

# **FISCAL REFORM IN MUSLIM COUNTRIES WITH SPECIAL REFERENCE TO PAKISTAN**

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*The paper discusses the problems of fiscal deficits being faced by a number of Muslim countries. Using Pakistan as a case study, the paper attempts to identify the causes of these deficits as a prelude to making reform proposals. The author gives a number of suggestions for reducing public sector outlays and ways and means for resource mobilization for essential government expenditure.*

## **1. INTRODUCTION**

A poor state of public finance is a feature common to most of the Muslim countries. In many of these, the situation has reached alarming proportions. They have been living beyond their means for too long. Huge budget deficits have been left uncorrected for decades. Instead of taking prudent decisions either to cut government expenditure or to mobilize additional revenue, easier means of bridging the gap by printing more money or borrowing from domestic and international markets were resorted to. The result has been an increase in the rate of inflation on the one hand and a huge build-up of public debt on the other. Both of these are repugnant to Islamic economic principles. Inflation distorts allocation of resources and renders the whole payment system inequitable. Public debt obtained on interest is even worse. It violates the clear and unequivocal prohibition of *riba* in Islam. Even on purely economic grounds, deficit financing is a dangerous policy except in a very limited way (to mobilize untapped resources by increasing aggregate demand through government expenditure). Similarly, public borrowing, even in a secular framework, would be prudent only if the expected rate of social return from the project being financed through borrowing is higher than the cost of obtaining the resources. However, this simple and rather obvious principle is often ignored in practice.

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What is even more disturbing is the fact that in spite of huge public sector allocations financed through borrowing, most of these countries have not been able to build viable physical and human infrastructures. It is painful to note that a majority of population in these countries is living in slums or undeveloped rural areas without even safe drinking water, not to speak of electricity, sewerage or other civic facilities. The rates of literacy are extremely low; health facilities are severely deficient; housing problems are very serious and transport facilities are extremely limited. Even after decades of high spending, most of these countries have not been able to develop good railroad facilities, good roads, good schools, adequate health care, sufficient energy for industrial and domestic requirements, adequate irrigation facilities and similar economic and social infrastructure. Where has all that money gone? What went wrong? How serious is the problem? These are some of the questions that will be addressed in this paper. In section two, we present the long run trends of the state of public finance in Pakistan as a case study. We have tried to highlight the aspects which may be similar to those found in many other Muslim countries.<sup>1</sup> In section three an attempt has been made to identify the reasons that have led to present fiscal problems. In section four we present some reform proposals with the hope that these will provide a basis for discussion and dialogue which may lead to the formulation of some guidelines for a viable strategy for fiscal reform in Muslim countries in the light of Islamic teachings. Section five summarizes the main findings of the paper and presents main conclusions.

## **2. ANALYSIS OF THE TRENDS OF PUBLIC FINANCE IN PAKISTAN**

Pakistan has been plagued with budget problems throughout its history. Rising expenditures, stagnant revenues, permanent budget deficit and excessive reliance on increasingly costly borrowing have become characteristic trends in the country's public finance. Table 1 gives data on Pakistan's public finance for the period 1971-72--1988-89. These figures present a summary picture of the public finance situation in the country. Total government revenue remained at a level of 15-17 percent of GDP throughout the period. As compared to this total, expenditure has been in the range of 23-25 percent of GDP. This has produced a constant overall deficit to the tune of 8 percent of GDP on the average. Such a large and permanent deficit is very serious in itself. But if we analyze the figures of government expenditure and revenue a little more closely, we can discern other disturbing trends as well.

While the overall figures of expenditure have been in the range of 23-25 percent of GDP, the composition of this expenditure has changed. There has been an upward trend in current expenditure and a corresponding downward trend in development expenditure. The ratio of development expenditure to GDP has registered a secular decline. In a mixed economy like Pakistan's, the government performs a wide range of economic functions. Provision of infrastructure is the most important activity reserved for the public sector. The development expenditure in the government budget basically caters for this role. Therefore, the declining trend in development expenditure is quite serious. No major infrastructural project has been undertaken during the last fifteen years. As a matter of fact, the country is wearing off the infrastructure that was created during the 1960's. Needless to say that this has serious implications for the long run development potential of the country.

Another disturbing feature of the public finance situation is that even though the current expenditure has been rising, very little has been spent on social sectors, which directly increase the welfare of the people. This is evident from the structure of government expenditure shown in Table 2. It may be noted that the two largest items of expenditure are defense and interest payments which taken together account for almost half of total government expenditure. As compared to this, the share of health and education is 1.0 and 2.6 percent respectively. In theory, the huge amount of borrowed money was to help build national infrastructure and public welfare projects. But in practice a large portion of it has been spent on financing current expenditure. This is why in spite of three decades of high government expenditure, the country neither has a viable infrastructure nor the quality of life has shown any significant improvement. The literacy rate is less than 30 percent which is among the lowest in the world. On the other hand, the infant mortality rate at 105 per thousand is among the highest in the world. Electricity is available to only 35 percent of population and merely 23 percent have access to sewerage facilities. About 40 percent of population does not even have access to clean drinking water. Housing conditions are also very poor. According to the Housing Census 1980, there were 3.5 persons per room. With increasing population and without corresponding increase in housing, the situation is feared to have further deteriorated.

On the revenue side of the government budget, we notice that the tax revenues have stagnated at around 13 percent of GDP. Within the total tax revenue, indirect taxes account for 87 percent while the share of direct taxes is only 13 percent. Since the incidence of indirect taxes on poor is relatively more as compared to direct taxes, this feature renders the tax

structure inequitable. Moreover, both in direct and indirect taxes the base is very small and the tax rates are rather high. For example, in a population of 113 million, the number of income tax assesseees is only about 1.5 million and among them also the upper 5 percent pay 96 percent of total income tax collected. Similarly, in the case of customs duties, more than 50 percent imports are exempt while rest of the imports are taxed at very high rates. These high rates of import duties have led to mis-declaration of value and smuggling. In the case of excise duties, narrowness of the base is even more pronounced. Only seven items contribute 87 percent of the total excise tax revenue. In case of the sales tax 80 percent of the proceeds come from levies on imports, 10 percent from excisable products and only 10 percent from other items.

Narrow tax bases and high tax rates result in a heavy tax burden on those who are in the tax net and leads to tax evasion on the one hand and corruption on the other. The National Taxation Reform Commission estimated that for the year 1984-1985 income tax to the tune of Rs.18,528 million was evaded as against Rs.7,000 million actually assessed. Even if we take a more conservative estimate, it is safe to assume that only one third of the tax actually due is collected.

Finally, coming to the analysis of the third area of public finance activity i.e. public debt, we notice a massive build-up of public debt. Relevant data is given in Table 3.

The overall size of public debt has increased at dangerously high rates. From Rs.150 billion in 1980/81, the outstanding public debt has risen to Rs.657 billion in 1988/89. This gives an annual growth rate of 20 percent which far exceeds even the growth rate in the nominal GDP. Consequently, the ratio of public debt to GNP has risen from 50 percent in 1980/81 to 82 percent in 1988/89.

Within the total public debt, the domestic debt has increased at a much faster rate than foreign debt with the result that its share in total public debt has increased from 42 percent in 1980/81 to 55 percent in 1988/89.

The domestic debt has increased at an annual average rate of about 25 percent which is an alarming rate by any standard. The major reason for this high rate of growth was that the liberal foreign aid that flowed into the country during the sixties and early seventies was no longer available. The aid that did flow during the eighties was largely used to repay past loans

with the result that net transfer of resources as a percentage of gross disbursement continuously declined over time. On the other hand, domestic resource mobilization through taxation as percentage of GDP was almost stagnant. Moreover, the government did not make any serious effort to cut its expenditure. The only way to meet the resource shortfall was heavy borrowing in the domestic market.

Besides the high rate of growth, the domestic borrowing has also become increasingly costly. This has resulted in rising interest payments on domestic debt. The government is offering increasingly higher rates to attract domestic savings. It should also be pointed out here that the higher rates of return on government schemes have not led to additional resource mobilization. They have only displaced private sector deposits. This can be easily verified by the ratio of private savings to GNP which has not shown any upward trend. It has hovered around an average of 10 percent.

*Fiscal Reform in Muslim Countries*

**TABLE 1**  
**SUMMARY OF PUBLIC FINANCE IN PAKISTAN**

(Rupees in Millions)

	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	
Total Revenue	8050	9763	14166	17426	19264	21910	26482	30704	38504	47002	51930	59181	72230	77403	89772	103878	118291	143509	
Tax Revenue	6103	7353	10347	12812	15544	17759	21585	25093	32509	38846	43003	49029	53646	55963	62978	82927	92998	106258	
Non-Tax Revenue	1947	2410	3819	4614	3720	4151	4897	5611	5995	8156	8927	10152	18644	21440	26794	20946	25293	37251	
Total Expenditure	11010	16255	23185	34355	32329	35171	40898	48994	54629	63639	71014	87121	100002	116819	134463	152402	179851	190329	
Current	8256	10619	15164	21183	19963	20133	25545	30500	32824	37839	44545	57738	71945	83769	94686	116242	129511	142329	
Development	2754	5636	8021	13172	12366	15038	15353	18494	21805	25800	26469	29383	28057	33050	39777	36160	50340	48000	
Revenue Surplus/Deficit	-206	-856	-998	-3757	-699	1777	937	204	5680	9163	7385	1443	345	-6366	-4919	-12369	-11220	1180	
Overall Budget Deficit	2960	6492	9019	16929	12480	12829	13893	17318	14461	14618	17175	25654	25147	36777	41749	64710	58587	44780	
GDP (mp)	54673	67492	88102	111183	130364	149748	176334	194915	234179	277395	321794	363884	421245	482108	547126	608145	685867	781432	
<b>PERCENTAGE OF GDP (mp)</b>																			
Total Revenue	14.72	14.47	16.08	15.67	14.78	14.63	15.02	15.75	16.44	16.94	16.14	16.26	17.16	16.06	16.41	17.08	17.25	18.37	
Tax-Revenue	11.16	10.90	11.74	11.52	11.92	11.86	12.24	12.87	13.88	14.00	13.36	13.47	12.74	11.61	11.51	13.64	13.56	13.60	
Non-Tax Revenue	3.56	3.57	4.34	4.15	2.85	2.77	2.78	2.88	2.56	2.94	2.77	2.79	4.43	4.45	4.90	3.44	3.69	4.77	
Total Expenditure	20.14	24.08	26.32	30.90	24.80	23.48	23.20	25.14	23.33	22.94	22.07	23.94	23.74	24.24	24.58	25.06	26.22	24.36	
Current	15.10	15.73	17.21	19.05	15.31	13.44	14.49	15.65	14.02	13.64	13.84	15.87	17.08	17.38	17.31	19.11	18.88	18.21	
Development	5.04	8.35	9.11	11.85	9.49	10.04	8.71	9.49	9.31	9.30	8.23	8.07	6.66	6.86	7.27	5.95	7.34	6.14	
Revenue Surplus/Deficit	-0.37	-1.27	-1.13	-3.38	-0.54	1.19	0.53	0.10	2.43	3.30	2.29	0.40	0.08	-1.32	-0.90	-2.03	-1.64	0.15	
Overall Deficit	5.41	9.62	10.24	15.23	9.57	8.57	7.88	8.88	6.18	5.27	5.34	7.05	5.97	7.63	7.63	10.64	8.54	5.73	

Source: Pakistan Economic Survey, various issues.

**TABLE 2**  
**STRUCTURE OF GOVERNMENT EXPENDITURE**

(Rupees in Millions)

	1979-80	1098-84	1984-85	1985-86	1986-87	1987-88	1988-89 (P.A.)	1989-90 (B.E.)
Current Expenditure*	32,324	71,945	83,769	94,686	116,242	133,645	153,066	163,733
Defence	12,655	26,798	31,866	35,606	41,335	47,015	51,053	57,926
Interest	5,070	14,128	16,529	19,734	23,955	33,238	38,132	45,291
Current Subsidies	3,821	4,668	5,368	5,706	5,809	7,950	13,277	11,037
General Administration	3,011	5,955	6,560	7,379	10,393	8,542	10,192	10,277
Social Services	3,979	9,815	10,485	12,375	15,452	17,325	19,304	19,657
All others	4,288	10,581	12,969	13,886	19,298	19,575	21,108	19,545
Development Expenditure	21,805	28,057	33,050	39,777	36,160	46,728	48,110	55,000
Total Expenditure	54,629	100,002	116,819	134,463	152,402	180,373	201,176	218,733
(As percent of Total Expenditure)								
Current Expenditure	60.1	72.0	71.7	70.4	76.3	74.1	76.1	74.9
Defence	23.2	26.3	27.3	26.5	27.1	26.1	25.4	26.5
Interest	9.3	14.1	14.1	14.7	15.7	18.4	18.9	20.7
Current Subsidies	7.0	4.7	4.6	4.2	3.3	4.4	6.6	5.1
General Administration	5.5	6.0	5.6	5.5	6.8	4.7	5.1	4.7
Social Services	7.3	9.1	9.0	9.2	9.2	10.1	9.6	9.0
Others	7.3	10.6	11.1	10.3	12.3	10.9	10.5	8.9
Development Expenditure	39.9	28.0	28.3	29.6	23.7	25.9	23.9	25.1
Total Expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

\* Current Subsidies are included in Current Expenditure and Development Subsidies in Development Expenditure.

Source: Finance Division.

P.A. Provisional Actuals.

B.E. Budget Estimates.

**TABLE 3**  
**SIZE AND COMPOSITION OF PUBLIC DEBT**

Year	Foreign Debt	Percent Share	Domestic Debt	Percent Share	Total Public Debt	Percent of GNP
1980-81	87,650	58	62,483	42	150,133	50
1981-82	96,798	55	79,089	45	175,887	51
1982-83	118,262	54	101,727	46	219,989	55
1983-84	127,832	51	122,683	49	250,515	54
1984-85	147,926	50	149,916	50	297,842	57
1985-86	178,839	46	203,119	54	381,958	65
1986-87	206,796	45	248,477	55	455,273	71
1987-88	247,034	44	290,146	56	577,180	72
1988-89	294,000	45	362,683	55	656,683	82

Source: Ministry of Finance

External debt increased at an average annual rate of 16.4 percent during 1980/81 -- 1988/89. The cumulative debt now stands at US \$ 15 billion which is about 37 percent of GNP. Debt service payments consume 25 - 30 percent of export earnings of the country thereby putting a huge burden on country's balance of payments.

These trends in public debt have important implications for future policy making in Pakistan and countries in similar situations. In the aftermath of recent developments in Europe, Soviet Union and the Middle East, it is expected that the foreign loans to many Muslim countries will become more and more difficult to obtain. Faced with financial crunch, the governments are in general prone to go to the politically easier "solutions". Since raising taxes and prices of public utilities is politically unpopular and cutting expenditures is difficult because of powerful pressure groups, it is feared that the governments would tend to resort to more deficit financing and domestic borrowing. These methods are politically attractive but economically they are extremely dangerous. Deficit financing would, in general, lead to higher rates of inflation and domestic borrowing would lead to higher rates of interest and lower private investment. These would adversely affect the future growth rates which would in turn increase the overall deficit and the country would go deeper and deeper into the red. Against this background, it is extremely important to have a hard look at the causes of fiscal problems and to adopt bold reform measures.

### **3. CAUSES OF FISCAL PROBLEMS**

The reasons that led many Muslim countries into serious fiscal problems may vary from one country to another. However, there are some factors which may be common to many countries. Identification of exact causes of the problems is essential before any reform is contemplated. In this section we discuss some of the more common reasons for fiscal deficits. Though we are guided by the experience of Pakistan, many of these reasons may be present in other Muslim countries as well.

#### **3.1 Big Government Philosophy**

The period starting from early 1940's and stretching well into 1970's was in general dominated by big government philosophy all over the world. Previously the only rationale for the involvement of public finance authorities in the production of goods and services had been the provision of public goods such as defense, law and order, justice, etc. These goods and services have certain technical characteristics (indivisibility, jointness of production, etc.) which make their provision by the private sector undesirable or unprofitable. Since the society needs these goods, they had to be produced by the public sector. In late 1930's John Maynard Keynes popularized the idea that the government can play a more active role in stabilization and growth through



management of aggregate demand. Under the Keynesian influence these two functions i.e. stabilization and growth, also became necessary components of public sector objectives. Roughly, around the same period governments started realizing that the market forces left to themselves, may not produce the distribution of income desired by the society. Partly due to rising levels of unemployment and income inequalities and partly as a reaction to communist philosophy, governments started taking upon themselves the responsibility of supporting the unemployed, the disabled, the old and the very young.

In the light of the prevailing philosophy, the developing countries were advised to increase public investment to take over many economic activities, especially through the creation of public enterprises, thus providing capital and managerial skills assumed to be lacking in the private sector. Most underdeveloped countries, followed this advice. For a large number of Muslim countries this period was very crucial. They were becoming independent after long periods of colonial rule and were in the initial stages of public policy formulation. Dominant philosophy and the strong desire to develop as fast as possible pushed them into the direction of having large public sectors. In addition, the private sector was overburdened with a host of regulations. Such over-regulation almost stifled the private sector. They did not realize that the assumptions on which big government theories were based did not prevail in their economies. (The recent theoretical developments have shown that they do not prevail even in the developed countries).

While these countries committed themselves to big government expenditure, they were not able to mobilize sufficient resources through taxation because: (i) The proportion of "cash economy" in these countries was very small which made it difficult to collect taxes; (ii) There were difficulties in defining and measuring the tax base and of assessing and collecting taxes due to low level of literacy; (iii) Administrative structures were not very well geared to fulfill these functions; and because (iv) Taxation is politically unpopular and governments, especially those which lack public support or stability, avoid this option.

The lack of sufficient tax revenue forced these governments to resort to borrowing and deficit financing. These two in turn became the major causes of the fiscal crises in these countries.

### 3.2 Borrowing On Interest

In order to fill the gap between total government expenditure and total government revenue, these countries borrowed heavily, both internally and externally. The result has been that public debt has accumulated to alarming proportions. Table 4 gives data on external debt in some Muslim countries. It may be noticed that in 11 out of the 20 countries, the total external debt is more than half of the size of their GNP. The debt servicing eats up around 30 percent of their exports of goods and services on average. This of course is a very serious situation. But yet, this is not the end of their malaise. In addition to external debt, they have huge domestic debt as well. Since all of this debt has been borrowed on the basis of interest, interest payments take a huge chunk out of government expenditure. In case of Pakistan, it eats up more than 25 percent of total government expenditure and is the second largest item of expenditure after defense.

**TABLE 4  
LONG TERM DEBT AND DEBT SERVICING FOR  
SELECTED MUSLIM COUNTRIES (1987)**

COUNTRY	DEBT OUTSTANDING		DEBT SERVICE	
	Total Amount (Million US \$)	% of GNP	Total Amount (Million US \$)	% of Exports of Goods & Services
Algeria	23025	37.2	6325	65.2
Bangladesh	8994	51.4	371	27.1
Burkina Faso	778	41.5	26	6.8
Cameroon	3775	31.0	637	30.1
Egypt	34828	105.3	2307	31.8
Indonesia	45066	69.3	6423	34.2
Iran	1396	1.4	953	5.7
Jordan	3969	72.0	611	26.8
Malaysia	21569	72.1	3927	18.7
Mali	1831	98.2	32	9.4
Morocco	17112	102.1	1370	32.7
Nigeria	23343	97.4	1219	15.6
Pakistan	14668	44.9	1341	26.8
Senegal	3251	74.8	294	32.3
Sudan	7711	95.3	132	28.8
Syria	3324	14.0	395	20.3
Tunisia	6801	74.1	968	28.8
Turkey	30763	46.6	4557	31.7
Uganda	1137	30.2	72	20.8
Yemen A.R.	2376	51.2	171	78.0

Source: Handbook of International Trade and Development Statistics, UNCTAD, 1989.

The reason that public debt has led to fiscal problems is that almost all of this debt is on fixed interest basis. While borrowing this money, there has been little consideration of the rates of return on these funds. A general, obvious and simple rule

which is easily forgotten is that no public spending financed by borrowing should be carried out unless the expected rate of return on it at least equals, and is preferably higher than, the cost of obtaining the resources. This is one of the evils of interest-based borrowing. The costs of servicing the borrowed capital have been higher than the rate of return on investments carried out with those funds. And even that is on the generous assumption that these loans were used for investment. In fact, a good part of these loans was used to finance current government expenditure. This again is due to the fact that under interest based financing, the financier has little interest in the way the funds are utilized as long as the borrower does not default. These inherent problems of interest-based borrowing are now widely recognized and a number of reform proposals are being discussed.

### **3.3 Huge Defense Outlays**

The third major reason for fiscal deficit in Muslim countries has been huge expenditure on defense. In Pakistan, it is the largest item of government expenditure and constitutes more than 30 percent of total government expenditure. There are a number of other Muslim countries where defense has taken 25 percent or more of total government expenditure. Since defense expenditure does not lead to a corresponding physical output, it creates a huge burden on government exchequer. Because of its crucial importance, however, it cannot be ignored by any government. Many countries find themselves in extremely sensitive circumstances which call for sizable defense outlays. Unfortunately, most governments have neither been able to execute the defense policies efficiently which could have saved considerable amount of money, nor have been able to motivate their populations to render necessary sacrifice that their situations demand.

If defense expenditure is met from the general budget, as is being done, then interest payments and defense taken together account for about 40-50 percent of total government expenditure in many Muslim countries, and in some cases even more. There is not much left to fulfill other functions that governments have taken upon themselves. Therefore, expenditure exceeds revenues and budget deficits persist.

### **3.4 Inelastic/Narrow Tax Structure**

As mentioned before, the governments in many of these countries took a very large portion of public expenditure as more or less given. When it came to mobilizing revenue to finance that expenditure, they were unable to do that. Judging from the

experience of Pakistan, the reasons for low revenue have been: (a) small tax base; (b) high tax rates; (c) widespread corruption; (d) tax evasion due to difficulties in defining tax bases clearly; (e) subsidized provision of public services; (f) complicated laws and procedures and (g) strong feeling of public animosity towards the system. Many of these facts apply to other Muslim countries in varying proportions.

Table 5 presents time series data on total government expenditure and total government revenue in selected Muslim countries. It can easily be inferred from these figures that persistent deficit is not anything special to the case of Pakistan. Most of the Muslim countries suffer from it. The reasons seem to be quite common as well. The inelasticity of total revenue is quite evident from the figures in Table 5. When we look to the structure of tax revenue, we again find significant similarities. The share of direct taxes in total revenue has, in general, been smaller than the indirect taxes, in most cases by a significant margin (See Table 6). Inelasticity of tax revenue is also common to a number of countries. This can be seen from the time series data on tax/GDP ratio for selected countries shown in Table 7.

### **3.5 Tax Evasion and Corruption**

The problems of tax evasion and corruption are also part of common knowledge. These are not easy to quantify, but their magnitude is generally believed to be substantial. In the case of Pakistan, it was estimated that the tax evaded was more than three times the amount of tax collected.<sup>2</sup> The major reasons for tax evasion are multiplicity of exemptions on the one hand and high tax rates on the other. Moreover, lack of clearly identifiable and easily assessable tax bases has made tax evasion quite easy.

TABLE 5

TOTAL GOVERNMENT EXPENDITURE AND REVENUE  
IN SELECTED MUSLIM COUNTRIES (% OF GDP)

Country		1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	
Algeria	Exp	----- N.A. -----							34.5	36.7	33.7	31.9	
	Rev	----- N.A. -----							37.8	32.2	29.8	29.1	
Bangladesh	Exp	10.31	12.28	10.11	13.91	12.83	11.35	10.95	12.11	N.A.	N.A.	N.A.	
	Rev	11.2	10.8	11.4	11.8	12.1	11.1	9.3	9.5	8.9	9.2	8.7	
Burkina Faso	Exp	13.8	15.99	16.24	15.4	17.5	13.8	16.6	13.4	15.4	16.7	N.A.	
	Rev	14.5	13.5	15.6	14.1	15.1	14.1	15.9	15.1	15.7	17.6	N.A.	
Cameroon	Exp	17.4	16.5	15.7	20.7	20.5	20.9	N.A.	N.A.	N.A.	N.A.	N.A.	
	Rev	18.5	19.4	16.4	17.5	18.0	23.4	24.7	N.A.	22.2	18.6	N.A.	
Egypt	Exp	42.43	44.3	N.A.	46.0	55.5	45.1	46.7	43.7	45.9	41.1	N.A.	
	Rev	38.4	37.0	N.A.	47.1	46.5	44.2	43.2	40.0	40.1	38.1	N.A.	
Indonesia	Exp	19.4	20.6	22.3	24.1	20.8	21.2	18.9	21.9	24.7	N.A.	N.A.	
	Rev	17.5	19.9	21.4	23.2	19.6	20.1	20.0	21.4	20.2	N.A.	N.A.	
Iran	Exp	41.4	33.2	34.2	33.8	30.8	28.1	23.9	23.4	N.A.	N.A.	N.A.	
	Rev	31.4	28.1	20.6	23.1	25.1	21.8	19.9	19.4	N.A.	N.A.	N.A.	
Jordan	Exp	48.8	59.8	49.6	46.9	47.8	46.1	40.5	44.1	42.1	46.8	N.A.	
	Rev	23.6	23.4	21.8	25.1	26.1	26.5	26.2	25.7	28.7	27.4	N.A.	
Malaysia	Exp	25.2	22.2	28.5	38.4	36.1	31.1	27.6	N.A.	34.4	29.0	N.A.	
	Rev	23.2	22.5	26.4	27.5	26.6	26.6	25.8	26.9	27.7	22.7	23.8	
Mali	Exp	18.0	17.4	24.4	22.8	27.9	30.7	30.7	34.9	30.2	27.8	N.A.	
	Rev	15.2	12.6	12.5	11.5	12.8	12.9	14.1	16.8	16.6	15.7	N.A.	
Morocco	Exp	34.4	34.9	34.9	40.3	38.6	33.9	31.9	33.0	33.3	30.3	N.A.	
	Rev	24.2	25.5	24.9	26.6	27.1	25.9	25.5	25.3	24.5	25.4	N.A.	
Nigeria	Exp	----- N.A. -----							14.5	12.9	18.2	23.6	N.A.
	Rev	----- N.A. -----							10.5	11.4	15.7	15.7	N.A.
Pakistan	Exp	17.5	18.6	17.5	19.2	17.2	19.4	19.6	19.4	21.9	21.0	20.7	
	Rev	14.3	15.1	16.3	16.4	15.7	15.9	16.9	15.8	16.4	16.3	17.1	
Senegal	Exp	19.8	20.7	24.4	26.5	30.5	28.3	30.8	----- N.A. -----				
	Rev	20.1	20.0	25.4	23.3	22.5	20.7	19.8	----- N.A. -----				
Sudan	Exp	----- N.A. -----							23.7	21.6	21.4	24.8	22.3
	Rev	----- N.A. -----							9.3	9.2	9.6	10.4	8.6
Syria	Exp	41.2	39.21	48.2	38.6	----- N.A. -----				36.9	28.1	N.A.	
	Rev	22.7	23.6	26.8	22.6	----- N.A. -----				24.1	22.4	N.A.	

Tunisia	Exp	34.0	33.8	31.8	32.5	37.8	39.0	39.1	37.0	38.8	35.2	N.A.
	Rev	31.4	32.0	31.6	31.9	34.3	33.6	36.5	33.7	34.5	31.5	N.A.
Turkey	Exp	23.1	24.1	23.9	22.6	N.A.	24.2	24.9	25.0	21.1	21.9	21.3
	Rev	20.5	19.7	20.1	21.3	N.A.	20.0	14.9	17.6	18.0	17.9	17.5
Uganda	Exp	9.3	6.1	5.5	9.1	13.9	14.0	17.8	17.4	15.0	N.A.	N.A.
	Rev	9.0	2.6	2.9	2.0	8.2	11.1	13.9	12.2	9.4	N.A.	N.A.
Yemen A.R.	Exp	21.6	33.3	34.4	39.2	41.4	38.6	33.4	28.0	25.4	31.4	30.7
	Rev	19.4	18.3	21.0	20.9	18.5	20.2	18.9	17.2	18.7	17.5	22.6

Source: Government Finance Statistics Yearbook 1989.

**TABLE 6**

**STRUCTURE OF GOVERNMENT REVENUE  
IN SELECTED MUSLIM COUNTRIES (1988)  
(% OF TOTAL REVENUE)**

COUNTRY	Direct Taxes	Indirect Taxes	Non-Tax Revenue	Total Revenue as % of GDP
Algeria	21.8	54.9	23.3	30.0
Bangladesh	11.9	71.5	16.6	9.5
Burkino Faso	23.6	55.7	20.7	17.6
Cameroon	36.7	37.6	25.7	23.4
Egypt	29.1	32.6	38.3	38.1
Indonesia	55.9	33.1	11.0	N.A.
Iran	22.9	22.7	54.4	N.A.
Jordan	9.8	53.4	36.8	27.4
Malaysia	32.9	37.3	29.8	22.7
Mali	12.5	78.4	9.1	15.7
Morocco	24.0	65.81	10.2	25.4
Nigeria	39.9	12.0	48.1	15.7
Pakistan	11.9	64.3	23.8	16.4
Senegal	23.0	71.5	5.5	19.8
Sudan	14.0	63.6	22.4	9.5
Syria	32.3	35.0	32.7	22.4
Tunisia	22.1	52.5	25.4	31.5
Turkey	39.5	42.0	18.5	17.5
Uganda	6.0	94.0	0.0	9.4
Yemen A.R.	19.7	40.3	40.0	22.6

Source: Computed from data given in World Development Report 1990 and Government Finance Yearbook 1989.

**TABLE 7**

**TAX/GDP RATIO FOR SELECTED MUSLIM COUNTRIES**

COUNTRY	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Algeria	-	-	-	-	-	-	-	-	-	-
Bangladesh	7.8	8.2	7.5	7.8	6.1	8.1	7.0	7.1	7.2	-
Burkina Faso	13.8	13.3	13.1	13.1	12.6	11.8	13.0	-	-	-
Cameroon	14.9	15.5	16.0	22.4	20.9	17.5	16.2	13.5	14.7	-
Egypt	-	29.2	28.4	27.3	25.9	25.4	26.0	21.7	21.0	21.1
Indonesia	20.3	20.0	18.0	17.2	16.6	18.0	13.8	14.6	14.4	15.2
Iran	6.8	8.5	7.4	7.4	7.8	8.1	7.4	6.5	5.9	5.9
Jordan	13.8	15.1	15.5	15.5	15.3	16.0	14.3	14.0	14.6	14.4
Malaysia	-	-	21.1	22.8	21.5	22.7	21.8	17.0	17.5	17.6
Mali	10.9	10.5	11.9	12.1	11.7	11.1	12.3	11.6	11.6	-
Morocco	20.3	21.1	21.0	20.7	20.4	19.7	19.4	20.9	-	-
Nigeria	-	-	-	-	7.0	5.8	9.0	5.9	-	-
Pakistan	13.9	14.0	13.4	13.5	12.7	11.6	11.5	13.6	13.6	13.6
Senegal	-	-	-	-	-	-	-	-	-	-
Sudan	-	-	-	-	-	-	-	-	-	-
Syria	10.5	8.8	-	-	-	-	12.7	14.9	14.6	-
Tunisia	24.1	24.4	25.8	26.6	26.4	24.8	25.5	23.5	23.2	23.6
Turkey	16.1	17.8	16.8	13.0	14.4	15.2	15.6	14.1	15.2	16.0
Uganda	3.2	1.4	18.3	12.1	13.1	4.2	2.3	-	-	-
Yemen A.R.	16.8	16.4	15.3	16.7	15.2	14.0	14.7	12.3	-	-

Source: Calculated from data given in Government Finance Statistics Yearbook, 1991.

#### **4. STRATEGY FOR FISCAL REFORMS**

Our analysis in previous sections has tried to emphasize the seriousness of fiscal problems in Muslim countries. We have also tried to identify the major problems in the area of public finance. In this section, we will make a few suggestions to tackle those problems. Before doing that, however, we would like to caution that the problems are very complex and long-standing. There are no easy solutions. Any reform effort will need both political will as well as public support. People have to be convinced of the need to make the sacrifices that they are asked to make. There is an urgent need to overhaul tax systems and to rationalize expenditure patterns. Fiscal reforms are being introduced all over the world. While it would be useful to take notice of various proposals for reform, it is high time that Muslim countries start to formulate their policies in the light of Islamic teachings.

##### **4.1 Defining the Proper Role of Public Sector**



Any reform proposal must start with defining the proper role of public sector. From a purely economic point of view, the experience of three decades following World War II, which were characterized by large public sector outlays, has shown that the big-government philosophy has serious flaws. The growth of public spending was justified on grounds that the government must promote economic growth, sustain economic activity and bring about a better income distribution. Yet the experience of many developed countries shows that economies have not become more stable because of governmental intervention; income distribution has not improved and the rate of growth has not accelerated because of the larger government involvement. Economic historians also quote that the period between 1870 and 1913 was one of the most dynamic periods for the economies of the modern world. The rate of growth was normally very high, and much modern infrastructure such as railroads, roads, and schools was built. Yet the level of public spending was remarkably low. For example, in France it was only about 10 percent of national income. Similar percentages are found for the other countries (Tanzi, 1990). These percentages raise doubts about the necessity of large public expenditures in promoting economic growth. In view of these facts and the recent theoretical developments in the field of public policy, more and more governments are now encouraging private sector, privatizing public enterprises and reducing regulations which limit private sector activities.

Muslim countries must take note of these developments. In addition, they must refer to Islamic principles in order to define a proper role for the public sector. In the recent literature on Islamic economics, there has been some discussion about the role of public expenditure in an Islamic state and whether a modern government has the right to impose additional taxes i.e. taxes other than the traditional Islamic levies and if so under what conditions. (see for example: Siddiqi, 1986 and Kahf, 1983). This literature is quite instructive. While there is widespread support for the right of a Muslim government to impose additional taxes, Islamic scholars are much more strict with regard to seeking clear and proper justification for any additional taxes and the utilization of public revenue.

#### **4.2 Creating Earmarked Heads of Public Expenditure**

A modern government has to perform a number of functions. In order to perform these functions it needs to mobilize resources. The predominant practice at present is that all government revenue is kept in a general pool out of which expenditure to various heads is apportioned. This practice has in general resulted in the neglect of

certain functions which from an Islamic point of view should get top-most priority. There are some other expenditures which are more or less unavoidable. Defense and debt servicing are examples of such expenditure. After meeting these expenditures from the general pool, sufficient amount is not left in the pool to perform other functions at the desired level. It is due to this fact that in spite of heavy government expenditures for decades, the general masses in a majority of Muslim countries live in miserable social and economic conditions.

In view of these realities and keeping the Islamic priorities in view, we suggest that a new scheme of apportionment of public expenditure may be adopted. This scheme is based on the principle of earmarking. Under this scheme, certain heads of expenditure should be established for which separate resources should be mobilized. Under normal circumstances, money mobilized for these heads should not be transferred to other heads of expenditures. To start with, we suggest that public expenditure may be classified under three heads, namely:

- (i) Poverty Elimination Programs (PEP)
- (ii) Defense
- (iii) General Expenditure.

### **4.3 Resource Mobilization for Poverty Elimination Programs**

This head of expenditure would be reserved for programs and schemes for the benefit of poor only. These may include direct grants, loans for self-employment schemes, scholarships for acquiring education and skills, low-cost housing for the poor, food coupons, etc. Major source of funds for these schemes would be *zakah*.

If this amount is not enough, as would be the case in most of the Muslim countries at present, additional taxes on the rich may be imposed. These taxes should be such that their incidence falls on the rich only. Income tax or wealth tax or net-worth tax are some possibilities.<sup>3</sup> The existing taxes in these categories should be reserved for PEP. As the level of poverty decreases, these taxes should also be reduced. In the long run, *zakah* proceeds and other built-in distributive schemes of an Islamic system<sup>4</sup> are expected to be sufficient to fulfill the needs of PEP. Earmarking the proceeds of these taxes (or alternative taxes specially designed for this purpose) will help to fulfill one of the most important functions of an Islamic state i.e. guarantee of basic needs. When people will see these taxes being spent on the poor, the level of tax evasion is also expected to go down. This will be especially so in the long run as the rates of these taxes decrease with decreasing level of poverty.

### **4.4 Resource Mobilization for Defense**

Defense is a function that every government must perform. There is hardly any doubt that from Islamic point of view, the performance of this function should occupy a very high priority in the objective function of an Islamic state. However, it should be pointed out here that while ensuring proper defense for the country, the government should normally seek from the people whatever level of sacrifice their defense requires. Whatever expenditure seems necessary should be raised from the public through taxation and voluntary contributions. It is against this background that we are suggesting that a separate head of expenditure on defense should be created. Under the joint pool system, while the defense may get the necessary funds, other heads of expenditure usually suffer. It is one at the cost of the other. Ignoring other necessary functions, especially the needs of the people creates internal instability, social tensions and public antipathy. In such circumstances, the very objective of defense build-up, i.e. ensuring national and territorial integrity, is jeopardized by "excessive" defense spending [Chapra, M.U., 1988].

Having defense as a separate head of expenditure will make the people realize that this is sort of an insurance premium that they are paying for a specific service, i.e.

security. The level of this premium that the nation has to pay, depends on the level of risk to which it is exposed. In order to raise necessary funds under this head, we have the following suggestions:

1. Since defense is a collective duty of all members of the community, a defense tax with a very broad base may be imposed. We suggest that a poll tax at moderate rates may be imposed on all persons possessing "*nis\_b*". This is a direct tax with a very broad base and being easily recognizable, there is very little chance for tax evasion.
2. The purpose of building a strong defense is to protect the faith, life, property and honour of the people against foreign aggression. One of the calamities that may befall someone's life or property is war. Just as people insure against other risks, they can insure against this calamity by building a strong defense. Therefore, we suggest that a small "defense premium" may be imposed on all property including agricultural land, dwellings, factories, movable property etc. The level of the defense premium will depend on the risk of war to which a country is exposed. Therefore, the premium should be adjusted according to that risk. Since the base is very wide, the rate of the premium will be very low and will not be burdensome.
3. Voluntary contributions have always made a significant contribution towards expenditure for defense in Islamic states. This source should also be tapped.
4. The share of "in the path of Allah" in *zakah* collections can also be spent under this head, whenever needed.
5. If the resources mobilized through the above measures are not enough, then the proposed rates may be adjusted by introducing moderate progression in the rates.

#### **4.5 Resource Mobilization for the General Pool**

Expenditure on all other government activities will be met out of this pool. The amount of resources to be generated for this pool depends on the number of activities that the government has to perform. It is important to realize that even though

expenditure for some inevitable activities of the Islamic state such as *dawah*, law and order and general administration have to be met from this head, in terms of the level of expenditure, other activities of the government such as building of infrastructure, education, health, energy, etc. take a much bigger chunk of government expenditure. Modern governments have to provide a number of public goods for the benefit of the society at large. The provision of these public goods by the government is justified on the grounds of their indivisibility and lumpiness. From an Islamic point of view, it has been argued that *maslaha* and the fulfillment of *fard kifayah* provide additional justifications for their provision by the government [Siddiqi, 1986].

While the provision of these goods by the government may be well justified, their provision through budget deficits and corresponding borrowing can hardly be justified. Huge public debt that has been built in their name, itself goes against the long run public interest. It is not even the case that these public goods could not be provided through alternative arrangements. Many of these could be. But the path of borrowing and deficit financing was chosen because it was politically easier. However, by doing so, the very justification for their provision by the government i.e. public interest, was sacrificed. A radically different approach for a number of items of expenditure under this head need to be adopted. Some suggestion in this regard are given below:

1. First and foremost, the role of the private and voluntary sectors, especially the latter has to be strengthened. *Awqaf* have historically played a very important role in the provision of public goods in Islamic societies. This role has to be rejuvenated.
2. The "benefit principle" whereby the beneficiaries should bear the cost is well established in Islamic jurisprudence. Therefore, wherever possible, this principle should be applied. In case of most of the public utilities such as telephone, gas, electricity, etc., this can easily be applied. Private sector can also participate in the provision of these goods on commercial basis. Many infrastructural projects, such as building of airports, railroads and highways can also be financed through user charges. As a general rule, public utilities should be priced so as to cover their costs.
3. Using development charges to undertake development projects in certain areas is also possible. Just as private companies develop residential areas and sell out residential plots with development charges, government or even

private companies can develop industrial areas, provide all necessary infrastructure and recover the costs through selling industrial plots.

4. In some infrastructural projects, Islamic modes of financing can be applied. All such opportunities should be availed.

5. Even after using the above mentioned techniques some projects which have substantial positive externalities and "exclusion" is not possible will remain. These have a genuine claim over the general pool of tax revenue. However, the application of above mentioned principles would reduce such claims by a very substantial amount. Resources for these remaining claims may be generated through taxation.

While we do not rule out any form of taxation that meets the principles of justice, equity and ability to pay, we would like to mention that it is not necessary that members of the community should contribute only in cash for the provision of public goods. If we define taxation broadly to mean transfer of resources from the private sector to the public sector, then one of the biggest potential sources for taxation in most of the underdeveloped countries hitherto untapped is labor. In other words, just as people are required to give money to the government, they may be required to give man-hours to public (community) projects. This would be one type of "community service" in Muslim countries and this can be a very good source for "financing" community projects. For countries with large populations and low income, this may be one of the largest sources for "taxation". Therefore, it seems desirable that these countries should have a separate ministry for community services to plan and execute community projects preferably through a decentralized institutional set-up and through creating circumstances and social incentives to motivate people to contribute work hours to community projects.

#### **4.6 Limiting the Role of Public Borrowing**

As mentioned before, most of the Muslim countries have relied extensively on public borrowing to fill the budget deficit. The resulting public debt has grown into a monster, literally. Beside other problems, interest payments are eating a sizable part of total government expenditure. In Muslim countries, this is most unfortunate. In addition to the economic problems that this public debt is creating for these countries, they are in violation of Islamic *shari'ah*. As a matter of fact, a number of their economic problems are a result of ignoring the unequivocal prohibition of borrowing on interest.

As pointed out by Chapra [1988], the Islamic ban on interest-based borrowing is in fact a blessing. It introduces a strict discipline into public spending to ensure that the government lives within its means. The constraint it will impose on government spending in the short-run will be more than offset by the much smaller debt-servicing burden in future, the sustained and steadier economic growth supported by real resources, freedom from external pressures and a dignified position in the comity of nations.

It is, therefore, suggested that all Muslim countries should impose a constitutional ban on future interest-based borrowing. Some people may argue that in the early Islamic period, Prophet (pbuh) himself resorted to borrowing in order to meet national requirements. In this regard, we must remember that such borrowing was on interest-free basis and that too was done in extremely difficult circumstances. There are exceptions to every rule. Therefore, while imposing constitutional ban on future interest-based borrowing, such exceptions can be included in the law. However, these should be clearly defined and restricted to very exceptional circumstances.

The existing debt should be converted into interest-free loans or to equity where possible. It may be pointed out here that debt-equity swaps are being undertaken all over the world. It should also be noted that citizens of Muslim countries have substantial amounts of capital invested abroad. Stopping this capital flight and attracting the capital invested abroad is perhaps the best course of action for these countries. Therefore, special policies should be designed for this purpose. The remaining part of existing debt should be paid off on emergency basis to give new policies a better start.

We would like to re-emphasize that there are a number of ways for the government to fulfil national requirements and that for genuine needs government can levy additional taxes also. If the circumstances of a nation require additional sacrifice, people should be convinced of that and then asked to make that sacrifice. It must be remembered that borrowing does not eliminate the need for sacrifice. It only postpones it and increases its magnitude.

## **5. SUMMARY AND CONCLUSIONS**

It is an unfortunate fact that most of the Muslim countries are suffering from budget deficits. The problems are both serious and complex. Governments have been living beyond their means for too long. Every Government needs resources for the fulfillment of its genuine needs. As a matter of principle, all genuine expenditure of the government must be met through taxes and non-tax revenue. Under normal

circumstances borrowing and deficit financing should not be needed. Unfortunately, in most of the Muslim countries that is not the case.

There is an urgent need for a radically different approach towards public finance. We have to stop looking for easy solutions and ad hoc arrangements and face the problem squarely and boldly. There is need for a structural change in both the expenditure and the revenue sides of the government budget. The present approach of taking government expenditure to be more or less exogenously given and then concentrating all efforts to mobilize that amount is basically wrong. It is people who should decide what they need in terms of public services and how they are going to provide for them. They must first be convinced about the genuineness of all government expenditure. And once they are convinced of that, they must pay all of it. The present practice of meeting a very substantial portion of government expenditure through borrowing must be discontinued.

The distinction between current expenditure and the development expenditure should be kept in view while mobilizing resources. The present practice of generating as much resources as possible from all sources and then meeting current expenditure out of the available resources and transferring the residual to the development budget is not correct. In our view, the two kinds of expenditure need to be mobilized through distinctly separate approaches. For determining the development needs, the possibilities of a more active participation by the private sector should be considered. Many public projects can be undertaken on the basis of Islamic financing techniques.

Introduction of some ear-marked heads of expenditures will help to ensure fulfillment of those functions without ignoring some other important public needs. Defense and Poverty Elimination Programs are appropriate candidates for such ear-marking.

Infrastructure for industrial development should be provided on the basis of development charges. The government should develop industrial estates in different parts of the country. Instead of tax holidays, which are not effective, the government should provide full infrastructure and then charge the costs through the allotment of industrial plots on the basis of actual costs. In areas where incentive has to be provided for regional development, concessional price can be charged.



In case of public utilities, an attempt should be made first to ensure efficient low cost production. Once that has been ensured the user charges should be fixed so as to recover full costs.

The role of *awqaf* in the provision of public goods such as education and health should be promoted. Voluntary contributions should also be encouraged. Contributions in terms of community service have great potential in Muslim countries. This should also be harnessed.

To conclude the paper we would like to re-emphasize that these countries need a thorough overhaul of their revenue and expenditure structures rather than ad hoc fine tuning.

### **NOTES**

1. In latter sections, we have given data on 20 out of 46 OIC member countries. The data on rich oil producing countries have not been given because these countries do not face fiscal problems that are the subject of this paper. Other than those, the sample is fairly representative of the situation in Muslim countries.
2. Report of the National Taxation Reform Commission.
3. We are not recommending imposition of all these taxes. These are some of the possibilities. Each of these taxes has its merits and demerits. Detailed analysis of individual taxes is not possible in the paper.
4. See Zarqa (1986) for an excellent description of these schemes.

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