

# Issues in Financing Corporate and Public Sector Needs through Islamic Instruments

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# Needs of Public Sector

If we review the history of Muslim states in the first two centuries, evidence is found for the state spending on the following heads:

1. Beneficiaries of *zakah* and *khums* (these have been mentioned above)
2. Grants to Individuals. These included regular pensions, monthly rations of food (and some times clothing) and occasional bonuses
3. Military Equipment and Installations
4. Civil Administration including market inspection (*hisbah*)
5. Payments to outsiders for seeking peace and protection or release of prisoners
6. Public Facilities such as public hospitals, rest houses for travelers, postal arrangements
7. Public Works such as building of roads, canals, dams, land reclamation and habilitation, and
8. Welfare Activities

# Resources available to the Public Exchequer (Bait al- Mal)

From the Qur'an and sunnah, five sources for financing public expenditure can be derived. These are:

1. Zakah
2. Khums
3. Fay'
4. Sadaqah/Voluntary Contribution
5. Borrowing

During the period of rightly guided caliphs, which is accepted as a source of Islamic law

6. Kharaj
7. Jizyah (a poll tax on non-Muslims), and
8. Ushur (a trade tax)

# Brief Description and Scope in Contemporary World

In Contemporary world the scope of most of these resources is limited.

- Potential of these sources today
- Role of state in modern times and
- Legitimacy or otherwise of imposing new taxes in modern times

# Potential of these Sources Today

Let us take them one by one: (Comments on the Potential of Each)

Zakah

Khums

Fay'

Sadaqah/Voluntary Contribution

Borrowing

Kharaj

Jizyah (a poll tax on non-Muslims), and

Ushur (a trade tax)

# Role of State

Resource mobilization for the public sector, naturally depends on the role of state.

From an Islamic perspective the state has two kinds of functions:

## (i) Vicegerency and (ii) Agentship role.

In its first role, the state has to implement the provisions of Shariah. This involves two things. First to implement the Shari ah laws in areas where these have been prescribed and second, to undertake fresh legislation to regulate and guide the society in affairs left unregulated by Shari ah. In legislating in such matters the state will be guided by the spirit and objectives of Shariah.

In terms of economic functions of state, it would oblige the state to perform the functions assigned by Shariah on a permanent basis such as *dawah*, defense, law and order, provision of justice and any other function which become necessary under present circumstances for the achievement of the objectives of Shariah. This latter category should emerge from proper process of *ijtehad*.

# Right-Sizing Public Sector

In its agency role the state has to serve the broader interests of the society and to exercise the authority given to it by the **collective will**. The state is obliged to perform any function that the society assigns to it subject to the condition that it does not violate any principles of Shari ah.

In its turn, the society is obliged to provide necessary resources needed for those. The size of the government must be limited by its ability to generate sufficient resources. Except for very short-term, budget deficits can defeat the very purpose for which they are incurred and should not be tolerated.

# Scope of Taxation in Modern Muslim States

There is widespread support for the right of Muslim governments to impose taxes other than the traditional ones. However, Islamic scholars are very careful with regard to seeking clear and proper justification for any additional taxes. They want to make sure that these are meant for the benefit of the people rather than filling the coffers of the rulers. This is due to a very high importance attached to the institution of private property in Islam. No one, not even the government, is allowed to take anyone's private wealth except for clear and strong justification for doing that in view of the overall *Maqasid al-Shariah*. But in view of the well-recognized Islamic principle that public interest takes precedence over private interest, once it has been established that people's interest can be served by a particular tax, taking private property becomes lawful.

In designing taxation policy, if any of the Western criteria of imposition of taxes is in conformity with Islamic values, there is no harm in using it but there is nothing sacrosanct about those criteria. We may have, for example, a "social justice criterion" Even though the taxes may not have to be restricted to rich only, the ability to pay the taxes must be a fundamental consideration. Specifically, even though it is permissible to impose some taxes on the poor, e.g. Tax on unnecessary consumption, they will be mostly corrective taxes and not basically revenue raising taxes. To ensure that taxes do not fall on the poor, it will be necessary to have a clear idea about the incidence of various taxes. It is in this sense that Islamic scholars generally favor direct taxes.

# A Tax with Huge Potential

What is a tax? Loosely defined, “it is transfer of resources from general public to the Government”

A huge transfer of such resources to public sector projects, especially in labour-abundant countries, is what I call ‘Taxation in Kind’.

It means community service for public projects, such as voluntary health workers, teachers, traffic wardens and even building sector laborers.

People properly motivated and employed to serve their own communities can reduce need for public funds on an enormous scale.

# Needs of Corporate Sector

- Needs for Establishing New Firms
- Needs for Expansion

# Sources of Funds

- Loans from Banks
- Floating Bonds
- Selling Shares on the Stock Market
- Retained Profits

# Some Important Islamic Financial Instruments

	CERTIFICATE	BRIEF DESCRIPTION
1	Islamic Deposit Certificates	Based on <i>mudarabah</i> principle, the proceeds of these certificates are meant for general purpose utilization by the issuing institution.
2	Term finance certificates (Declining participation)	The certificates are issued on the basis of a temporary <i>musharakah</i> and is redeemed by the issuer within a specified time
3	Islamic Investment certificates	These are similar to Islamic deposit certificates; but their proceeds are meant to be utilized in specific projects.
4	<i>Mudarabah</i> certificates	<i>Mudarabah</i> certificate represents ownership in the beneficiary company without a voting right issued so far by several institutions including 36 listed companies in Pakistan.

# Islamic Financial Instruments-Contd

5	<b>Sukuk</b>	<p><i>Sukuk</i> refer to financial instruments meant to mobilize resources from the market based on the strength of one's balance sheet, credentials, track record, goodwill and prospects of the proposed project. They are meant to provide an Islamic alternative to conventional bonds. Due their wide spread use we will discuss them in some detail in coming slides.</p>
6	<b>Collective Investment Schemes</b>	<p>A <b>collective investment scheme</b> is a way of <u>investing</u> money with others to participate in a wider range of investments than feasible for most individual investors, and to share the costs and benefits of doing so.</p> <p>Terminology varies with country but collective investment schemes are often referred to as <b>mutual funds, investment funds, managed funds, or simply funds</b>. Around the world, large markets have developed around collective investment and these account for a substantial portion of all trading on major <u>stock exchanges</u>.</p>

# Some Details on Sukuk

*Sakk* (singular of *sukuk*) literally means cheque or promissory note for receivable. Technically *sukuk* refer to financial instruments meant to mobilize resources from the market based on the strength of one's balance sheet, credentials, track record, goodwill and prospects of the proposed project. They are meant to provide an Islamic alternative to conventional bonds. *Sukuk* can play a positive role in mobilization of savings on a vast scale. They benefit investors as well as those who have projects to finance that bear the promise of eventually generating sufficient revenue to meet the costs yet leave a surplus. Their proliferation increases the efficiency of the financial system. Also, they are capable of meeting credit needs of government and businesses in a manner that keeps credit supply linked with real assets.

## Sukuk- Contd

Financial engineers have come up with fancy, often confusing, names for various types where 'engineering' is more in names than in substance. The basic ideas are quite simple. *Sukuk* are basically, certificates based on ownership of certain assets (or their usufruct). Generally, these certificates are negotiable in secondary markets. They represent 'ownership' in the assets (or usufruct) underlying the issue. Those with variable returns are based on *mudarabah* or *musharakah*. More popular are those with pre-determined, fixed incomes like the one based on *ijarah*, (lease). There are *sukuk* based on *salam* or *istisna* contracts. Also there are hybrid issues whose underlying assets are mixtures of these. *Murabahah* receivables being debt obligations are not considered fit for *sukuk* issue. But they have been accepted in such a mixture as long as they are in a minority. Due to this last point, while *sukuk* offer a usefully potential mechanism for secondary market resource mobilization, they also open the way for sale of debt receivables (as minority share in a general *sukuk* issue). Since, the sale of debt except at its face value is not generally acceptable by scholars, the use of *sukuk* where debt receivable are a noticeable proportion, remain suspect from a *Shariah* point of view.

## Sukuk- Contd

Even these popular ijara sukuk got a jolt when the chairman of the Shariah Board of AAOIFI, made a remark in November 2007 that about 85 percent of sukuk did not comply with Islamic law because of repurchase agreements. That sent shock waves to the sukuk market around the globe and according to industry experts sukuk issuance dropped to around \$14 billion in 2008 as compared to some \$50 billion in 2007. Though Standard & Poors estimated in September 2008 that the sukuk market will exceed \$100 billion by 2009, even with the latest hiccup, no RELIABLE statistics exist that can confirm that their estimation was fulfilled.

## Sukuk- Conclusion

‘Damage control’ efforts have started earnestly, but my own view is that even if the sukuk market witnesses some recovery, it will in the short-run be only due to excess liquidity in the market. Sukuk will remain under clouds for some time and there is a big challenge for financial engineers to come up with new sukuk structures that can reassure investors about their Shariah-compliance. Every challenge is also an opportunity and this one is a trillions-dollars opportunity. Therefore, financial engineers better get to their drawing boards quickly.