

**RESOURCE MOBILIZATION FOR GOVERNMENT EXPENDITURES  
THROUGH ISLAMIC MODES OF CONTRACT: THE CASE OF IRAN**

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The paper argues that in conventional economic system, fiscal and monetary policies are independent of each other, unintegrated and often conflicting. As an example, he points to the “crowding-out-effect”. The crowding-out effect arises from the way money has been defined and through money market via the rate of interest. This paper argues that in an Islamic economy, financial (rather than monetary) and fiscal policies are not necessarily mutually exclusive. In the absence of interest-based loan markets these two policies not only co-exist, they also reinforce each other. The paper attempts to demonstrate that the Iranian experience in using integrated financial and fiscal policies has been quite successful. An Islamic state can use Islamic modes of contract to partially or even completely finance some public expenditure.

**1- INTRODUCTION**

If a fallacy is allowed to enter into a system it will ultimately perpetuate itself into more self-defeating features. One of the most hazardous fallacies in capitalistic economic system is the allowance given to the “interest” to exist and play a redundant role in the system. The results emanating from this dangerous and fatal allowance are inflation, unemployment, recession and stagflation. On the one hand, positive rate of interest does not allow capital to be used up to its maximum (potential) level at which the marginal product of capital ( $MP_K$ ) becomes zero.<sup>1</sup> On the other hand, banks are allowed to create money as much as possible within the limits of the required reserve ratio irrespective of the production capacity of the economy in the sense that any element (in this case, rate of interest) which prevents money from being used as real (physical) capital will make its own way into money market. Classical economists have failed to recognize that the mere existence of interest would automatically require speculation, hoarding money and holding idle-cash balances as its prerequisites.<sup>2</sup> It was left to Keynes to recognize this necessity and to put it in a theoretical framework. Having truly recognized the impact of a positive rate of interest on the economy, Keynes admitted that not only interest is of no help but

rather holds back the productive capacity of the economy and “ may make automatic full employment impossible, even if wages and prices were entirely flexible”.<sup>3</sup>

Keynes must be regarded as the most influential economist, ever since classical economists, to have fully recognized the adverse effects of having an interest-based economy. Yet he was incapable of offering a substitute institution for interest. It is interesting to note that despite all the evils that exist in a capitalistic system he added one more fallacy into it; i.e. regarding capital and money similar and interchangeable phenomena.<sup>4</sup> This, seems to me, is the reason why rate of interest has been given so much weight and attention in this system while almost no significant role is seen for the rate of profit in Keynesian macroeconomic analyses. Furthermore, monetary theory has over-shadowed the capital theory and has unnecessarily been recognized as an unsolved issue.<sup>5</sup>

The fallacy of recognizing the institution of “interest” as something real, rather than conventional has led the Western economists to consider money as a real good.<sup>6</sup> It did not take a long time for Western economists to realize that the standard macroeconomic theory deals with five aggregates (i.e. consumer goods, producer goods, labor services, money and bonds) but that, at the same time, only three relative prices are solved for (i.e. the price level, the wage rate and the interest rate).

Looking at the constrained optimum solution, this implies that one of the goods must either be merged into one of the others or eliminated in some way. The redundancy of money market was not recognized by Western economists. To solve the problem in their way, i.e. to keep money market intact, Keynes aggregated capital goods (or their financial counterpart, equities) with bonds to produce four markets: consumer goods, non-money assets, labour force and money.<sup>7</sup>

In this aggregation, the rate of interest replaced the rate of profit and crucial role of the rate of profit was almost forgotten.<sup>8</sup> This is probably the reason that capital market is overshadowed by money market in the Keynesian model.

Another self-defeating character of the capitalistic system is the separation of monetary policy from fiscal policy which really makes the system such an untegrated one that it is, as if, the two policies have been designed for two separate economic systems.<sup>9</sup> This futile insistence is still adhered to in spite of that system’s inability to combat<sup>10</sup> inflation and /or unemployment. This feature by itself has brought about the long-lasting debate between monetarists and neo-Keynesians on the crowding-out effect.

Monetarists have for long time challenged the position of Keynesians on the grounds that fiscal policy produces strong crowding-out effect whereas monetary policy, by producing a strong impact on output, does not cause any such effect.<sup>11</sup>

Changes in the pattern of government spending obviously have real effects on the economy. Public spending may, perfectly or imperfectly, substitute for private spending in such a way that changes in public spending may be fully or partially offset by private spending. Hence, the crowding-out effect may be at work.<sup>12</sup> This effect can be interpreted as a situation in which wherever government is present, the private sector shall be absent. This, naturally, makes one to think that the public-private goals might be mutually exclusive and, therefore, there is a conflict between the private and the public interests. This is, the special feature of the capitalistic system.<sup>13</sup>

Even if government spending is on public goods the effect will depend on whether the change in spending is thought by the public to be permanent or transitory. One should not, however, expect change in government spending to have a one to one effect on aggregate demand.

It is important to note that whether the simple version of the crowding-out effect is used or it's more sophisticated one (with government budget restraint), the effect in the former is at full force but the effect is mild in the latter case; although it will not be entirely eliminated. The reason is that in both cases there is an adverse effect on investment through the rate of interest, i.e. an increase in the rate of interest would cause a decline in investment expenditure.<sup>14</sup> This is shown Fig. (1) below:

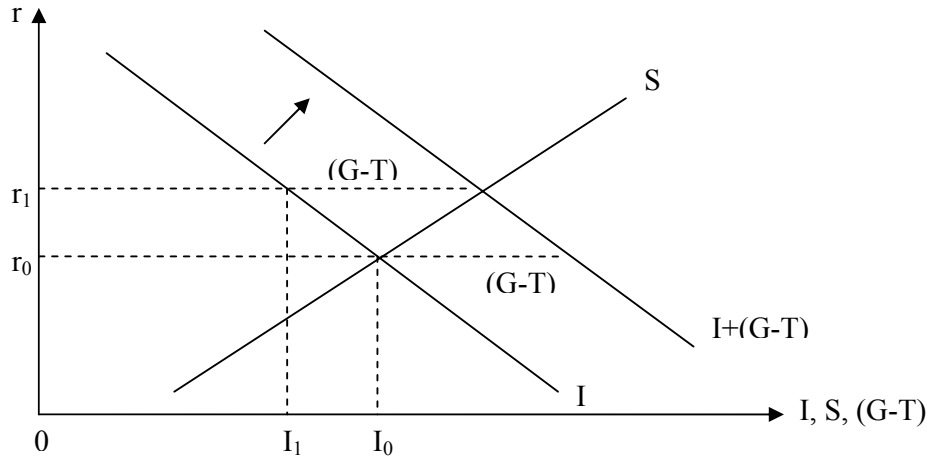


Fig. (1): The Crowding-out Effect

As a result of budget deficit of the amount  $(G-T)$  through borrowing from the money market, the investment curve  $I$  would shift to  $I + (G-T)$ . This would result in an increase in the rate of interest from  $r_0$  to  $r_1$ . In such a case, there are three effects working together. Increase in the rate of interest would increase saving, moving along  $S$  curve; but there are two adverse effects. One is a reduction of private investment from  $OI_1$  to  $OI_0$  and the second a decrease in consumption to finance the increased saving. Therefore, any increase in government expenditure will be offset by an equal amount of reduction in private spending.<sup>15</sup>

The important point is that it is possible, under these circumstances, to have the rate of interest reduced to  $r_0$  even if government tried to compensate for the increase in the rate of interest because as soon as an increase in demand for loanable funds has caused the rate interest to go up, it will not go back to  $r_0$  unless an equal amount of money is poured into the market which is self-defeating.

Keynes, in my view, has had the clearest idea about the capitalistic economy. He believed that presence of unemployment in this system is the rule full employment is the exception.<sup>16</sup>

## **2-SOCIAL RESPONSIBILITY: BALANCE BETWEEN PRIVATE AND PUBLIC INTERESTS**

Man has two characteristics, first his worldly life (body) which determines his tendencies towards lust and material possessions and indeed explains the characteristics which man has in common with other animals and second, the Godly

and Heavenly characteristics (soul). The latter are the driving force behind his tendencies towards ethical values. In part, this distinction shows the difference between man and other animals.

*“By the soul, and the proportion and order given to it;*

*and its enlightenment as to its wrong and its right”. (91:7-8) Qur’ān*

On the basis of the above principle, one can search for the cause of any social conflict in the inherent contradiction between the two characteristics of man mentioned above.<sup>17</sup> Since the root cause of all social problems and wars stems from the inner battle between the two dual tendencies of man, remedy and solution should be sought in the same place; i.e. inside man. So long as battle does not end with the victory of wisdom over any lusts, any solution put forward would, in time, prove fruitless. That is why the Holy Qur’ān establishes an unbreakable relationship between the inner part of a man’s life and his external world and beliefs. It is important to state that the motion of human societies throughout the history has always been a function of the evolution of man’s inner world:

*“Verily never will God change the condition of a people until they change it*

*themselves (with their own souls)”. (13:11) Qur’ān*

Believing that Allah is the ultimate owner of everything is the most fundamental principle in the school of economic thought in Islam. However, it should be noted that here the ownership not be understood in its legal context but in its philosophical interpretation which explains the true sense of creation and the domination of Creator over his created world which is a real and most developed type of ownership.

The Holy Qur’ān has vigorously emphasized this concept of ownership:

*“Yea, to God belongs all that is in the heavens (skies) and on earth”*

*(53:31) Qur’ān*

*“Yea, give them something yourselves out of the means which God has given to*

*you”. (24:33) Qur’ān*

A Muslim under the strict observance of this principle will never look upon acquiring wealth as his ultimate aim, and even when he earns it, he strongly believes that what he has earned belongs to Allah, the Almighty, and his role is to act as a vice-regent of the real owner, who is Allah, the Almighty:

*‘It is not your wealth nor your sons, that will bring you nearer to Us in degree;  
but only those who believe and work righteousness’.* (34:37)Qur’ān

On the basis of this Verse, it can be agreed that general life in this world is a trial for all the human beings. A true Muslim should take his trial with utmost care and vigilance in order to be nearer to Allah; otherwise he cannot succeed in this trial.

This principle also provides the basis for the assertion that Allah, as the ultimate owner of the universe, created wealth on earth for the benefit of all and not for the benefit of only some groups. Indeed, the main axiom is that the property and assets in a society belong to its people as a whole, and in case of a conflict between the interests of individuals and those of the society’s, preference is to be given to the interests of the society.

*“In order that it may not (merely) make a circuit between  
the wealthy among you”.* (59:7)Qur’ān

Although Islam accepts the differences in individual’s income and recognizes it as a natural necessity which stems from the existing inequality between the talents and capabilities of individuals, yet at the same time it forbids the perpetuation of this difference in the social system of Muslim society. The holy verse does not give any definition of the desired balance but based on some interpretation of existing evidence, the Holy Qur’ān condemns the concentration of wealth in the hands of a rich minority. Rather, it should be used to generate benefits for the public as a whole, though not necessarily on an equal basis.

It is interesting to note that in order to achieve the proper balance between individual and the general public interests; the Third Principle (Chapter One) of the Constitution of the Islamic Republic of Iran asserts that:

*The government of the Islamic Republic of Iran, in pursuance of .....is obliged to use all her potentialities for the following:*

*.....the participation of the general public to determine the political, economical, social and cultural destiny of her own....development and strengthening Islamic brotherhood and cooperation among all people.....*

More will be said about this in the following sections.

### 3. LEGAL BACKGROUND

In complete absence of an interest-based loan market in an Islamic economy, we shall not expect the aforementioned adverse effects of capitalistic system to exist. The absence of this institution (interest) combined with replacement of conflict with cooperation between individuals and the public, one would further expect no room for crowding-out effect to exist in this system; (this will be shown below by use of Fig.2). I strongly believe that the main reason behind the prohibition of Riba in Islam might have been to prevent the subsequent fallacies which will eventually emerge.<sup>18</sup> To this end, the Law for Nationalizing Banks with the following goals was approved by the Islamic Revolutionary Council on 7 June 1979.

In order to protect national rights and capitals, set the wheels of the production in the country into motion and safeguard the deposits and saving of people in the banks, while accepting the principle of right and conditional ownership, and in consideration of:

*...the mode of acquisition of income of banks, and the illegal transfer of capital abroad,*

*...the basic role of banks in the economy of the country, and the natural connection of the economy of the country with the banking institutions,*

*...the banks' debts to the government, and their need for government management,*

*...the need for coordination of the operation of banks with other national organizations,*

*...the need to direct banks' activities toward Islamic management and profitability; from the date of approval of this Law, all banks are declared nationalized, and the government is under obligation to take immediate steps to appoint managers for the banks.*

It is clear from the content of the Law that it was designed to protect the public interests through preventing the outflow of capital, reduction of banks' debts to the government and, last but not the least, and rather the most important of all, was “ the need to direct banks' activities towards Islamic management and profitability”. Following these guidelines “the Law for Usury-Free Banking Operations” was enacted on 30 August 1983 which was intended to be put effectively into action as of 21 March 1984.<sup>19</sup>

Nowhere in twenty-seven articles and four notes of the Law, are banks allowed to lend money. They would rather supply part of the capital<sup>20</sup> of a potential investor. Furthermore, implicit in the foregoing sentence is that banks are supposed to monitor where the capital they have provided would go. Had they been able to provide money (i.e. loan), as is practiced in interest-based banking system, they would not necessarily know for what kind of activity the loan is being used as long as the borrower provided sufficient collateral.

The Law provides thirteen different modes of contract, through which facilities can be granted. These are (1) Qard-al Hasan, (2) Mudarabah, (3) Civil Partnership, (4) Equity Partnership, (5) Direct Investment, (6) Installment Sales, (7) Hire-Purchase, (8) Forward Deals (Salam), (9) Ju`ālah, (10) Muzara`ah, (11) Musa`qat, (12) Debt Purchase, and (13) Guarantee Notes.<sup>21</sup>

Two out of the given goals of the Law read as follows.<sup>22</sup>

*Creation of a monetary and credit system based on rights and justice (in an Islamic framework) for the regulation of a proper circulation of money and credit towards economic stability and development of the country. Working towards the fulfillment of the economic aims policies and plans of the government of the Islamic Republic with the help of monetary and credit instruments.*

To achieve these goals Article 19 reads:

*Policies regarding the granting of short-term credit and facilities (one year) shall be presented by the General Assembly of the Central Bank of the Islamic Republic of Iran, and approved by the Council of Ministers; and policies regarding the granting of five-year and long term credit and facilities, shall be presented to the Islamic bills of five-year and long-term development projects.*

This Article, quite obviously, integrates financial and<sup>23</sup> fiscal institutions as if they were complements, rather than substitute government agencies. This will only make sense if money is considered an “impure public good” and void of being a store of value, as opposed to being a private good and functioning as the store of value which is the case in capitalistic systems.<sup>24</sup>

Integration of financial and fiscal policies will naturally change the substance and functions of the Central Bank and rule out its independence. We cannot have both Islamic banking and independent so-called “monetary policy” at the same time. The advocates of independence of fiscal and monetary policies (mostly, monetarists who

are concerned about the crowding-out effect) have based their discussion on the assumption that the monetary policy is more powerful and works faster than fiscal policy. Monetarists, furthermore, favor rules over discretion of the authorities. They also conclude that money stock is highly associated with economic activity, implying that changes in the latter can be predicted from changes in the former. They further claim that effect of fiscal policy is weak and of monetary policy, strong. Monetarists claim that the money supply (which, according to them, is an important aggregate) is the main source of disturbance; the economy will be better regulated if monetary aggregates are used. These, among other, propositions have led monetarists to the position that a predetermined monetary rule can have the strongest effect on the economy. They have not, as yet, ruled out the use of fiscal policy. However, they strongly believe that its effect is rather weak.<sup>25</sup>

All of the arguments presented above are the positions of Western economists within the framework of interest-based banking system. They cannot, for obvious reasons, be equally used in an Islamic banking system. On the grounds that Islamic banking system is totally different from that of interest-based banking, it is rather a big mistake to follow the Western economists.<sup>26</sup> The mere abolition of Riba changes the most important attribute of money (in the eyes of Western economists) in capitalistic economies. Money can no longer perform the store of value function that it does the capitalistic system. The third function of money in an Islamic setting is to stabilize the general price level. Furthermore, money should be considered an “impure public good”.

#### **4- ANALYSIS OF STATISTICAL EVIDENCE**

In an Islamic state, both financial and fiscal policies could be jointly used as complements in order to serve the interests of the general public. This can be accomplished through stabilization of the value of the country’s money. However, each individual Muslim is presumed to perform his own social responsibility. On the basis of this and the arguments presented earlier and regarding the government responsible for all the successes and failures of the economy,<sup>29</sup> the Islamic Consultative Assembly (the parliament) has approved the Article 19 of the Law for Usury-Free Banking Operations. To this end, ever since the Law has been ratified,<sup>30</sup> the Islamic Parliament of Iran has included Clause No.3 in the annual budget of the country which reads as follows:

*...in order to develop productive employment....the Central Bank of the Islamic Republic of Iran, within the country's monetary policies and in regards to the first economic-social and cultural plan for those development programs which are economically-technically and financially viable; but the required collateral and agent's share of capital does not correspond with banks' regulations, is bound to provide, from the internal sources of the said banks, and in case of insufficient resources from other sources of other banks, the required facilities....*

Provincial distribution of banking facilities and the bank deposits of Iran after the enactment of Islamic Banking Law appear in Table (1). Column (1) of this table shows that in 1984-1985 fiscal years, none of the 24 provinces was able to fully utilize her own bank deposits. In 1989-1990 there has been a slight change. Seven provinces out of 24 in this year did not only enjoy the benefits of their own deposits but also benefited from the surpluses of other provinces and by 1991-92 this number doubled.

Clause No.3 of the recent Iranian annual budgets, as mentioned before, intended to improve the economic conditions of the country through injection of banking facilities. It was left to the executive branch of the state to provide ways and means to this end. Figures in column (2) of table (1) are not promising. [Note (1) Tehran, the capital city, has had exceptional performances, so have the inflicted areas numbered 7, 8,14,15,17 and 18. Therefore, for all possible comparisons special care has to be given to this point].

Column (3) of this table reveals that three of the most deprived provinces of the country (i.e., number 5, 6, and 14) have preserved their status from 1989-90 to 1991-92. Only one of these provinces, number 14, is the war inflicted region whose status has considerably changed from 1984-85 to 1991-92 period. During the period of 1989-90 to 1991-92 no drastic change can be observed except for two provinces, 22 and 23. It is noteworthy that province No.23 which benefited most from banking resources in 1984-85 (ignoring Tehran) also shows a reduction in her deprivation index from 325 to 222.

To use all potentialities of the country to combat poverty and recover the deprived provinces of Iran, the parliament has quite rightly directed part of the banking system's facilities to be used for this purpose. The amount of facilities granted amounted to 122,189 and 424.5 billion Rials for 1990-91, 1991-92 and 1993-94, respectively, [see Table (2)]. Furthermore, both tables show that the initiation of the

Iranian parliament to combat poverty of the Iranian provinces has not been quite successful. However, it was an admirable attempt. The reason for this failure could be attributed to the poverty of the regions themselves. The vicious circle might have been at work. That is, poor regions have, by definition, poor potentialities to absorb financial facilities of the banking system which, in turn, means further poverty. However, the figures show a drastic increase during the period under consideration. It is hoped that further coordination of the executive and legislative branches of the Iranian government would reduce the gap between developed and deprived provinces of the country. There is no need to mention that lot of benefits can be gained from a regionally-balanced growth.

It was claimed earlier in this paper that elimination of the prime fallacy (i.e., the institution of interest) from an economy would not necessarily produce crowding-out effect. To prove this important issue, a financial-fiscal policy mix is used in Fig. (2).

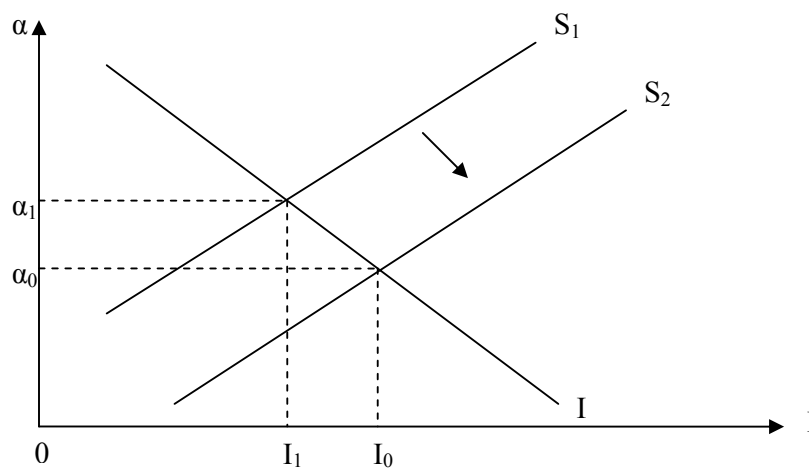


Fig. (2): Absence of Crowding-out Effect

Notes: I= investment; D- demand for investible fund; S= supply of investible fund;  $\alpha$  = relative profit-share of the bank to that of the investor. For further details of constructing the curves and symbols use, see I. Toutouchian (Nov.1993)

The shift of  $S_1$  to  $S_2$  might be thought to be the result of an increase in supply of investible funds in order to finance a portion of government expenditures. This can be accomplished, not surprisingly, by printing bank notes. Since Islamic banks are not

allowed to create money, no harm will be done to the economy by following this practice. Printing money, in this setting means higher level of potential capital (i.e., money) in the hands of the banking system. The banking system will, in turn, transform in into capital. This is, in effect, the force behind the supply of investible fund which would cause the curve  $S_1$  to shift to  $S_2$ .

To match the Iranian experience with Fig.(2), the above-mentioned clause No.3 of the Iranian budget has caused the supply of investible funds to swift from  $S_1$  to  $S_2$  and as a result the relative profit share of the bank to that of the investor to decrease from  $\alpha_0$  to  $\alpha_1$ . The end result would be a reduction in the profit share of the depositors. Now, the question is, should the depositors pay for this reduction? It is worthwhile to note that the ending part of clause No.3 has provided the answer. It urges the Plan and Budget Organization to include, let me call it if I may, the compensating variations, in the next annual budget. This means that government bears the burden of this reduction without producing an appreciable adverse effect on the general public in that the bulk of tax revenues are supposed to be collected from the rich. The ultimate result is that the integrated financial and fiscal policies, without producing crowding-out effect, would increase the level of investment expenditures to serve the public interests. However, the remarkable conclusion drawn from above analysis does not, by any means, imply that the banking system of Iran has been running perfectly. Based upon the findings of my independent studies I have my own reservations in this regard, the discussion of which is beyond the scope of this paper and requires a separate research.

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- The data for Tables (1) and (2) have been supplied by Mr.Gh. Shahrokhi and Mr.M. Yarnia, respectively; both from Iran Banking Institute.

**TABLE 1**  
**SOME ECONOMIC STATISTICS OF IRANIAN PROVINCES FOR SELECTED YEARS**

Province	1984-1985			1989-1990			1991-1992			
	(1)	(2)	(3)	(1)	(2)	(3)	(1)	(2)	(3)	
1	TEHRAN	.25	.98	100	.36	1.30	100	.77	1.01	100
2	CENTRAL	.54	.94	352	1.19	1.18	431	1.15	1.07	434
3	GUILAN	.87	.99	566	.87	1.16	520	1.06	1.29	533
4	MAZANDARAN	.89	.98	633	1.16	1.16	581	1.14	1.14	581
5	EAST AJARBAIJAN	.54	.91	668	.85	1.18	639	1.15	1.04	659
6	WEST AJARBAIJAN	.62	.95	758	1.08	1.19	751	1.09	1.12	737
7	KERMANSHAH	.48	.89	632	.83	1.15	677	1.02	1.48	679
8	KHUZESTAN	.73	.91	577	.55	1.25	570	.57	1.41	561
9	FARS	.31	.97	505	.38	1.19	531	.40	1.07	545
10	KERMAN	.60	.94	631	.78	1.21	546	.81	1.07	530
11	KHORASSAN	.73	.97	681	1.00	1.19	643	1.20	1.03	665
12	ISFAHAN	.35	.98	329	.76	1.21	303	1.20	4.11	315
13	SYSTAN&BALUCHISTAN	.36	.95	805	.48	1.32	764	.56	1.27	766
14	KURDESTAN	.86	.89	824	.94	1.19	794	.93	1.28	792
15	HAMEDAN	.65	.94	772	.86	1.22	742	.96	1.08	744
16	CHARMAHAK & BAKHTIARY	.42	.90	750	.64	1.23	691	1.01	1.09	698
17	LORESTAN	.75	.91	785	1.03	1.18	764	1.07	1.12	772
18	ILAM	.39	.88	772	.94	1.34	614	.93	1.75	681
19	KOHKILOUYEH & BOYER AHMAD	.88	.88	747	1.09	1.19	746	1.30	1.12	747
20	BOUSHEHR	.57	.93	731	.49	1.24	725	.66	1.18	701
21	ZANJAN	.51	.90	606	.93	1.19	623	1.01	1.29	592
22	SEMNAN	.57	.94	450	1.10	1.29	528	1.23	1.13	386
23	YAZD	.58	.94	325	.90	1.31	316	1.15	1.10	222
24	HORMOZGAN	.38	.94	775	.28	1.38	693	.34	1.12	675

Note: (1) = Ratio of banking facilities granted to deposits; (2) Ratio of absorbed to approved budget; (3) Deprivation index (100 means least deprivation).

Numbers greater than unity in columns (2) show that budget amendments have provided the excess of absorbed over approved figures.

Source: Bureau of Economic Indices, Central Bank of Iran, for (1) Total budget of the country for (2) Various Issues. Figures on Columns (3) have been personally calculated. Other provinces; however, this number doubled for 1991-92.

To conclude, it makes a big difference whether an economic system is going to use monetary-fiscal mix or financial-fiscal mix. The former produces a new fallacy and conflict, via changes in the rate of interest, between private and public interests. However the abolition of interest and the resulting elimination of money market in the latter (through capital market) provide and enhance the cooperation within and among economic agents. However, there might be some criticism<sup>31</sup> of this sound and just-founded practice, on the grounds that this action is, in a sense, a cover-up to government's budget deficit. To show the fallacy of this argument, it suffices to give just one example. The ratio of the total banking facilities granted (according to the

budget law) to the absorbed budget, during 1991-92, was 0.07. This small ratio proves that bank facilities were not intended to cover-up government's budget deficit.

**TABLE 2**  
**DISTRIBUTION OF BANKING SYSTEM FACILITIES AMONG IRANIAN PROVINCES IN COMPLIANCE WITH BUDGET LAWS (BILN.RIALS)**

PROVINCE	1990-91	1991-92	1993-94	
1	TEHRAN	6.1	7.9	55.0
2	CENTRAL	4.5	6.5	20.2
3	GUILAN	3.7	6.2	20.7
4	MAZANDARAN	5.2	9.1	30.1
5	EAST AZARBAIJAN	5.0	10.3	35.5
6	WEST AZARBAIJAN	4.6	9.3	25.8
7	KERMANSHAH	6.3	8.1	30.0
8	KHUZESTAN	8.7	13.2	38.5
9	FARS	6.1	10.7	33.5
10	KERMAN	8.0	10.2	30.2
11	KHORASSAN	8.0	12.4	38.2
12	ISFAHAN	5.8	9.0	26.5
13	SYSTAN&BALUCHESTAN	5.0	9.6	25.3
14	KURDESTAN	6.1	8.5	24.0
15	HAMEDAN	4.3	6.3	23.0
16	CHAR-MAHAL & BAKHTIARY	4.0	6.2	20.5
17	LORESTAN	3.6	6.7	27.0
18	ILAM	4.1	5.6	23.2
19	KOHKILOUYEH&BOYER-AHMAD	3.4	4.8	19.4
20	BOUSHEHR	4.1	5.2	19.0
21	ZANJAN	3.8	6.2	17.5
22	SEM NAN	3.8	5.8	23.0
23	YAZD	3.5	4.8	16.4
24	HORMOZGAN	4.6	6.9	20.0
Specific appropriations:				
A	The share of deprived regions	At least 20%	At least 30%	50%
B	The share of employment- Generating activities	50%	At most 50%	50%

Source: Iranian Annual Budget Laws (various issues).

## 5- SUMMARY AND CONCLUSIONS

The practice of Islamic banking has developed new areas of research for investigation and, hence, greatly expanded the frontiers of knowledge of economics. These areas are numerous and, due to the ever-expanding frontiers, hard to identify. In this paper, I have tried to show that in the course of investigating our own Islamic countries we need not follow our Western counterparts. Our problems have their own remedies. There are many<sup>32</sup> instances that we need not, at all, follow the Western already-made prescriptions. The true independence of an Islamic state can be maintained by adhering to her own Islamic values. If these values, and the guidelines derived from them, are properly used by intellectually-independent Muslim scholars, one should expect native solutions to be found for our own native problems.

Independent monetary policy, in the west, has its own logic and that is to give the authority to the responsible agents for the purpose of check and balance and accountability. In a very different society, i.e., an Islamic state like the Islamic

Republic of Iran, with Islamic values prevailing in policy-making circles, every individual Iranian is supposed to bear his own social responsibility; independent action of one institution from others has no room.

My research experiences, and as one of the members of the Usury-Free-Draft-Law-Writing committee, has led me to view money as an “impure public good” and void of store of value. However, I have proposed a different function to be performed by money in an Islamic economy; that being “price stabilizing”function<sup>33</sup>. This function can hardly, if at all, be given to money in a capitalistic economic system. It is because the ability of banks to create money, in this system, does not allow prices to be stable.

Furthermore, these experiences have further convinced me that integrating financial with fiscal policies is a well-and-justly-founded practice, if of course, properly used. I maintain the Iranian parliament has rightly recognized the necessity for this integration and in the process of the country’s annual budget appropriation, appropriate importance has been given to this issue. I further maintain that deep understanding of Islamic economics, in general, and Islamic banking, in particular, would ultimately prevent one to claim that have to use their own facilities independent of social interests’ considerations. Probable weaknesses in banking management should not be attributed to the Law for Usury-Free banking Operations (in the Islamic Republic of Iran). The Law, I feel, is one of the best, if not the best, Law ever since the revolution enacted by the Iranian parliament. It is sound and firm in contents and, if properly used by qualified management, serves the goals of the country the best. Any changes, if made to this law in practice, on purpose or inadvertently, will harm the country more than helping it.

The Iranian experience can be adopted by those Muslim countries with similar banking laws and commitments. They should not fear about the consequences provided that the banking administration is well-trained and well-qualified.

Evaluation of the integrated financial and fiscal policies, experienced in Iran, was beyond the scope of this paper. Theory suggests that promising results should be expected. However, mismanagement and ignorance about its working, undoubtedly, could overshadow the results.

## NOTES

1. See J.M.Keynes (1964); P.203, 234-5, 356; also see G.Ackley (1969); P.192, 405 for a clear the brief explanation of the nature of the “interest” and its consequences.
2. These three elements compose the triangular of store-of-value function of money which I have called “the triangular trap”; see I. Toutouchian (Nov.1993); P.17.
3. Refer to note (1) above. One need not search for a better explanation of unemployment in capitalistic economic system than that given by Keynes. Furthermore, it can easily be demonstrated, with the help of Keynes’ explanation of hoarding and speculation, that inflation is a built-in feature of capitalism (see M.Friedman’s proposal at the end of this note). The equilibrium condition requires that  $S+DH+\Delta M=I$ , where  $S$ =saving,  $DH$ =dishoarding ( $= - H$ ,  $H$ =hoarding),  $\Delta M$ =change in the money supply and  $I$ = investment. Given the magnitude of  $S$ , the value of  $I$  perpetuates, through money multiplier, to a greater magnitude,  $M$ . The only case where  $\Delta M=I$  is to have  $S=H$ . This is a very rare occurrence in capitalistic system because statistical evidence should have proven  $S\neq H$  to be the case. This might have been one reason to have led Professor M. Friedman to suggest 100 percent reserve requirement (See M. Friedman, 1966). This, logically implies that  $\Delta M=I$  which, cet. par., through a positive rate of interest causes the actual investment to fall short of potential investment and lead to inflation. It is also interesting to note that just one out of four principles advocated by M.Friedman (1966) is about monetary policy which is completely independent of his fiscal policy proposals. However, this one proposal is to be used “to eliminate both the private creation and destruction of money and discretionary control of the quality of money by the central bank authority. The private creation of money can perhaps best be eliminated by adopting the 100 percent reserve proposal...” (See M.Friedman, 1966, p.339).
4. This was done through his suggestion of combining bond market with capital market; see D.Fisher (1980); p.30.
5. It is, I suppose, the responsibility of the author and other Muslim economists to review capital theory in the light of: (1) the proper functions

of money in an Islamic economy void of store-of-value but replacing it with “price stabilizing” function, and (2) considering “capital” as an environment and “capital goods” a “whole” and indecomposable into small units, money-wise, but decomposable, time-wise.

6. J.B.Say rightly recognized that money had two functions to perform; namely, the medium of exchange and unit of account (but not store of value). But it escaped him that as soon as one admits a return to money (i.e. rate of interest) it becomes liable to speculation. Leon Walras, from the beginning, assumed money a “good” like other goods in the community; see J.Aschheim and C.Y.Hsieh (1969);pp.35-39 and D.Fisher (1980);pp.44-6. It was left to Keynes to fully recognize speculation, hoarding and holding idle-cash balances as necessary if money is considered a “good” and allow to bear interest; see J.M.Keynes (1964);pp.158-65, 194-210.
7. See D.Fisher (1980); p.30.
8. In a capitalistic economy, the share of “capital” is the sum of profit and interest. One, then, has to ask: (1) if money and capital are the same (according to Keynes) why capital’s share is the sum of profits and interest whereas, in determining the optimum stock, rate of interest is treated independently from MEC? And (2) if capital and money are two different things why, then, in macro-theory textbooks there is no such thing as capital market to be governed by the rate of profit? That is, the role of the rate of profit is overwhelmed by the rate of interest. The former, in reality, determines the level of investment and the later just serves as cut-off rate and part of production cost.
9. The features mentioned in the paper, of course, will not exhaust all the possibilities. However, in the light of the Islamic teachings, higher order fallacies can be found as one digs into the nature of capitalism. One more example is the independence assumption made about utility functions of individuals (see I.Toutouchian [1984] chapter two) which is contrary to God-Created nature of human-beings.
10. One shall remember the Mundell-Fleming result that monetary-fiscal mix is important; see J.Eatwell, M.Milgate and P.Newman (1987); Vol.1, p.730. More importantly, Friedman, implicitly, maintains the

independence of monetary from fiscal policy via asserting that the former is “the best” and “the enemy” of the latter, which is “the good”. “We do not know enough to be able to achieve stated objectives by delicate, or even fairly coarse, changes in the mix of monetary and fiscal policy. In this area particularly, the best is likely to be the enemy of the good. Experience suggests that the path of wisdom is to use monetary policy explicitly to offset other disturbances only when they offer a clear and present danger’; see F.C.Wyckoff (1981); p.287.

11. See C.L.Jain (1981); p.139. For further reading on the subject consult J.Eatwell, M.Milgate and P.Newman (1987); pp.728-30; H.S.Rosen (1988);pp.624-5; C.V.Brown and P.M.Jackson (1991); pp.118-120; and W.H.Buiter (1985);pp.14-75.
12. Refer to M.G.Hadjimichalakis (1982); p.89.
13. This conflict could be viewed as a market failure. Well-known causes of market failure are: (1) imperfect competition, (2) externalities, and (3) public goods; see F.R.Flahe and D.R.Lee (1981); pp.68-73.
14. See M.G.Hadjimichalakis (1982); pp.88-9, 207,243, and 247; C.Christ (1979); pp.526-38; M.Friedman (1967); pp.14-55 and A.S.Blinder and R.M.Solow (1973); pp.319-37. For further elaboration on the interest elasticity of demand for and supply of money consult M.Friedman (1967).
15. See R.M.Miller and D.D.Van-Hoose (1993); p.464.
16. See J.M.Keynes (1964); pp.249-50.
17. For further details see I.Toutouchian (1984); pp.95-111. A version different from these statements can be found in International Association of Islamic Banks (1983, 1403H); part 5; p.148, 150-51.
18. I have shown in my theoretical paper (Nov.1993) that if a recession occurs, in an Islamic state, the mere practice of Islamic banking would most probably dissolve it. It had remained to show that inflation, in such a state, would not, in theory, happen. I have been fortunate to have been able to do it in the last summer, see I. Toutouchian (summer 1994). It should be noted, however, that fluctuations in prices of some commodities, in some years and occasions, may prevail, which is, of course, different from inflation.
19. The responsibility of writing the draft-law for Usury-Free Banking Operations was given, at the beginning of 1982, to the Ministry of

Economic Affairs and Finance. The then Minister delegated the authority to his deputy for banking affairs. A committee composed of three economists (including the author of the present paper), one specialist in finance from the Central Bank, two bankers, one businessman, a lawyer, and finally two ulama (on an alternative basis) was organized. Long sessions were held in order to prepare the draft-law. After preparation, it was discussed in the council of Money and Credit of the Central Bank of Iran, the High-Council of Bank and finally at the cabinet, respectively, before it was handed over to the parliament. A special committee was set-up at the parliament to discuss the items thoroughly which, finally, led to the approval of the above-mentioned law.

I, first, as an advisor to the Minister for Economic Affairs and Finance, and then as the Deputy-Minister for Economic and International Affairs of the Ministry, was present throughout the above-said processes except at the sessions held in the cabinet. I was the only economist who participated in all those stages.

20. “Capital” here has been broadly defined to consist of both equity (physical)-capital and money-capital. One example of the latter is mudarabah contract. In my paper (summer 1989) I have proposed money to mean potential capital and , therefore, as soon as it is legally combined with one factor of production it is to be considered actual capital and, therefore, eligible to earn return. To evaluate which one of the facilities granted by banks can be considered capital or otherwise requires a separate research.

There are, without any doubt, some shortcomings in the Law which have been the source of misunderstanding even among high officials of the Islamic Republic of Iran as well as academic circles. One of the most misunderstood, if dangerous, features of the Law is that the term “monetary policy” has, inadvertently, been used over and over again (see Articles 1, 2 and 20). Admittedly, at the time of preparing the draft-law, no one, including the present author, had crystal clear ideas about all aspects of Islamic Banking. Although my research experience on Islamic economics goes back to 1976 (three years before the Islamic Revolution in 1979) yet, due to various time-engagements, I started my research studies

on Islamic banking about eight years ago. With all my research background taking into consideration, whenever I read the Law, I am convinced that some terminologies and phrases have to be amended. For example, in the light of some consideration in the present paper, as well as other papers of mine, the term “financial policy” must be substituted for “monetary policy” because it truly reflects the spirit of law. That is, Islamic banks can no longer be monetary institution, but rather financial institutions, see note 26 below. Usage of the phrase “monetary policy” has caused, as mentioned before, a great deal misconceptions in my country. It is because those ignorant as well as inflexible unqualified Western trained officials, with little and, most of the time, no interest and knowledge in Islamic economics, quite deliberately, tried to channel banking facilities towards supply of money, rather than “capital”, and more important than that, money creation which is in complete contrast with spirit of the Law reflected in thirteen different modes of financial contracts.

The “credit” is another misused term in the Law which needs modification. It is because credit, customarily, bears interest but if it is interest-less then the Islamic word “Qard-al Hassan” could be used instead. Furthermore, mismanagement of the banking industry in my country has been mistakenly attributed to the so-called shortcomings of the Law in practice. To fully investigate these and other points and also discuss the resistance of the selected unqualified executives in banking industry requires a separate research. Further research is also needed to evaluate the multi-dimensions of the Islamic banking in Iran.

21. For details about the legal aspects and accounting procedures of different contracts, see A.A.Hedayati, et al (1988); pp.72-278. Using explicit and implicit features of the Law, I have been blessed by The Grace of Allah the Almighty to write several theoretical papers on Islamic banking; the interested reader shall consult the references. Most of these papers that have been presented in domestic seminars are in Persian but the English version of “money in Islamic Economics”, “A Brief Comparison between Cost of Capital in Interest-based and Interest-free Systems”, and “Comparative Analysis of Investment in Capitalistic and Islamic Banking Systems under Certainty and Risk Conditions” are available upon request.

22. See parts one and two of Article 1 of the “Law for Usury-Free Banking Operations” (1983).
23. As mentioned before, the nature and substance of practical Islamic banking (on the grounds that it shall supply capital rather than create money) led me to substitute “financial policy” for “monetary policy”; see I.Toutouchian (summer 1989).
24. Ibid.
25. For further details, see C.L.Jain (1981); pp.134-56.
26. Twelve years after the 1979 Islamic Revolution of Iran, this mistake has been committed; see M.H.Adeli (1991). However, it was a big shock to Iranian Islamic-economic experts, including the author of this paper. Adeli, citing economic literature, none of which was on Islamic banking, has claimed that the Central Bank of the Islamic Republic of Iran (and the banking system) has to closely follow capitalistic counterparts and be independent. As mentioned before, independence of a capitalistic central bank has its own logical basis. The basis is simple enough in that banks in that system are allowed to create money by law which, if not properly fine-tuned, could have an adverse effect on the value of the national currency. Hence, to identify the responsible agent for any harm to the value of money, the Central Bank had to operate independently. Therefore, there is a one to one correspondence between authority and responsibility. In contrast, banks in an Islamic state are not supposed to create money, but rather supply capital. Furthermore, in such an economic system, money market shall not exist to have an adverse effect on the value of currency; see I.toutouchian (Nov.1993). Additionally, the responsibility for stabilizing the value of an Islamic state’s currency is on the shoulders of all agents, including each individual citizen of the country, combined. In conclusion, in such a state, the independence of the Central Bank (or the banking system as a whole) is meaningless and, therefore, baseless. To be sure, this does not reduce, by any means, the responsibility of the banking system. In an Islamic state, both financial and fiscal policies must be jointly used in order to maintain in the short-run, and improve in the long-run the public welfare rather than economic interests of powerful groups.
27. See I.Toutouchian (summer 1989).

28. See I.Toutouchian (summer 1994).
29. Refer to I.Toutouchian (Nov 1993); p.19.
30. There is one exception in 1983-84, before enactment of the Law, during which the Iranian economy enjoyed the highest amount of oil revenue since 1973-74. In other words, inclusion of Clause No.3 in the annual budget law was not due to shortage of funds, as some have argued.

Note: The Iranian calendar starts on March 21 and ends on March 20. The following table shows the Iranian solar (Hijrah) calendar with the corresponding Gregorian calendar:

Solar (Hijrah) Calendar	Gregorian Calendar
1362	1983-84
1363	1984-85
1364	1985-86
1365	1986-87
1366	1987-88
1367	1988-89
1368	1989-90
1369	1990-91
1370	1991-92
1371	1992-93
1372	1993-94
1373	1994-95

31. As an explicit, but rather irrelevant, example see M.H.Adeli (1991).
32. See M.U.Chapra (1985); pp.19-22.
33. See I.Toutouchian (summer 1994).

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