islamic fiscal policy conceived in the terminologies currently in vogue, and with reference to modern fiscal theory, will be a fruitless and self-defeating exercise. It is imperative to have a clear vision of not only the value base of an Islamic economy but also to spell out its *modus operandi*. Without such an effort, we are likely to fall in line with other economists and paint the economic landscape of an Islamic society largely similar to that of a value-less and profit-based society.

Elements of an Islamic Fiscal Theory

An economy has to deal with four basic problems. The limited supply of productive resources leads to the problem of scarcity which involve a specific decision as regards the allocation of the available productive resources and the institutional means through which the desired allocation is to take effect. Closely linked to it is the problem of distribution which relates to the manner in which the `real output' is divided among the various individuals and family spending units of a society. The attempt to increase the productive base of the society to bring about an improvement in the societal welfare over time, creates the problem of economic growth and the institutional means through which it has to be vigorously pursued.

Contingent upon the devices chosen to tackle all these problems, economic disturbances of varying intensities occur, which require a set of measures, conveniently summed up as stabilization policies.

The nature of decisions taken by a particular society to effectively tackle one or all of these problems, and the institutional means already in existence or freshly designed for that purpose do not depend on purely economic considerations of cost and benefit only. Nor is there any degree of specificity associated either with the economic targets or institutional means such that defy their part or total substitution. A particular decision as regards the allocation of productive resources which determines both the volume and composition of real output to be produced and its division between the market or government sectors arises out of the preferences, values and the political influence of the various sections of a society. Similarly, the distribution of effective demand as between the various spending units of a society is vitally linked with a given state of income and wealth distribution and desire of the society to alter it.

It will be wrong to assume, therefore, that the superficial similarity of tools of economic policy used in different societies proves the "means specificity" of the economic issues stated above.

Islamic Economy: A Three Sector Model

Modern economies offer two institutions to tackle allocation and distribution problems, namely, the market and the government. Alternatively, the two may be referred to as the private and the public sectors. Private sector is characterised by the forces of demand and supply, price and profit motive. The public sector acts not in defiance of the forces of demand and supply as reflected in the price phenomenon but as a corrective mechanism and as a supplement to it. In this sector profit motive is substituted by social welfare. In the so-called free enterprise economies, private sector is the prime allocative and distributive mechanism whose excesses, lapses and distortions are corrected by the public sector. The socialist economies reverse this role - public sector is the prime allocative and distributive mechanism while the private sector acts as the minor partner in the process. However, an Islamic economy may be characterised as a three sector economy. It will comprise the private sector motivated with profit, the private sector free of any profit motive (the voluntary sector) and the public sector. Alternatively, we may describe the three institutions as the market, voluntary economic institutions and the government. The three sectoral characterisation of the Islamic economy derives from the value premise of an Islamic society which involves the voluntary flow of a sizable part of its total resources in such activities as are calculated to attain welfare on the day of judgement but have significant economic implications for the society.

To avoid confusion, it may be appropriate, at the very outset, to define the third sector. It encompasses all such individual and social activities, which are not by intent or design, undertaken to attain any economic or material benefit for the doer or doers, but generate wide ranging economic repercussions. Thus though some of these operations may appear outwardly similar to the private sector but are essentially different in object and conduct. For instance, the cash disbursement of *sadaqat*, creation of *awqaf*, organisation of education and health services for the poor, contribution (voluntary) to the state's defence needs, construction and maintenance of mosques, provision of shelter and meals to the way-farers and various forms of charitable activities fall within this sector. To this, we may add that part of *zakah*, which may be left for assessment and distribution to the individual assessee - we mean *zakah* on *amwal - batinah* (as specified for instance, in recent Pakistan legislation). Empirical and historical evidence suggests that substantial economic and financial resources have passed through this sector in Muslim countries.[9] The volume of the economic resources flowing through the third sector will be a function of the state of *taqwa* of an Islamic community. It will be, so to say, a barometer of the state of moral health of the *Ummah*. It will be distinct from the public sector in as much as it will be totally free from any element of compulsion. Even in an Islamic society state operation will in effect be compulsive in nature even if overall design may be decisively moral and religious. Moreover, there is nothing wrong if the public sector is actuated by economic benefit and aims at maximization of profit or of eventual social good. But the third sector will lose all, if it aims at economic benefits.

The Allocation Function

The allocation function in an Islamic economy will be performed through each one of these institutions separately as well as jointly with each institution working complementarily to the other. But each sector will operate in its own characteristic way. The market mechanism, however, will not be the only institution in the allocation branch. Its allocative function will be implemented through the price mechanism acting in conjunction with the profit motive. The pattern emerging out of the market mechanism will. however, be modified by the voluntary institutions operating through *sadaqat* and non-profit economic activities of the economy. This modification may basically alter certain economic magnitudes and flows.

In the first place the allocation of sizable monetary resources through the voluntary institutions may increase private expenditure in some crucial avenues of productive activity where the market fails to operate. For instance, it is likely to increase private expenditure on the production of goods and services beyond the equilibrium indicated via the equality of marginal revenue and marginal cost. In modern market based economies such a shortfall in production is compensated by supplementary public expenditure. Private institutions may also channelise privately owned savings in such avenues that do not indicate a reasonable rate of return to private investment. As an illustration we may cite the production of coarse textile fabrics the profit motive of the private businessman prevents him from expanding his supplies to meet the full societal requirements. For such an expansion is likely to exercise a downward pressure on prices, thereby reducing the reasonable rate of marginal return, a calculation not wholly

(9) See Siba'i.

based on objective cost assessments but partly derived from subjective evaluation of what constitutes a reasonable rate and the expected rate of return in alternative investment. The second case may be illustrated through the provision of rent-free schools, development of shrines. etc. Thus voluntary institutions may do two specific things. They may make up the shortage of output of goods and services which the market fails to do and secondly invest in such avenues as do not attract private capital motivated by profit.

Public and Quasi Public Goods

Modern economists usually classify goods into two separate categories, namely private goods and public/social goods. The latter are defined as those economic goods which the entire community consumes, and in whose respect cost and revenue calculations are not possible on account of the indivisibility of benefit derived there from. For instance, defence is a public good. Radio and T.V. networks are other examples. It will be more appropriate, however, to define public goods not on the basis of the indivisibility of the benefit derived there from but on the basis of their being non-profit goods, that is to say, goods required by the society whose benefit is not translatable in terms of economic revenues. For example, investment in education, science research, health and certain items of social overheads. In all modern economies public goods are usually reserved for the state. The state ensures allocation of a part of the community's resources to the production of public goods, usually through conscription, or borrowing. In an Islamic economy, however, the voluntary institutions will play a significant role in certain areas of public and quasi public goods. Private resources may be passed to the state for some activities, or may be directly expended on their production. For instance, education is one important area where considerable private resources may flow without regard to a reasonable rate of return. In this respect it may be pointed out that religious, general and scientific or technical education are all treated at par in so far as they jointly improve the quality of a Muslim community and its prowess. That is the reason why all knowledge has been strongly recommended by the Prophet's tradition as the goal of the Muslims. Next is the provision of health care for the diseased, incapacitated, weak and poor which is a necessary and desirable quality of the *Muslim Ummah*. Thirdly, defence may also claim a sizable part of resources channelised through the voluntary institutions. We may, therefore, envisage that in an Islamic economy voluntary institutions will provide not an inconsiderable part of the resources required for the production of public and quasi public goods and services.

Gross National Output and its Composition

The voluntary institutions will, however, exert a direct influence on consumption and national output. The disbursement of accruals from *awqaf*, *zakah* and *sadaqat* to those who do not have financial resources to buy certain goods/services or their desired quantities are likely to enter the market and thus raise the money demand. With higher marginal propensity to consume, the receivers of these funds are likely to spend proportionately a greater part of their income on consumption. Given excess capacity and unemployed resources, this phenomenon may release forces that increase output of such consumption goods as enter the poor mans budget. That may result in a different pattern of intersectoral and intrasectoral allocation of resources and alter the composition of the society's output. It is obvious that the resultant change in the composition of output will be in favour of the poor man's goods and services. This will be an indirectly allocative impact of the voluntary institutions which will express itself through the market.

Optimum Allocation

An optimum intersectoral and intrasectoral allocation of resources is a desirable objective of every economy. The market mechanism fails to bring about the desirable pattern of intersectoral allocation of community's resources for the obvious reason that it acts on the basis of profit - the only relevant factor in its behaviour. Its decision as regards the priority of investment in different sectors may not coincide with the optimum required by the sum total of socio-economic benefits or costs. Any deviation from this optimum is corrected by the state both through regulatory techniques and direct participation in the economic process. In the three sector model we have presented above, the distortions emerging out of the market mechanism will be rectified by voluntary institutions as well as the government. We have already indicated above that an allocation pattern weighted in favour of luxury goods/or comforts will be suitably altered by the activities of the voluntary institutions. Thus within the industrial sector (intrasectoral) itself an altered allocation of resources may be brought about. As between industry, agriculture and services, the allocation emerging out of the market will be similarly modified. We have already discussed above. the wav in which social services will attract not an inconsiderable part of resources flowing through voluntary institutions.

Role of the State

It may be safely asserted that a significant part of the role associated with government in correcting distortions or deviations from the socially optimum allocation of resources will be taken over by the voluntary institutions. Even though minimal, the government's role will not be any the less important. First, the government may alter the pattern of voluntary institution's expenditure through its educative effort. It may provide the necessary information in respect of the needs of the poorer classes. expend a part of the resources handed over to the public sector in accordance with its own assessment of priorities, alter the time and spatial distribution of *zakah* and *sadaqat* resources. use or cause to be used a part of these resources in directions where market forces have resulted in supply deficiencies. As indicated above the voluntary institution's economic behaviour is likely to change the market allocation of resources through its impact on consumption demand. But the government sector's allocative function will not be limited to indirect or complementary/supplementary measures. Its allocative function will also relate to direct public expenditure in those avenues where neither of the two sectors, jointly or separately, are able to enter, or where supply deficiencies require a larger share of the community's resources than that allocated otherwise. It may also involve the removal of sectoral disparities generated through the economic activities of the two sectors.

Deviations from, or failure to attain, the socially-optimum allocation of resources, will therefore, be corrected by the government sector. Although such a failure of the market mechanism may be partly compensated by the voluntary institutions in an Islamic economy, gaps arc still likely to remain for the reason that this sector too, by reason of its individualistic approach, will fail to take a total view of society's economic and social needs. Although proceeding from different value premises and working under different assumptions, both the market and voluntary institutions may result in socially sub-optimal allocation of resources. An example may help in understanding this situation better. Roads connecting the market with the production point may be translatable in terms of cost/revenue calculation of an entrepreneur. But roads connecting far-off villages to the town are most likely to be excluded from the list of profitable investment of the private sector as well as the voluntary institutions' evaluation of what is useful for the under-privileged in the society. Similarly industrial projects with long gestation periods are likely to attract much less capital than necessary. Hence, the government sector will be required to step in.

Given its concept of social welfare, and given its value premise. the Islamic economy will decide the mix of its resource allocation between the three sectors. Where and if, the actual and optimum intersectoral allocation of resources do not coincide, the government will strive to correct the intersectoral imbalance of resource allocation through the devices indicated above as well as taxes. Contemporary discussions of optimal intersectoral allocation of resources, may be traced back to Hansen and Galbraith. Hansen contends that the public sector should be used to promote educational and cultural development. He believes that economics in a mature society should emphasize social priorities rather than the goal of maximum national output. Galbraith asserts that due to traditional bias against public sector spending and what he calls a "dependence effect" there has been an under-allocation of resources to the public sector. This discussion, however, does not indicate a theoretical principle which may guide an optimal allocation of resources, except that of relevance of social objectives. The attempt made by some economists to work out a precise formula of resource allocation through the indifference curve technique is at best arbitrary. The production potential of the society, as determined by its resources and technology is brought into a relevant relationship to society's preference, for public and private goods, as made effective by the state of income, wealth and political choice and shown through an indifference map. But that is an effort which proves conclusively that no "value-free" marginal analysis based criterion of a universally valid optimum intersectoral allocation of resources is possible. The Islamic economy will determine the optimal allocation of resources as between three sectors with reference to its social norms and value premises. Its guiding principle will be the maximization of aggregate social welfare which has both a material as well as spiritual dimension.

An optimum allocation of resources in an Islamic economy may be defined as the one that establishes an equilibrium between the moral and economic imperatives of the society, given its income, and the state of technology. As indicated above moral imperatives will be primarily taken care of through the voluntary institutions, while the institution of market will reflect its economic imperatives. The public sector will not only supplement the economic activities of the two but will also act in a way calculated to ensure a better performance by both. In addition to this aspect of the government's economic activities, the allocation function of the public sector will also involve direct public expenditure to help the economy reach the equilibrium indicated above.

Figure 1.
Optimal Inter Sectoral Allocation of Resources in an Islamic Economy

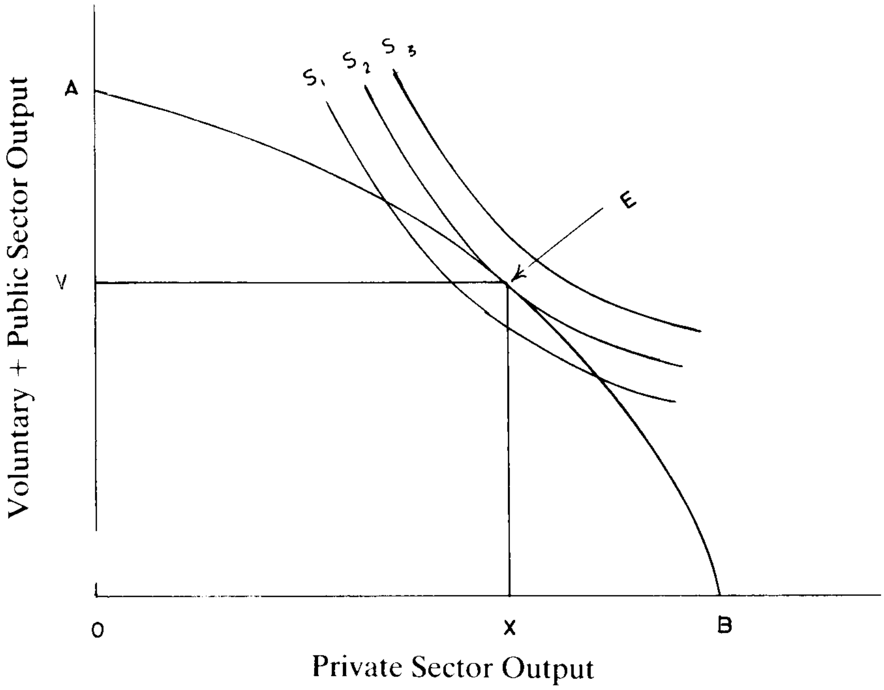


Fig. 1 - showing an optimal allocation of resources between the private sector with profit and voluntary sector. The public sector has been shown on Y axis together with voluntary sector. S_1, S_2, S_3 are social indifference curves. The point where S_2 is tangential to production possibility curve AB is that of optimal allocation. The distribution of resources shown in the above diagram has only an illustrative significance. It is subject to change in response to the general economic and technological requirements on the one hand, and the state of moral consciousness of the Islamic society, on the other.

The Distribution Branch and Islamic Economy

Although in an Islamic economy the distribution function will be performed through the activities of the voluntary institution sector aided and supplemented by government operations but for purposes of the present analysis, let us assume that most part of *zakah* resources - the chief distributive device - are imbursed through the state. Thus distribution function may be initiated through any facet of the government budget ranging from expenditure policies to various forms of government revenue-gathering activities.

The main objective of distribution function may be achieved through either an exhaustive public expenditure programme or a scheme of negative taxes and or transfer payments or other secular taxes on income and wealth. Since *zakah* proceeds are envisaged as the principal redistribution mechanism in an Islamic economy and since it is traditionally a form of transfer let us start with it.

Zakah **as a Negative Tax:**

The transfer of funds between individuals through *zakah* disbursements or other taxes may redistribute real income amongst the members of the society via the redistribution of purchasing power. *Zakah* payment may be conceived of in terms of what is described as a "negative tax". Under the concept an individual is considered to be capable of making a positive tax contribution to the government if his personal income exceeds poverty level proportions but is considered eligible to receive the negative transfer of funds from the government if his personal income is below a designated poverty level of income. Under *zakah* transfer payment the government may similarly designate a poverty line based on current living standards and make payment to those individuals whose income falls below the poverty line so designated. But the calculation of such eligibility will be more complex in an Islamic scheme of things. Any poverty line designated with reference to current standards of living and income will have to be adjusted in the light of *zakah nisab*. *Nisah* allows for a dynamic interpretation in terms of cost of living index and reasonably defined current standards of living (See al Qardawi). But sometimes there is a loose link between current incomes which fall short of needs and ones savings in terms of gold/jewellery, which exceed *zakah nisah.* Hence, the disbursement of transfer payments, will have to take into account both these aspects of the situation. (See Figure II A & B).

A l00% payment of trunsfer/*zakah* funds to bring individuals above the poverty line may have to be revised for its likely disincentive effect on work effort. Thus a trade-off may necessarily arise between the goal of alleviation of poverty and protection of work efforts. In case l00% transfer/*zakah* payment conceived as negative income-tax to bring individual above the designated poverty line involved an expenditure in excess of *zakah* proceeds, a trade-off may inevitably arise between the goal of mitigation of poverty, preservation of labour incentive and loss of revenue. In that situation a 40% or 50% payment may be considered as sufficient.

Figure II A
Diagram showing 100% Compensation for being below Poverty Line

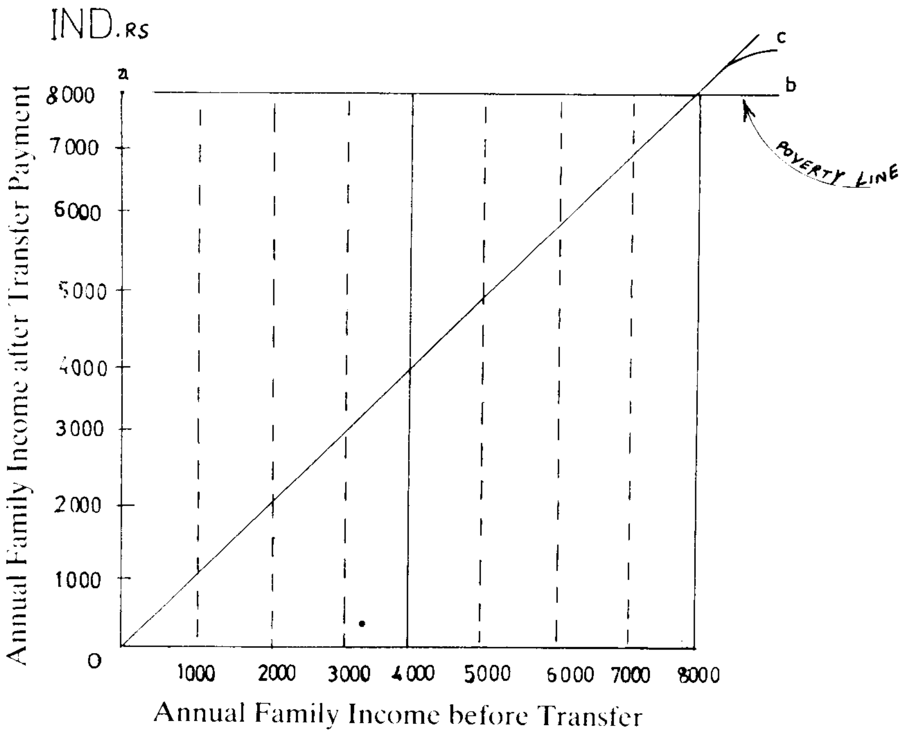
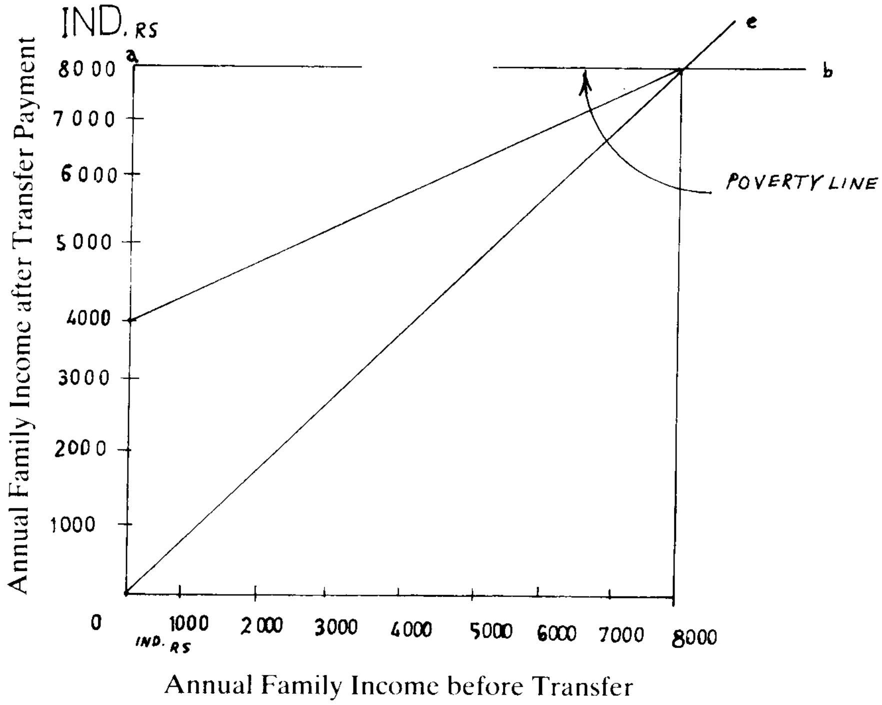


Figure II B
Diagram showing 50% Compensation



Notes: These diagrams are based on the assumption that the Income Tax exemption limit represents the poverty line. At the time the study was prepared Rs. 8000/- p.a. was the personal Income Tax exemption limit in India. Since then it has been revised upward to Rs. 1500/- (1982). As stated in the text the poverty line has to be redrawn with reference to current reasonable living standards and *zakah nisab* assessment criteria. The significance of the above diagram lies in exploring the possibility of laying down a theoretical framework for *zakah* disbursement and its likely adjustment against work efforts and incentive.

Exhaustive Public Expensiture and Redistribution Function

Modern governments have the option to redistribute real incomes either through transfer payments or direct availability of certain important quasi public goods to the poor. A mix of both the approaches however, is a realistic policy goal. There are some pertinent questions that arise in this respect when we proceed to analyse the approach of an Islamic state to its distributive function. As we have seen above *zakah* disbursements in the form of transfer payments or negative income-tax have traditionally been held valid. But the formulation of an exhaustive public expenditure programme intended to make available to the poor certain important public or quasi public goods financed out of *zakah* revenues is received with mixed feelings by the knowledgeable. At any rate, two forms of public expenditure programmes for the poor are universally approved. These are education and health programmes. Educational programmes not only improve the ideological and cultural receptivity of the poor but enhance their income earning capacity as well. Empirical researches have conclusively proved a positive functional relationship between human resources development and aggregate economic performance of a nation/community/group of people. The tendency of the market is to under-supply education items from its nature of being a quasi public good, that is to say, a good whose benefits defy easy quantification or pricing. But increase in the supply of education to the poor has a redistributional role as well. If free of charge, it confers direct financial benefit on the recipient and ensures future financial returns in terms of increased earnings. In this regard technical education is of greater importance. It benefits the poor more by increasing their skill and income-earning capacity.

An Islamic state's distribution function may, therefore, be performed through an expenditure programme of education, medicaid, medicare facilities. These items belong to the allocation as well as distribution branch of fiscal economics. But direct production of a number of private goods, such as textiles, shoes, medicinal drugs, etc., free of cost or at cheap rates to the poor, and financed out of *zakah* funds are also permissible within the *Shar'iah* limits.

Stabilization Function and Islamic Fiscal Policy

If we assume that Islamic economies are expected to materialise in that part of the present world which is characterised as underdeveloped, many of the destabilization problems, such as the deflationary or inflationary gaps of the intensities experienced by advanced economies will not be relevant. Still some such problems as monetary inflation, temporary recession may be experienced depending upon the financial organization of the Islamic economy.

If the Islamic economies opt for a fractional reserve monetary system, where banks have the power and ability to create bank money, excess credit situations may occur. The substitution of interest by *mudaraba* or profit-sharing and consequent restructuring of the capital market, are calculated to establish a direct link between bank money and productive investment. But the urge of the banker to seek more and more avenues of investment will still be there, with the significant difference that he will be directly exposed to losses, if the investment is not profitable in the strictly economic (not financial) sense. It is sometimes argued that such a direct involvement is most likely to dissuade the banker from excess credit creation, for marginal investment may be highly risky. But the fact that the bank portfolio may be quite wide ranging and that losses in some investments may be absorbed partly by the cushion provided for this purpose, and the specific provision in terms of reserves may insulate the shareholders from shock of losses, may still encourage the banker to create excess credit. Any amount of credit that does not correspond to the real resources elsewhere in the economy may generate inflationary pressure. To this urge we may add differing interpretations of what is an economically profitable investment. The banker intent upon maximizing the earnings of his shareholders may include not only productive investments on his list of sound investment projects but quite an impressive schedule of commercial transactions, which do not add an iota to GNP. In the absence of speculative transactions involving bonds and stocks wide fluctuations in market conditions are not feasible. Hence such investments will continue to be attractive. Thus bankers in an Islamic state may also be prone to excess credit creation. Financing of public expenditure through the printing press, or bank borrowing (free of interest) may accentuate the inflationary gap.

Zakah collection and its disbursement may act as effective stabilizing agents against such a situation. *Zakah* levies even though not directly connected with current income will, in effect, constitute a charge on it. With fixed rate, *zakah* levies will, therefore, constitute an in-built fiscal stabilizer. *Zakah* disbursements, however, may work as discretionary fiscal stabilizers as well, with the government managing it as it does transfer payments or exhaustive government expenditure programmes. It may, however, be pointed out that on account of the *zakah* rate and base being given, it may not be adequate to the needs of the situation in some periods. In that situation other taxes, whose rate may be varied, and transfer expenditure, which are not financed out of *zakah*, may be used to that effect.

A comprehensive set of fiscal measures appropriate to an Islamic economy may be designed to remedy such a situation. The elimination of modern varieties of purely financial papers and speculative trading in them, will exercise a restraining influence on excess money supply. In addition the state may devise discriminatory penal taxes on some investments and businesses that exert relatively higher destabilizing effects on the economy. Moreover, it may decrease/increase public expenditure depending upon the needs of the situation.

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