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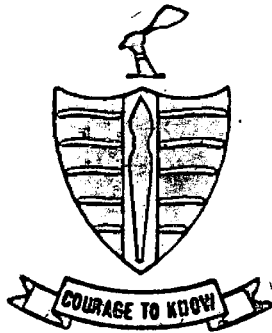
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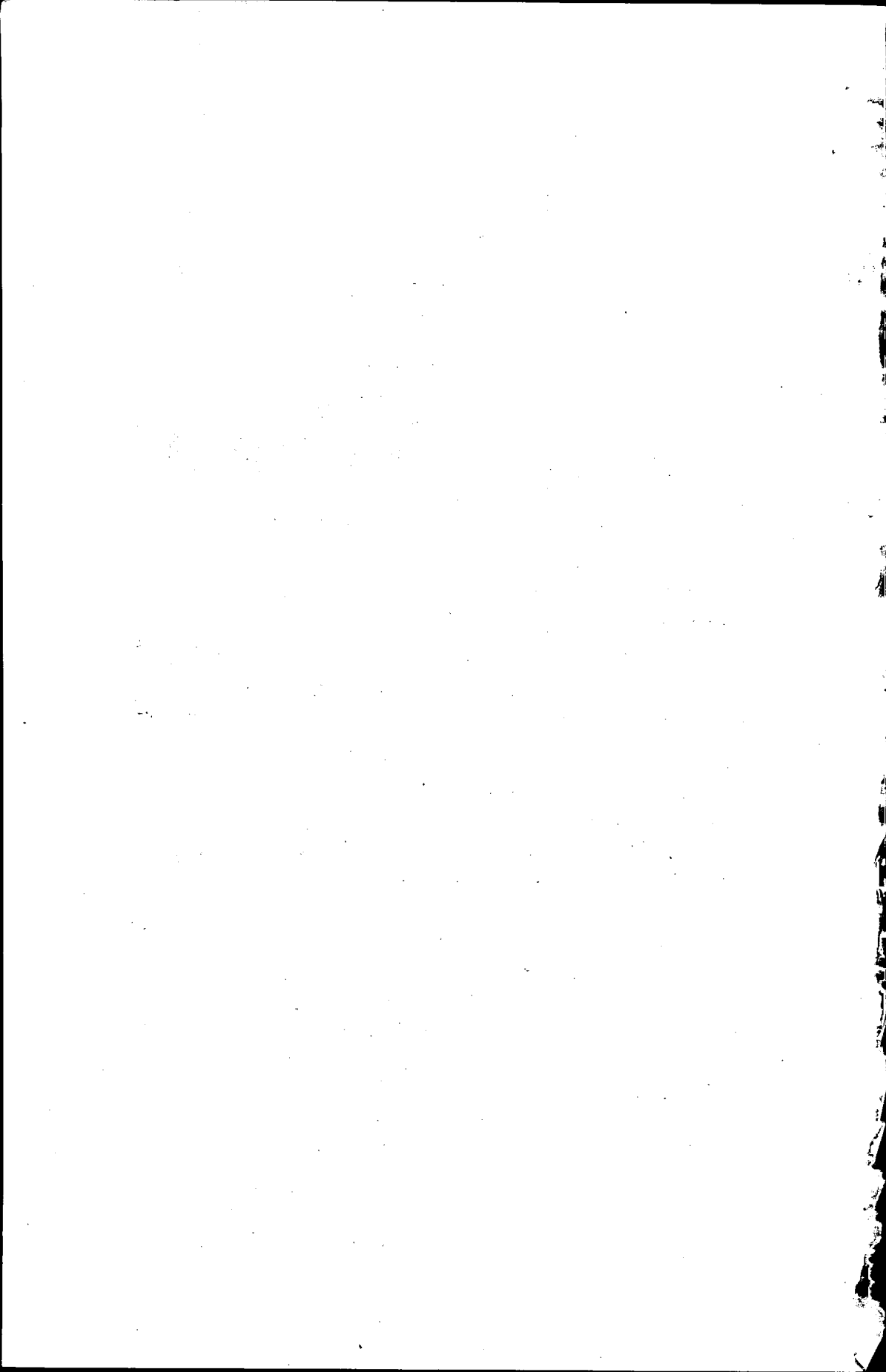
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Introduction

Islam goes beyond the narrow concept of religion and prescribes an ideal way of life encompassing all its myriad dimensions. It provides a complete system embracing socio-economic values, codes and goals for the society to be pursued.

Of late, there has been revival of interest among the muslim countries to Islamise laws, education and society and to replace the existing economic order with an Islamic one.

Elimination of Interest is the greatest challenge facing muslim countries seeking to restructure their economies in the light of Islamic teachings. The International Institute of Islamic Economics, Islamabad addressed itself to this task by holding a number of seminars and workshops to shed light on practical ways and replacing the interest based monetary and Financial system in consonance with the teaching of Islam.

In December 1984 the institute held a Seminar on "Islamic Financing Techniques", to hold comprehensive discussion of financing techniques as mudharbah, Musharaka Ijara, Bai-Salam and Bai-Muajjal/Murahaba. The idea was that Banking practices be reorganised by using such techniques of financing as permissible in Islam and which give promise of positive returns to depositors.

In view of the growing interest in such practices not only in muslim countries but in many free enterprise economies we are publishing in this issue, three papers read in the Seminar, with the

kind permission of the International Institute of Islamic Economics, Islamabad.

It is however clarified that the Institute has requested the authors of the papers to revise them in the light of the comments and discussions made during the Seminar.

The proceedings of the Seminar shall be published by the Institute which will include the papers as well as the comments and discussions on the papers.

—*Editor*

Mudharba : Principles and Practical Applications**

DR. MA'BID ALI AL-JARHI*

I. INTRODUCTION

All praise is due to Allah, the Cherisher of the universe, and praise be on the seal of the prophets, Muhammad, peace be upon him.

The origin of the word mudharaba comes from dharaba fil ardh, meaning to travel far on earth indicating an example of the efforts used in investing done by the mudharib. Another synonym of mudharaba is giradh. Its origin comes from garadha, meaning to cut, implying one's setting aside a part of his capital for investment¹, which is done by rabulmal, or capitalist, or financier.

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**This paper was written in response to a request by the International Institute of Islamic Economics, Islamabad. The Author has benefitted immensely from a recently published research in Arabic by Abdul Sattar Abu Ghuddah, and borrowed heavily from it, as footnotes will subsequently show.

Acknowledgement is due to the Institute for its encouragement and patience with several broken deadlines. Thanks are also due to Mrs. Souad Muhammad Farag for typing the paper.

The paper, as it stands, is in a preliminary form, which would require further improvements through, at least, the expansion of some parts. I pray to Allah to assist us along the road of learning for His sake and the sake of His message.

(1) ابن منظور ، لسان العرب مجمع اللغة العربية ، المعجم (Ibn Manzoor) الوسيط ، دار المعارف ، القاهرة 1392 هـ (1972 م) الجزء الاول ، ص 536 .
(Academy of Arabic)

The Hanafis and Hanbalis, following the convention prevailing in Iraq have used the words *mudharaba*. Meanwhile, the Malekis and Shafe'is have used the word *giradh* or *mugaradha* following the convention of Hijaz. Both words have acquired the same meanings linguistically, that is, to invest the financial capital provided by others for a share of profit.

In *fiqh*, both *mudharaba* and *giradh* refer to a profit-and-loss-sharing (PLS) contract of a company in which the first party (or parties) (*rabbulaml*, or the capitalist) participates with financial capital, and the second party (*mudharib*, or the worker) with his effort². The resulting profit is apportioned between the two parties according to a preagreed formula.

(2) Schools of thought give different wordings of that definition, but with the same general meaning, Compare :

عبدالستار أبرغدة ، الحضاربتى او القراض والتطبيقات المعاصرة .

(Abu Ghudda), The Second Islami Bank Conference, 1403H (1983), p. 3

* الاهام مالك . الموطن ، روايته يحيى بن يحيى الليثى ، اعداد احمد راتب
عروهوش ، الطبعة السادسة ، دار النفائس ، بيروت ، 1401 هـ (1982) ، صفحته
(Imam Malek) 480.

* الشوكانى (محمد بن على بن محمد الشوكانى) ، نيل الاوطار ، دار الجيل ،
بيروت ، 1973 ، الجزء ، الخامس ، صفحته 390 - 392 .
(Al-Shawkani)

* البهوتى (منصور بن يونس بن ادريس البهوتى) ، شرح منتهى الارادات ، دار
الفكر ، القاهرة ، 1046 هـ الجزء ، الثانى صفحته 327
(Al-Bahouti)

* القارى (احمد بن عيدان القارى) ، مجلته الاحكام الشرعية ، دراسته و تحقيق
عبدالوهاب ابراهيم ابو سليمان و محمد ابراهيم احمد على الطبعة الاولى ، مطبوعات
تمهات ، جدة 1401 هـ (1981) ، ص 536
(Al-Qari)

* السيد سياب ، فقه السنن ، دار الكتاب العربى ، بيروت ، الطبعة الاولى ،
(Sabiq) 1391 هـ (1961) ، المجلد الثالث ، صفحته 202 .

II. MUDHARABA AS A COMPANY

Contemporary writers of Islamic jurisprudence have defined mudharaba as a profit-and-loss-sharing (PLS)¹. Since this contract is a form of a company, it would be helpful to review the related classification of contracts and companies. It must be noted though that the classification of mudharaba as a contract owes its origin to the Hanbali school, whose opinion in this regard dominated the opinion of those classifying mudharaba as a semi-employment arrangement in which one party's services are compensated for through payment².

Companies are classified into two categories. The first category is the property company شركة المال in which an asset and/or its services are jointly owned by more than one person³. The property company is either voluntary or obligatory⁴. It is voluntary as in the case of more than one person being gifted some asset and having accepted such gift, or when they jointly purchase some asset. It is obligatory in the case of bequest. In the case of such company, no partner can take any actions regarding the share of the other partner.

The second kind is the contractual company شركة العتود in which persons agree on some course of a joint action⁵, particularly a formula for providing capital and sharing profit⁶. Contractual companies are of five kinds :

1. Rein Company شركة العنان in which a number of persons

(1) Please refer to the introduction above.

(2) Al-Qari, op. cit., p. 536.

(3) Sabiq, op. cit., p. 255-256.

(4) Al-Qari, op. cit., p. 536.

(5) Sabiq, op. cit., p. 356.

(6) Compare this opinion with that of Abu Ghuddah, op. cit., p. 3, where he states that the first party volunteers his efforts. My opinion is that the question of dividing profits is separate from that of compensating the second party for his efforts. When that party gets no share of the profits, he also bears no share of the loss. In this case, he becomes an agent who must be compensated for his work. As will be discussed later on, when the second party violates some of the mudharaba conditions, he guarantees the return of the principal plus profits in full, and gets only his wage in the effort spent.

jointly provide capital and effort for investment. Neither capital nor effort need to be shared equally, while profit is to be divided according to a preagreed formula.

2. **Mudharaba Company** شركة المضاربة in which persons provide a second party specific resources for investment for a prespecified share of the profit. When the profit share of the capital provider is set to zero, the company collapses to a mere (interest-free) loan. When the profit share of the second party is set to zero, the company collapses to a mere *ibdha*, *ابضاع*, or a trading arrangement through which the first party provides "merchandise" to the second party who sells it obtaining none of the resulting profit, but being compensated only for his effort⁶. The second party may accept such arrangement for the benefits resulting from pooling some of his resources with those of the first party in investment. The larger size of capital could bring forth higher profits on the investment of the second party's funds⁷.
3. **Labour Company** شركة الابدان which is composed of persons pooling their efforts and expertise to undertake jointly certain tasks and share the returns according to some preset proportions. It is not necessary that members of such company should have the same profession, not the returns gained be a result of the effort of both⁸.
4. **Party Company** شركة المعاوضة which gives all partners equal power to act on behalf of each other in all fields. It thus encompasses all the categories of companies combined¹⁰. Parity in power between partners has been considered by some as sufficiently critical to insist they also should be equal in

(7) وزارة الاوقات والشؤون الاسلاميه ، الموسوعه الفقهيته ، 1400 هـ (1980) (7)
الجزء الاول ، صفحتي 173-178 (Fiqh Encyclopedia)

(8) It is also called bodies, skills, or undertaking company, Sabiq, p. 360.

(9) Sabiq, op. cit., p. 359-360); Al-Qari, op. cit., p. 561-562.

(10) Al-Qari, op. cit., p. 563.

wealth¹¹. Others, noting that absolute parity cannot be ascertained, opined that such company would be prohibited¹².

5. Goodwill Company شركة الوجوه in which partners do not provide any capital. Instead they use their goodwill to obtain credit from suppliers. This is why the Shafe'i and Maliki schools prohibited such company, noting that companies are related to either effort or capital, whereas both are absent¹³. However, the Hanafis and Hanbalis have approved it on the basis of the effort it involves¹⁴.

We can therefore conclude that mudharaba is best viewed as company in the form of a contractual arrangement. This view facilitates its treatment as a set of economic relationships, within the legal institutional framework. Obviously behavioral as well as analytical implication can be more easily visualized in this context.

III. LEGITIMACY

Scholars are unanimous about the legality of mudharaba. The companions of the Prophet have dealt according to this form, and examples are many¹⁵. Al-Shafe'i reports that Umer the Calif placed funds owned by an orphan with someone to use it in mudharaba.

The two sons Umer, Abdullah and Ubaidullah, were reported to have gone to join the army in Iraq. On their return, they passed by Al-Bassra, where its governor, Abu Mussa Al-Asha'ary, offered to lend them money which they could use for trade, on the condition that they would repay the principal to the Calif in Madina. They used the money to buy merchandise in Iraq which they sold in Madina for a profit. When they came to the Calif Umer to repay the principal, he asked if all the soldiers in the army were loaned in the same manner. When they said no, Umer deduced that the two men were

(11) Sabiq, op. cit., p. 357—359.

(12) This is the opinion of Al-Shafe'i, Sabiq, op. cit., p. 358.

(13) Sabiq, op. cit., p. 359.

(14) Al-Bahouti, op. cit., p. 339, and Sabiq, op. cit., p. 359.

(15) Al-Shawkani, op. cit., p. 394, and Sabiq, op. cit., p. 203-204.

particularly loaned because they were his children. He therefore demanded the payment of the principal and the profit.

Yet, Ubaidullah remarked that if the money were lost, they would have had to repay regardless. One person present suggested that the deal would be considered as mudharaba in which profit would be shared equally between the two men and Baitulmall. Umer approved¹⁶.

Uthman, the Calif, reported that he was given money for mudharaba¹⁷. The Prophet, peace be upon him, himself worked on mudharaba-basis with Khadija's money¹⁸. In addition Hakiem Ibn Hezam reported that when Al-Abbass, gave money to anyone on the basis of mudharaba, he would set a condition that the mudharib¹⁹ would not use it in trading in perishables, nor the goods purchased be carried by sea or through a flood route. Otherwise the mudharib guarantees the principal. The Prophet, peace be upon him, when petitioned to review that condition, gave his approval²⁰.

The consensus of the scholars is that mudharaba existed before Islam, and the Prophet, peace be upon him, approved of it²¹; according to Ibn Hajar. In addition Ibn Hazm says "Each section of fiqh has a known origin in Qura'an and Sunnah, except for girad, which has none such, but it is a correct and absolute consensus²²".

(16) Imam Malak, op. cit., p. 479-480 ; Al-Shafe'i, and Al-Darqatni in Al-Shawkani, op. cit., p. 394.

(17) Al-Shawkani, op. cit., p. 394 ; Imam Malek, op. cit., p. 480.

(18) (Ibn Hazm) على بن سعيد بن حزم المجلى دار الاتحاد العربى الطباعة القاهرة 1387 هـ (1907).

(19) Mudharib, is the second party in the mudharaba contract.

(20) Al-Shawkani, op. cit., p. 394, reported by Al-Darqatni and Al-Baihaqi.

(21) Sabiq, op. cit., p. 203.

(22) Abu Ghudda, op. cit., p. 3 ; and Al-Abadi, عبدالله المرجم العبادى ، موقف الشريعة من المصارف الاسلامية ، الاتحاد الدولى للبنوك الاسلامية ، القاهرة ، الطبعة الاولى 1402 هـ (1981) ، صفحته 208 - 214.

IV. PREREQUISITS

There are five conditions which need to be satisfied in order to have a legitimate mudharaba. They include the contractual form, and conditions related to partners, capital, labour (effort), as well as profit²³.

A. Contractual Form :

As a contract, mudharaba must contain the two main elements, viz, an offer and its acceptance. Details related to the form of the offer and its acceptance are many, and have been elaborated by jurists²⁴.

It must be noted, in addition, that the contractual relationship between the two parties : rabbulmal and the mudharib is flexible in the sense that it fits into different moulds, some of which are²⁵ :

1. When the mudharib receives the capital, he is considered as a trustee who is obliged to return the funds if requested before starting to work.
2. When the mudharib starts working, he becomes an agent of rabbulmal, acting on his behalf.
3. When profit is realized, the relationship becomes a contractual company in which profit is to be shared.
4. If for some reasons to be elaborated below, mudharaba becomes void and therefore nullified, it is transformed automatically to an employment contract. In this case,

(23) Al-Abadi, op. cit., p. 214, and Abu Ghudda, op. cit., p. 4. The five conditions have been mentioned by

Al-Nawawi in : *الامام القنوي ، روضته الطالبين ، المكتب الاسلامي للطباعة والنشر.*

The following exposition of those conditions has been adopted from Abu Ghudda, op. cit.

(24) See, for example, Al-Qari, op. cit., p. 549—553.

(25) The above forms are listed by Abu Ghudda while being credited to the Hanafi school among others. See Abu Ghudda, op. cit., p. 9, 10.

rabbulmal gets all the profit and bears all the losses. The mudharib gets a corresponding wage if mudharaba is profitable. Otherwise, he gets no wage at all²⁶.

5. If the mudharib violates some of the conditions or restrictions contained in the contract, he becomes an usurper who is fully responsible for guaranteeing the return of the capital in full.

B. Conditions Related to Partners :

Mudharaba partners must be legally competent. Rabbulmal (capitalist) must be competent to appoint an agent, either directly or through his legal guardian. The mudharib must be competent to act as an agent²⁷.

C. Conditions Related to Capital :

The mudharaba capital should have the following characteristics :

1. It should be in monetary, or at least financial form not in merchandise form (عروض التجارة). The reason is that the value of merchandise might change during the period of mudharaba, which introduces uncertainty to the value of capital and, hence, to the profit. However, the Hanafis and Hanbalis opined that merchandise would be acceptable, if the mudharib is authorized to sell it at the outset and then use it as capital. The Hanbalis also approved of providing capital in the form of tools and machinery. In this case, depreciation must be deducted from profits. This amounts to treating depreciation in the same manner that losses are compensated for from successive gains in the case of financial capital, for the rule is to keep one's capital intact²⁸.

(26) This is justified because it prevents void mudharaba to become more profitable to the mudharib than the legitimate one.

(27) Abu Ghudda, op. cit., p. 4.

(28) This is the opinion of the author, which is alluded to by Abu Ghudda (op. cit., p. 5), but found no basis for it. The basis here is that the principal of keeping capital intact before sharing profit must be applied equally to both financial and real capital.

2. It should be present either at the time of concluding the contract or at the time of starting operations.
3. It should not be in the form of debt (receivables), for debt may or may not be collectable. It is possible that the mudharaba contract appoints the mudharib as a collecting agent to collect the debt and then invest it. If the debt is owed to the mudharib himself, it should be present with him at the time of contract²⁹.
4. It should be of quantity and quality known at contract time.
5. It should be handed in to the mudharib. The Hanbalis ruled out that it is sufficient to make it available part by part depending on the investment requirements.
6. It should not be composed of funds mortgaged with the mudharib against a debt owed by rabbulmal, even if rebbulmal allows the mudharib to use the mortgaged funds for investment. It is noted in this regard that the rules related to mortgage according to the Malekis is that the mortgage funds are to be kept as security but not to be used for any purpose. It is also noted that some shareholders in Islamic banks borrow using their shares as collateral. To apply the above rule renders that either the bank is not allowed to invest the value of these shares, or when it does, (a) it does not guarantee the principal, and (b) the net profit (after deducting costs) goes to rabbulmal³⁰. This is similar to the case of *Ibda'* in which all the net profit goes to the capitalist.

(29) The scholars disagreed on whether a debt owed to the mudharib qualifies to be capital. This was probably in concern for its presence with him ; Abu Ghudda, *op. cit.*, p. 5.

(30) Please refer to Sabiq, *op. cit.*, p. 153-160 for the conditions of the mortgage. Abu Ghudda (*op. cit.*, p. 16) puts forward the view that the value of the stocks are considered as a trust when invested by permission of the mortgagee. The profit in this case may be shared by both parties. The opinion we offer above is close to the general mortgage rules.

D. Conditions Related to Labour :

The mudharib, who presents labour in the mudharaba arrangement, is supposed not to violate the rules of the contract. He is also supposed to stay within the restrictions set out by rabbulmal, provided that such restrictions would not completely close the door for investing the funds.

The Hanafis and Hanbalis allow for a time limit to be set for mudharaba, while the Malekis and Shafe'is do not. The mudharib may provide the funds on the basis of mudharaba to another mudharib (subcontracting), but rabbulmal may prohibit him from doing so.

A question is raised on whether the mudharib can be asked to provide guarantees. Scholars have agreed that an absolute guarantee of capital automatically nullifies the mudharaba contract, with the exception of the Hanafis who nullify the condition, keeping the contract in effect. Meanwhile guarantees against negligence, contract violations, and inability to meet one's obligations are permissible.

A question arises on whether rabbulmal is allowed to work with the mudharib. Some scholars give a negative answer, on the basis that the mudharib must have full authority to act. Some Shafe'is reason that (when rabbulmal can appoint two mudharibs, neither would have full authority. Therefore, they allow rabbulmal to work with the mudharib even if this limits the latter's power.

Abu Ghudda³¹ uses this opinion as a basis of approving the participation of rabbulmal in contemporary companies, in managerial or technical capacities, especially that these companies have legal (as opposed to natural) personalities where decisions are made by a selected group.

In addition, scholars allowed rabbulmal to volunteer his assistance to the mudharib without payment, and when the second party to the mudharaba contract is not rabbulmal (e.g., parent or guardian), he may work with the mudharib.

(31) Abu Ghudda, op. cit., p. 15.

Finally, the mudharib is authorised to do the following categories of tasks³² :

1. A category related to the nature of mudharaba and to business convention in general, e.g., to purchase, sell, lease, mortgage, etc.³³.
2. A category related to his power of discretion (if he is so allowed), e.g., giving the capital to another mudharib, or mixing it with another.
3. A category that is not allowed unless explicitly stated in the contract, e.g., borrowing, donation, etc.

E. Conditions Related to Profit :

Profit, according to the Hanafi opinion can be earned in three ways. The first is to use one's capital. The second is to employ one's labour. The third is to employ one's judgement which amounts to taking risk as in the case of subcontracting. The last way of earning profit is called by scholars *dhaman* ^{ذمان}.

In mudharaba, the way profit must be apportioned between *rabbulmal* and the mudharib must be agreed upon and stated in advance. Since profit is defined by Muslim scholars as growth of capital, the share of the mudharib must be related to profit and not to capital.

(32) These are taken from Al-Abadi, op. cit., p. 230 as adapted from (Al-Mirghaniani) 'المير غنياني' الهدايتة، المكتبة الاسلامي، القاهرة، الجزء الثالث، ص 210-211.

(33) Compare this with Abu-Ghudda, op. cit., p. 7, 8 ; where he accepts the concept of Business common practices and convention.

(34) The other three schools mention the first two only. See Al-Abadi, op. cit., p. 231—233 ; and (Al-Kassani). الكاساني (علاء الدين). مسعود الكاساني) بدائع الصنائع في ترتيب الشرائع، تقديم و تعريب احمد مختار عثمان، مطبعة العاصمة، القاهرة.

V. SUMMARY OF BASIC RULES³⁵

A. General Rules :

1. Profit is to be shared jointly according to a preagreed and declared formula.
2. Profit is to be calculated as growth in capital. When no profit is realized, the mudharib must be compensated for his efforts.
3. Release of funds by capitalist either at once or in parts as need arises.
4. Restrictions, permission, and authorization, when agreed are allowed.

B. Reasons for Nullification :

1. Restricting profit distribution to one party of the company in exclusion of the other.
2. The mudharib's bearing a part of the loss without his violation of contract rules.
3. Indetermination of the mudharib's profit share (qualitative description is not enough).
4. Setting a condition on the mudharib to guarantee principal, without his violating the contract.
5. Making the participation of rabbulmal in work a precondition.

VI. SCOPE³⁶

Some fiqh writers have limited the scope of mudharaba to mere commercial activities, viz, buying and selling. We can mention in

(35) Summarized from Abu Ghudda, op. cit., p. 7.

(36) Al-Abadi, op. cit., p. 218, 219 ; Abu Ghudda, op. cit., p. 8.

this regard the Maleki Ibn Rushd³⁷, the Shafe'i Ibn Hajar³⁸, and the Hanafi Al-Sarkhassi³⁹.

Other scholars expanded the scope of mudharaba to include trade, agriculture and industry. In this group, we find from the Malekis Sahnoun⁴⁰, from the Hanafis Ibn Abdeen⁴¹, and practically all the Hanbali scholars⁴². The opinion of these depend on two arguments. The first is that the scope of mudharaba was narrowed to reduce uncertainty الغرر. However, while a wider scope would increase uncertainty, this would not necessarily lead to conflict⁴³. The second is that business practices at the time may have influenced the proponents of a narrow scope. It is therefore better to allow what is acceptable by convention without getting to specifics which change by time and customs⁴⁴.

V. FUND PLACEMENT THROUGH INSTITUTION

Writers have recently tried to investigate whether mudharaba is applicable to "Islamic" banks⁴⁵. This was a reaction to the effort of

(37) ابن رشد (محمد بن أحمد بن محمد بن رشد القرطبي-الجهدي) ، (Ibn Rushd, Sr.) ، بدايته المجتهد و نهايته المقصد ، الطبعة الرابعة ، دار المعرفة ، القاهرة 1398 هـ (1978).

(38) ابن حجر (شهاب الدين أحمد بن حجر الهيثمي) تحفته ، المحتاج بشرح المنهاج .

(39) السرخسي (محمد بن أحمد السرخسي) ، المبسوط ، مطبعة السعادة القاهرة .

(40) سحنون (عن الإمام بن سعيد بن حبيب التنوخي القهر و اني) (Sahnoun) المدونة الكبرى (عيد السلام مالك بن انس) ، دار الفكر ، بيروت 1398 هـ (1978).

(41) ابن عابدين (محمد امين) ، حاشيته رد المختار على الدر المختار الطبعة الثانية ، مصطفى البابي الحلبي ، القاهرة 1386 هـ (1966).

(42) Al-Bahooti, op. cit.,

(43) Abu Ghudda, op. cit., p. 8.

(44) Ibid. ; Ibn Abdeen, op. cit.

(45) محمد عبدالله العربي ، محاضرات في النظام الاسلامية ، مطبعة يوسف ، القاهرة 1385 هـ (1965).

* عيس عبده ، بنوك بلا فوائد ، بيروت ، دار المفتح ، 1965 (Abdu)

* سامي حمود ، تطوير الاعمال المصرفية بما يتفق والشريعة (Hammoud)

* الإسلامية ، دار الاتحاد العربي للطباعة ، القاهرة ، 1976.

Al-Abadi, op. cit.

establishing financial institutions which would follow the rules of Sharia'. However, this situation is not peculiar to banks. Any institution, whether financial or non-financial can obtain funds to invest from savers. Therefore, in what follows, the application of mudharaba is discussed in relation to all investment institutions, taken to encompass, commercial, agricultural, industrial and financial enterprises of all sizes and legal structures.

Placing funds through these institutions is characterized by pooling of funds and continuity of placement. Those characteristics have been thought to be non-conforming to the rules of mudharaba. In addition, the requirement of settlement of operations before calculating the profit has been considered as problematic. This is discussed in what follows, before the alternative adaptations to mudharaba are reviewed.

A. Pooling and Continuity :

1. Pooling of Funds.

Whenever a mudharib accepts funds from more than one person, and whenever he does not invest each sum in a separate venture, he is pooling funds. This does not present any particular problem in the case of these sums owned by the same individual. All scholars allow for pooling in this case either before investing the (first and consecutive) sums, or after the first sum has been liquidated. The malekis approve of pooling the different sums owned by the same individual at all times⁴⁶. When different sums advanced are owned by different individuals, the following principles must be observed :

- (a) The mudharib must be capable of handling the investment of all the funds he received.
- (b) The mudharib must have the permission of those who place funds with him to pool⁴⁷.

(46) Abu Ghudda, *op. cit.*, p. 20.

(47) The Malekis do not require permission, Abu Ghudda, *op. cit.*, p. 20.

2. Continuity of Mudharaba.

Continuity of mudharaba can be justified as automatic renewal of which is based on prior approval. Therefore if funds were placed for one year, and mudharaba ended in six months, it would be understood implicitly that the mudharib is permitted to reinvest in another mudharaba.

Abu Ghudda⁴⁸ raises the question of whether the profit would be reinvested or paid out, which would imply that the loss of the first mudharaba (or a part thereof) can be offset by some of the profit of the second mudharab. This would be unfavourable to rabbulmal. It would also imply that the profit of the first mudharaba would offset the loss (or part thereof) of the second one, thus depriving the mudharib of his profit share due on the first mudharaba.

Abu Gudda suggests in this regard to design mudharaba operations lasting from the beginning to the end of the financial year⁴⁹. Funds placed before the beginning of the year would be treated as interest-free loans. Funds withdrawn (against rules of contract ?) would not earn any profit.

This solution is impractical, for it constrains the investing institution with regard to choosing the proper timing and maturities for its investment. Particularly, pooling of funds would require relating the maturity structure of investments as a whole with that of funds received as a whole.

My opinion is that whether the profit should be distributed at the end of each mudharaba or reinvested must be left to the agreement between the mudharib and rabbulmal. It would even be better to allow the investing institution to set the date of profit distribution, preferably at the end of the financial year.

B. Settlement and Profit Calculus :

Scholars use the word *tandheedh* تَنْهِيض to mean the liquidation of all real assets of a mudharaba arrangement (through their cash

(48) Ibid.

(49) Abu Ghudda, *op. cit.*, p. 21.

sale), immediately before calculating the profit. However, questions were raised on whether asset evaluation would be sufficient for the purpose of settlement.

Abu Ghudda's opinion⁵⁰ is that there is no need for actual liquidation when neither rabbulmal nor the mudharib is withdrawing from mudharaba. In the case of fund pooling, the party whose fund-placement matures would be considered withdrawing (by permission) from mudharaba, and therefore has sold to the other partners the part of his share in the assets which has not been liquidated yet, as evaluated on the date of his withdrawal. This is legitimate as an agent-conducted trust sale *بيع الامانة على سبيل التولية*.

It must be noted, however, that evaluating assets at withdrawal time would complicate the accounting process, especially that in some institutions, entry and withdrawal are made almost daily. If we would authorize the mudharib to distribute profits only at the end of the financial year, then funds are withdrawn, the final settlement would not be made until the end of the financial year. At the same time assets would be evaluated.

C. Attempts for Alternative Adaptations :

The opinions elaborated above are motivated by the flexibility inherent in Islamic Sharia' when it comes to protecting legitimate interest of all parties concerned, avoiding the imposition of unnecessary harm, and giving ample room for lawful economic activities. Some scholars attempted to find alternative adaptations of mudharaba. Four are reviewed in this section. The fifth is a call to stick to the form of a simple mudharaba company as, when interpreted with the above spirit, this can fulfil our contemporary needs.

1. The Investing Institution as Both Mudharib and Rabbulmal⁵¹: This form considers the investing institution as mudharib, and those advancing funds as rabbulmal. However, since the investing institution advances the same funds to direct investors (businessmen), it can be considered as rabbulmal.

(50) Abu Ghudda, op. cit., p. 17.

(51) Al-Arabi, op. cit., p. 36, Al-Abali, op. cit., p. 257.

This from is clear and simple. Yet it helps little in answering the questions related to pooling and profit calculus⁵².

2. The Investing Institution as Partner and Then Rabbulmal⁵³ :

This opinion considers the institution as a partner with those who placed funds with it, through its participation with its own financial resources supplied by its shareholders. Then the institution carries out the management of the financial pool on hand in the capacity of an agent to both shareholders and those who placed funds with it.

This opinion leads to two results. The first is that since the institution is a partner with others, profits and losses are to be shared. The second is that the institution can be given an extra percentage of the profit for its own management effort. In addition, this opinion allows for pooling as well as settlement before liquidation⁵⁴.

3. The Investing Institution As Agent⁵⁵ :

If those who place funds authorize the institution to invest their funds, it acts as mudharib, while the owners of the financial pool are rabbulmal. If the authorization is to finance projects, in return for a commission paid out to the institution by fund owners, it acts as an agent.

4. The Investing Institution as a Joint Mudharib :

This alternative is contributed by Hammoud⁵⁶ who views

(52) Abu Ghudda, op. cit., p. 10.

(53) (Theoretical and Practical Encyclopedia) الاتحاد الدولي للبنوك الاسلامية، الموسوعة العلمية والعملية للبنوك الاسلامية، القاوه 1937هـ (1977)، الجزء الاول، ص 23-27.

(54) Abu Ghudda, op. cit., p. 10.

(55) Al-Jammal، المصارف و بيوت التمويل الاسلامية، دار الشروق 238-239، Al-Abadi, op. cit, p. 238-239، الطبعته الاولى، ص 192.

(56) Hammoud, op. cit., p. 428, ff. ; Al-Abadi, op. cit., p. 234-239 t The Theoretical and Practical Encyclopedia, op. cit., p. 23-27.

mudharaba as composed of three parties : rabbulmal, the project manager as a special mudharib, and the Institution as a joint mudharib in the sense that he acts as such for more than one rabbulmal. Hammoud then draws similarity between the concept of a joint mudharib and a joint worker, who provides his services for more than one person, e.g., a repairman in his shop, a laundry man, a tailor, etc.

The specification of the joint mudharaba and its claimed similarity with joint workmanship allows Hammoud to draw some important but controversial conclusions. First, is that the right to restrict mudharaba moves from rabbulmal to the joint mudharib. Second, the joint mudharib guarantees the principal to rabbulmal as the joint worker guarantees the goods provided to him by his (joint) employers, e.g., things to repair or to clean. Third, dividing profit does not require *tandeedh*, since that is meant to keep capital intact which is done through the guarantee of mudharib.

The above results have met with strong objections from several sources⁵⁷. In particular, the similarity drawn between the joint mudharaba and the joint worker. such claimed similarity has no jurisprudential support. In addition, the joint worker guarantees the objects in his custody only under certain conditions⁵⁸.

5. The Mudharaba as a Company : An Eclectic View :

Abu Gudda⁵⁹ considers the different Muslim schools of thought to be successive attempts to formulate an opinion, *ijtihad*. While individuals may hesitate in moving from one school of thought to another depending on convenience, the society as a whole should do so, especially when it is looking for an important general application.

(57) The Theoretical and Practical Encyclopedia, op. cit., Al-Bbadi op. cit., Abu Ghudda, op. cit., p. 11, 12.

(58) Fiqh Encyclopedia, op. cit., p. 297, 298.

(59) Abu Ghudda, op. cit., p. 13, 14.

Abu Ghudda continues to say that it is important to distinguish between the case in which a jurisprudential opinion is based on texts (of Qura'n or Sunnah), and the case in which an opinion is based on jurisprudential rules which in turn have been deduced from other opinions through ijtiḥad or which itself leaves some room for ijtiḥad.

Some opinions in Fiqh are mere applications of the following rules :

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|--|-----------------|
| (a) The realization of legitimate interests. | المصالح المرسله |
| (b) Elimination of means to transgress. | سد ذرائع الفساد |
| (c) Convention. | العرف |
| (d) Necessity or lack thereof. | الضرورة |

From the above, Abu Ghudda reaches some important conclusions⁶⁰ :

1. The mudharaba contract had been known in pre-Islamic times, but then approved by the Prophet, peace be upon him.
2. The conditions set in detail by Muslim scholars were the product of necessity and convention at their time.
3. Therefore, those conditions are the product of ijtiḥad solely⁶¹.
4. Mudharaba is suited to cover the modern institutional set-up for investment, for it has kept its legal form, that is being a company, whose most important characteristics is the forgiving of slight discrepancies.

We can therefore conclude that the tendency to develop laborious alternatives with tedious jurisprudential justifications is not justified, not needed.

V. MODERN APPLICATION

When mudharaba was used during the early years of Islam, the number of investors was limited, the size of capital was small, and

(60) Abu Ghudda, op. cit., p. 14.

(61) Abu Ghudda supports this opinion by referring to Ibn Rashd Sr., op. cit., vol. 2 p. 252, and others, Abu Ghudda, op. cit., p. 14.

technology allowed for simple commercial, agricultural and manufacturing ventures. However, the form of mudharaba as a PLS company has been easily adaptable to quantitative as well as qualitative changes.

Contemporary conditions require creative institutional framework, within which the PLS company arrangement can develop to face the challenges of huge number of investors, enormous financial resources, and ever expanding technological frontiers. In this section, some applications of mudharaba are discussed under both non-banking and banking arrangements.

A. Non-Banking Arrangements :

People can channel their savings to investment directly through either fund placement or shareholding.

1. Fund Placement :

A saver can place his funds directly with an investor who could be an individual businessman or a company, both working in trade, production, or services. This form is a straightforward mudharaba contract which would satisfy the necessary conditions mentioned above.

In an Islamic economy, it should be permissible for individual and corporate business concerns to accept investment deposits meaning funds placed with such institutions for investment purposes according to the rules of mudharaba. Those deposits can be collected against deposit certificates⁶² which can be standardized legally into two forms :

- (a) General investment certificates.
- (b) Specific investment certificates.

Those certificates can be issued in various denominations and maturities. They would be tradable, which would create a secondary market for them.

2. Shareholding :

Savers can hold stock in companies which carry out investment themselves directly, or in companies which place funds with other direct investors hold stock in companies, i.e., financial and holding companies.

(62) محمد علي الجارحي، نحو نظام نقدي و مالي اسلامي، المركز العالمي لابحاث الاقتصاد الاسلامي، جده 1409 هـ (1981).

B. Banking Arrangements :

Banks here are meant to be a particular kind of financial companies which accepts demand deposits and is capable of providing certain services, e.g., bank guarantees, letters of credit, etc. Banks therefore carry out the same functions of financial intermediation which finance companies undertake.

On the demand side, banks can obtain funds through selling stock as well as taking investment deposits. The latter can be done either directly through marketing investment (general and specific) certificates. Those certificates have the same characteristics as those issued by a finance company.

On the supply side, banks can finance investment through purchasing stock, direct placing of funds, and purchasing of investment certificates issued by financial and non-financial companies.

C. Financial Intermediation :

It is obvious that trade, production and services companies would be attracting funds of maturity structure suited for their own operations. Finance and banking institutions, meanwhile, have to accept funds in the maturities desired by savers, which may not be best suited for the maturities demanded by investors. It is therefore a common complaint that a finance or a banking institution has to attempt to balance the generally shorter maturities on the saving side with the generally longer maturities on the investment side.

This is usually done through producing a financial asset (an investment certificate) of higher quality than would be produced by the individual saver, for the same maturity. The higher quality results from attaching the name of the issuing institution, as backed by a superior balance sheet.

However, the higher quality of financial assets will not assist in transforming shorter (saving) maturities to longer (investment) without an effective secondary market⁶³.

(63) Islamic banks and finance companies badly need to co-operate towards creating such market.

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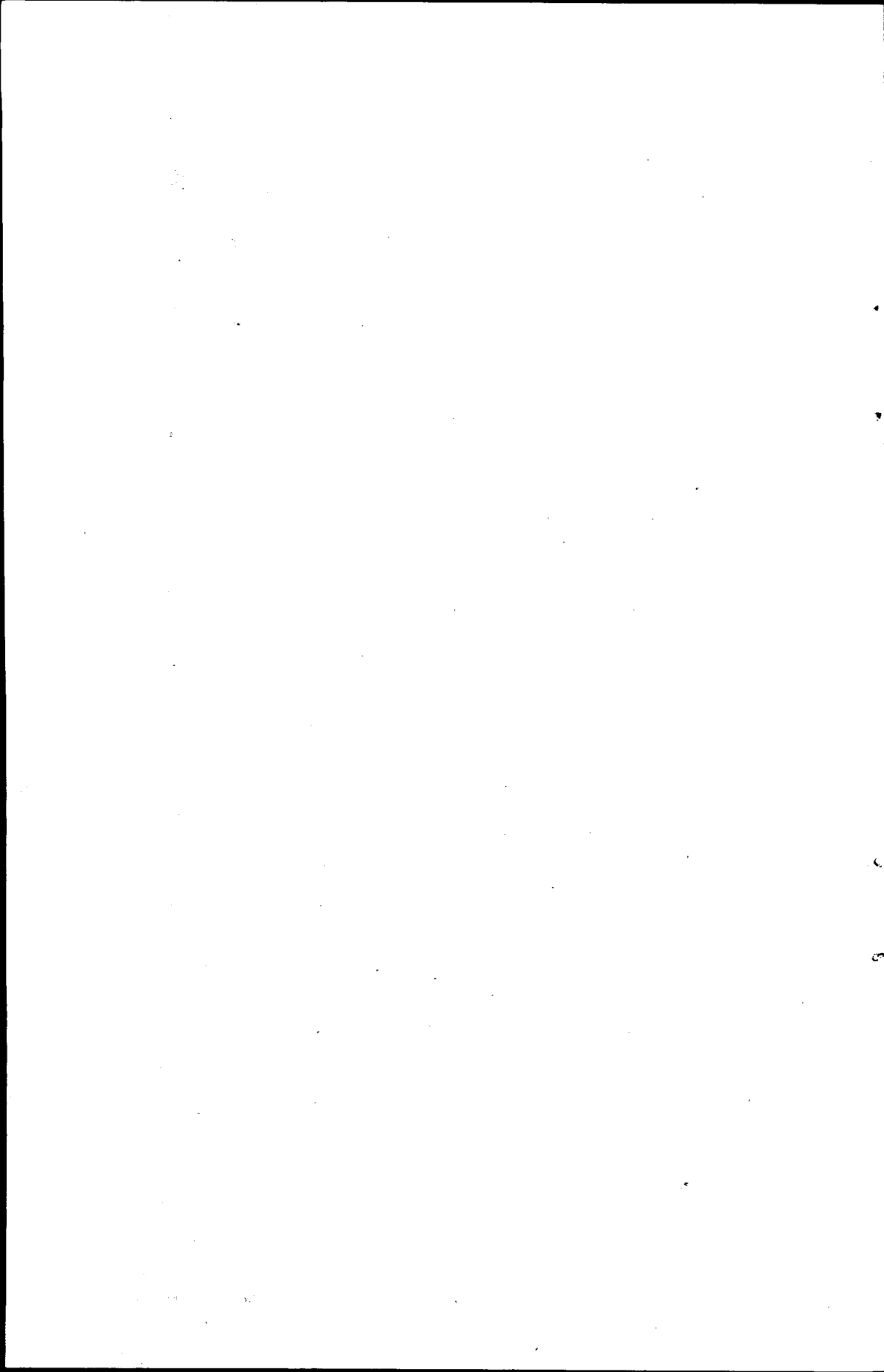
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MUSHARAKA AND ITS MODERN APPLICATIONS

ABDUL MALIK IRFANI*

What is Musharaka

Literally the word "Shirka" means mixing (1). The term *Musharaka* has the underlying idea of mixing one's capital with the capital of an other in such a way so as to lose their identity and make them inseparable (2).

Hanfa define the term *Musharaka* as a contract between the intended partners in respect of capital and profit (3).

To the *Hanabala*, *Musharaka* is a combination of titles or powers of appropriation (4).

To the *Shafia*, *Musharaka* is a proof of a right to a thing for the partners (5).

The *Malkia* take the *Musharaka* as a permission for appropriation to each of the partners to the capital of each of them (6).

A comprehensive definition of the term *Musharaka* is "to join two or more persons and work for profit with determined capitals and share the profit and loss with determined rates (7).

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1. Al-Syed Sabiq, *Fiqhus-Sunnah*, Vol. III, p-354.

2. Al-Jaziri. *Kitabul-Fiqh*, Vol. III, P-63.

Al-Sarkhasi, *Mabsoot*, Vol. XI, P-152.

Ibnul-Abideen, *Raddul Mohtar*, Vol. III, P-459.

3. Al-Syed Sabiq, *Fiqus-Sunnah*, Vol. III, p-354.

Ibnul-Abideen, *Raddul-Mohtar*, Vol. III, P-459.

4. Ibnul-Qudama, *Al-Mughni*, Vol. V, P-3.

5. Al-Khateeb Al-Sharbeeni, *Mughnil-Mohtaj*, Vol. II, P-211,

6. Al-Durdeer, *Al-Sharhul-Kabeer*, Vol. III P-348.

7. Siddiqi, Muhammad Nijatullah, *Shirkat wa Mudharabat ke Shari' Usul*, P-19.

Historical Background

From the very inception of human society the technique-ways, to meet the day to day needs, have been changing with the change of social, economic, scientific, cultural and political circumstances, especially habits, fashions and standard of living. These technique-ways regulate the commercial activities and vary from place to place and time to time. The *Arabian* society at the rise of *Islam* had very simple technique-ways and forms of business peculiar to that society. Out of these forms of business *Mudharaba* and *Musharaka* fulfilled their needs and suited their requirements. These business forms were frequently practised by them (8). *Musharaka* is the subject-matter of our discussion.

The advent of the Holy Prophet (S.A.W.S.) saw the practice of *Musharaka* already prevailing over the commercial activities in *Arabia* (9). He not only ratified it, but also did himself business on *Musharaka* basis (10).

After *Hijra*, when *Muhajireen* and *Ansar* were made brethren to each other, many of them started business together as partners in the forms of *Musharaka*, *Muzara'* and *Musaqat*, the nature of transaction being identical. As a matter of fact the diversification of nomenclature, in *Arabia*, with a slight change in characteristics named *Muzara'* in agriculture, *Musaqat* in gardening and *Musharaka* in business. *Musharaka* of capital and labour was named as *Mudharaba*. These four forms were so developed that they became independent institutions and the jurists formed detailed rules therefor. The rules of *Musharaka* given in the *Fiqh* literature pertain to various shapes of *Musharaka* prevailing in the age of these jurists i.e. in the second and third century of *Hijra*. These shapes of *Musharaka* has no resemblance to the shapes prevailing to day.

8. Al-Marghinani, Al-Hidaya, Vol. II, P 622.

9. Al-Sarkhasi, Al-Mabsoot, Vol. XI, P-151.

9. Ibid

10. Al-Nasai, Ibno Maja, Al-Hakam, Abu Dawood,

Validity

The practice of *Musharaka* was already vogue in *Arabia* and the Holy Prophet (S.A.W.S.) not only allowed it to be continued but did himself business on *Musharaka* basis, before his *ba'that* and *Al-Saib bin Yasid* was one of his partners (11).

The Holy Prophet (S.A.W.S.) told that God says, "I am third to the two partners till one of them deals dishonestly with the other" (12). The Prophet (S.A.W.S.) said on an other occasion, "Hand of Allah is on those partners who are not dishonest" (13). He further said, "Do the partnership business on equal basis. It brings the increase" (14).

There is a consensus of opinion among the jurists of all schools of thought (including *Hanfia*, *Malkia*, *Shafi'ia*, *Hanabala* and *Shia*) of all the ages and places that *Musharaka* is a valid and legitimate contract in *Islam* (15). The jurists, however, differ in its types, conditions and other details.

The various forms of *Musharaka* has been considered to be valid on the basis of *Istihsan* by the jurists of *Hanfi* School of thought (16) as discussed hereinafter.

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11. Abu Dawood ;
 12. Abu Dawood.
 13. Abu Dawood.
 14. Al-Marghinani, *Al-Hidaya*, Vol. II, P-623. This Hadis has not been found in any collection of Ahadis. The words "on equal basis" mean and include the commulative effect of capital, work and responsibility in distribution of profit.
 15. Ibnul-Qudama, *Al-Mughni*, Vol. V P-3.
Al-Syed Sabiq, *Fiqhus-Sunnah*, Vol. III, P-354.
Ali A-Khaff, *Al-Shirqat*, P-5, 21.
Ayatullah Shirazi, *Mausuatul Fiqh*, *Kitab Al-Shirakah*, P-56.
Ibnul Abideen, *Raddul-Muhtar*, Vol. III, P-459.
 16. Al-Marghinani, *Al-Hidaya*, Vol. II, *Kitab Al-Shirkah*.

Conditions of Musharaka

The following are the basic conditions of a contract of Musharaka (17), i.e.

- (a) Proposal and its acceptance. The pre-requisites of this condition are (i) free-will, (ii) sound mind, and (iii) maturity of age.
- (b) Agency i.e. each partner is an agent of other partners in all aspects of partnership business.
- (c) The profit being known i.e. rate of profit should be pre-determined.
- (d) The loss to be borne in the proportion of capitals.

Other conditions vary from type to type and will be given hereinafter when that particular type of *Musharaka* is discussed.

Types of Musharaka

Originally *Shirkat* (Partnership) is of three types, namely, —

- (a) *Shirkat-fil-milk* i.e. partnership in ownership,
- (b) *Shirkat-fil-dain* i.e. partnership in debt,
- (c) *Shirkat-fil-uqood* i.e. partnership by contract.

We are not concerned here with the first and the second type of *Shirkat*. Our subject matter is *Shirkat-fil-uqood* i.e. *Musharaka*.

Musharaka is of four types, namely, —

- (a) *Shirkat-ul-Mufavadha*,
- (b) *Shirkat-ul-Inan*,
- (c) *Shirkat-us-Sanai*,
- (d) *Shirkat-ul-Wujooh*.

An other division of *Musharaka* has been opted by some jurists

17. Al-Marghinani, Al-Hidaya, Vol. II, Kitab Al-Shirkah.
Al-Jaziri, Kitabul-Fiah, Vol. III. P-76 and the following pages.
Ibul-Abideen. Raddul-Mohtar, Vol. III, P-465-66.

According to them there are three types of *Musharaka*, namely,— (a) *Shirkat-ul-Amwal*, (b) *Shirkat-ul-Abdan*, and (c) *Shirkat-ul-Wujooh*. Again each of these types are of two kinds i.e. (a) *Shirkat-ul-Mufavadha* and (b) *Shirkat-ul-Inan* (18).

The first mentioned division of four types has been adopted by majority of the jurists of all schools of thought, although the latter-mentioned division is more logical and analytical than the former one.

The jurists agree on the validity of *Shirkat-ul-Inan*, but are not unanimous on the validity of other types of *Musharaka* (19).

Shirkat-ol-Mufavadha

Al-Mufavadha means sharing every thing on equal basis. This is a partnership of two or more persons in a business with the following conditions (20) :—

- (i) Equal capital.
- (ii) Equal power of appropriation in the partnership property and equal participation in the affairs of the partnership.
- (iii) Same religion.
- (iv) Each partner is an agent of other partners.
- (v) Each partner is responsible on behalf of other partners for their acts and deeds.
- (vi) Equal share in profit and loss.

Shirkat-ul-Mufavadha is a valid type of partnership according

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18. Al-Jaziri, Kitabul-Fiqh, Vol. III, P-67.
Ibnul-Abideen, Raddul-Mohtar, Vol. III, Kitab Al Shirkah,
 19. Al-Syed Sabiq, Fiqhus-Sunnah, Vol. III, P-357.
 20. Al-Syed Sabiq, Fiqhus-Sunnah, Vol. III, P-358.
Al-Marghinani, Al-Hidaya, Vol. II, P-623.
Al-Jaziri, Kitabul-Fiqh, Vol. III, P-67.
Al-Sarkhasi, Al-Mabsoot, Vol, XI, P-152.
Ibnul-Abideen, Raddul-Muhtar, Vol. III, P-466.

to the *Maliki* and *Hanfi* Schools of thought (21). *Shafi'ia*, *Hanabala* and *Shi'as* take it as a invalid one (22). The *Hanabala*, however, validate it with some conditions as to further restrictions on equal rights (23).

Shirkat-ul-Mufavadha is very cumbersome, if not impossible (24) due to unfeasibility of some of its strict conditions lacking flexibility and adaptability, hence unsuitable to the varieties and diversities of partnership business changing from case to case according to the needs, financial limitations, legal restrictions and economic pressures. As remarked by *Ali Al-Khafif* *Shirkat-ul-Mufavadha* cannot last for a long period and is factually non-existent (25).

Shirkat-ul-Inan

In this form of *Musharaka* two or more partners share the business on the following conditions (26) :—

- (i) Capital may be invested by the partners on any proportion.
- (ii) Power of appropriation in the property and participation in the affairs of the *Musharaka* may be different and unproportionate to the capital invested by the partners.

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21. *Al-Marghinani, Al-Hidaya, Vol. II, P-623.*
Ibnur-Rushd, Bidayatul-Mujtahid, Vol. II, P-191.
Malik bin Ans, Al-Mudawwanatul-Kubra, Vol, V, P-68.
Al-Syed Sabiq, Fiqhus-Sunnah, Vol. III, P-257.
 22. *Al-Shafi'i Al-Umm, Vol. III, P-231.*
Ibnul-Qudama, Al-Mughni, Vol. V, P-22.
Ayatullah Shirazi, Mausuatul Fiqh, Kitabul-Shirkat, P-30.
Al-Halli, Sharaiul Islam, Q II, P-130.
 23. *Al-Zuhaila, Al-Fiqhul-Islami fi Asloobi-hil-Jadeed, Vol. I, P-61-13.*
 24. *Ali Al-Khafif, Al-Sharikat, P-61.*
 25. *Ali-Al-Khafif, Al-Sharikat, P-63.*
 26. *Al-Marghinani, Al-Hidaya, Vol. II, P. 630-632.*
Ibnul-Qudama, Al-Mughni, Vol. V, P-16-17.
Ibn Rushd, Bidayatul-Mujtahid, Vol. II, P-189.
Al-Khateeb Al-Sharbeeni, Mughnil-Mohtaj, Vol. II, P-212.

- (iii) Profit may be divisible, unequally and un-proportionate to the capital invested, and may be according to the agreement of partners.
- (iv) Loss is to be shared in proportion to the capital invested.
- (v) Each partner is an agent to other partners.
- (vi) No partner is responsible to indemnify for the acts of commission and omissions of other partners.

The last-mentioned condition at (vi) above has not been properly justified. Some jurists, e.g. *Al-Marghinani* says in *Al-Hidaya* (27), that *Shirkat-ul-Inan* shall not hold good if there is an indemnifying clause in the contract of *Musharaka*, because the word "inan" means to avoid or evade from a thing. To these jurists the conditions are to be governed by these literal meanings of the word "inan". This is, however, a minority view. The majority view has a very realistic approach. According to majority of the jurists (28), including *Al-Sarkhasi*, *Al-Kasani*, *Ibnul-Qudama*, *Al-Khateeb Al-Sharbeeni* and *Ali Al-Khafif*, the word "inan" means rein of an animal and *Shirkat-ul-Inan* is a type of partnership in which reins of powers of appropriation remain in the hands of all the partners. This latter version of the word "inan", if accepted does away with the non-indemnifying condition. Secondly the reasoning of *Al-Marghinani* (and others having the same view) is vague as it has not been made clear as to why the meanings of this word cast off the indemnifying condition leaving all the other conditions unaffected thereby. Thirdly if partners are allowed to work as agents to other partners, they cannot be absolved from the consequences thereof. Lastly an important source of Islamic law i.e. *Istihsan*, which comes forward whenever the people feel some difficulty in a particular rule, demands to avoid the last-mentioned condition (i.e. non-indemnification) in

27. *Al-Marghinani*, *Al-Hidaya*, Vol. II, P-630.

28. *Al-Sarkhasi*, *Al-Mabsoot*, Vol. XI, P-151.

Al-Kasani, *Badai-us-Sanai*, Vol. VI, P-57.

Ibnul-Qudama, *Al-Mughni*, Vol. V, P-12.

Al-Khateeb Al-Sharbeeni, *Mughnil-Muhtaj*, Vol. 2, P-212.

Ali Al-Khafif, *Al-Sharikat*, P-31.

order to make the *Shirka-ul-Inan* a practicable contract encompassing a vast field of varieties and diversities in the business world today.

Shirkat-ul-Inan is a valid form of partnership in the eyes of all schools of thought (29). It is the most suitable for each and every person, adaptable to any situation and practicable in the present advanced commercial practices.

Shirkat-us-Sanai

It is, also, called as *Shirkat-ul-A'mal*, *Shirkat-ul-Abdan* and *Shirkat-ul-Taqabbul*. Through this form of *Musharaka* the artisans, technicians and other manual labourers join together, without any capital, to produce some commodity or make any other thing. In this type of *Musharaka* the wages of partners may be agreeably settled by the partners unproportionately according to their capacity of work quantitatively and qualitatively (30).

Hanfa, *Malkia* and *Hanabala* consider it as valid, whereas according to *Shafi'ia* and *Shia* it is invalid (31).

29. Al-Marghinani, *Al-Hidaya*, Vol. II, P-630.
 Al-Syed Sabiq, *Fiqhus-Sunnah*, Vol. III, P-357.
 Ibnul-Qudama, *Al-Mughni*, Vol. V, P-16.
 Ibnur-Rushd, *Bidayatul-Mujtahid* Vol. II, P-189.
 Al-Khateeb Al-Sharbeeni, *Mughnil-Muhtaj*, Vol. II, P-212.
 Al-Halli, *Sharai-ul-Islam*, Q. II, P-130.
30. Al-Syed Sabiq, *Fiqhus-Sunnah*, Vol. III, P-359.
 Al-Marghinani, *Al-Hidaya*, Vol. II, P-636.
 Ibnul-Qudama, *Al-Mughni*, Vol. V, P-6.
31. Al-Syed Sabiq, *Fiqhus-Sunnah*, Vol. III, P-357.
 Al-Marghinani, *Al-Hidaya*, Vol. II, P-636.
 Al-Khateeb Al-Sharbeeni, *Mughnil-Muhtaj*, Vol. II, P-212.
 Ibnul-Qudama, *Al-Mughni*, Vol. V, P-6.
 Al-Halli, *Sharai-ul-Islam*, Q. II, P-130.
 Malik bin Ans, *Al-Mudawwanatul-Kubra*, Vol. V, P-42.

In strict sense of the term, *Shirkat Sanai* is not a *Musharaka* for the purpose of profit, but is just a loose form of co-operation for wages among the artisans, technicians and other manual labourers.

A necessary condition of the *Shirkat Sanai* is to work without capital. With this condition only a simple transaction is possible. The complicated commercial activities coupled with public control, are limiting the scope of this type of *Musharaka* day by day and it is going to be obsolete soon.

Shirkat-ul-Wujooh

This is a partnership among the persons, having no capital, desirous to reap benefit of being influential by purchasing goods on credit and selling them on cash and thus making profits out of such bargain, the profit and loss being in proportion to the responsibility borne regarding goods purchased (32).

Shirkat-ul-Wujooh is valid to *Hanfia* and *Hanabala*, but invalid to *Malkia*, *Shafi'ia* and *Shias* (33).

This type of *Musharaka* is a single joint venture without any capital and is rarely found these days. As a matter of fact the advanced commercial and accounting techniques and complicated legal requirements of business activities have made it almost impossible to do any business without any advance investment, capital or working.

A brief survey of different types of *Musharaka* brings us to the conclusion that only the *Shirkat-ul-Inan* suits to our requirement and, therefore, needs further analysis and discussion on scope of its application to the present commercial structure.

32. Ibnul-Abideen, Raddul-Muhtar, Vol. III, P-482.

33. Al-Marghinani, Al-Hidaya, Vol. II, P-636-637.

Ibnul-Quddama, Al-Mughni, Vol. V, P-11.

Al-Syed Sabiq, Fiqhus-Sunnah, Vol. III, P-357-359.

Al-Khateeb Al-Sharbeen. Mughnil-Mohtaj, Vol. II, P-212.

Al-Halli, Sharai-ul-Islam, Q. II, P-130.

Urf of Musharaka

A deep study of all forms of *Musharaka* in the light of principles of Islamic jurisprudence leads us to arrive at—

- (a) that the Holy *Qur'an* and the Holy Prophet (S.A.W.S.) are silent on the types, conditions, validation and invalidation, proportion of capital, distribution of profit and loss, rights and liabilities of partners and determination of *Musharaka*,
- (b) failing to have a direct guidance from *Qur'an* and *Sunnah*, the basis on which the jurists formed their opinions is *urf* (i.e. practice of the people).

As discussed earlier *Musharaka* was already a prevailing *urf* in *Arabia* at the rise of Islam and the Holy Prophet (S.A.W.S.) ratified and confirmed this *urf*.

Urf is the Islamic basis of *Musharaka* being deeply rooted in it. It will, not, therefore, be out of place to elucidate the *tashr'ei* position and potentialities of *urf* with particular reference to *Musharaka*.

Urf means practice of the people, use of the people, custom or usage, not repugnant to *Qur'an* and *Sunnah*. *Ibnul-Abideen* defines it as "practice, old or new, of the people of Muslim countries" (34). The Holy *Qur'an*, repeatedly emphasizes for more than 25 times (35), to act according to "*urf*" or "*mā'roof*" (both of the words, from the same root and having the same meanings), e.g.

- (i) (O, Prophet) command them (the Muslims) to act according to *urf* (36).

34. *Ibnul-Abideen*, *Rasail*, Vol. II, P-125.

35. To quote some of them ; A-A'raf : 157 and 199, Al-Baqra : 178, 180, 235 and 263, Ale-Imran : 104, 110 and 114, Al-Nisa : 6, 19, 25 and 114,

Al-Tauba : 67, 71 and 112, Al-Haj ; 41, Luqman : 17, Al-Mumtahinah : 12.

Al-Talaq : 6, Al-Ahzab : 6.

36. Al-A'raf : 199

- (ii) You (Muslims) command according to *ma'roof* (37).
- (iii) The Prophet commands according to *ma'roof* (38).
- (iv) They (the Muslims) command according to *ma'roof* (39).

It has been recognized by the jurists that types and conditions of *Musharaka* are regulated (rather than influenced) by *urf* (i.e. practice) of the business community (40). *Urf* is the basis on which the whole building of *Musharaka* stands. How much the activities of *Musharaka* are centred around *urf* is clearly evidenced by the following maxims of Islamic law formulated and unanimously, recognised by the Muslim jurist :—

- (i) Custom (*urf*) has a force of law (41).
- (ii) The literal and true meanings are abandoned according to the custom (42).
- (iii) A thing known among merchants is like a condition agreed upon by them (43).
- (iv) What is directed by custom is as binding as a thing directed by "*nass*" i.e. *Qur'an* or *Sunnah* (44).
- (v) The use of people is a rule according to which it is necessary to act (45).
- (vi) A thing impossible by use of custom (i.e. *urf*) is factually impossible (46).

- 37. Ale-Imran : 110.
- 38. Al-A'raf : 157.
- 39. Al-Tauba : 67, 71 and 112.
- 40. Al-Kasani, *Badai-us-Sanai*, Vol. VI, P-58, 68, 69, 71-72, Ibnul-Qudama, *Al-Mughni*, Vol. V, P-16, 17. Al-Sarkhasi, *Al-Mabsoot*, Vol. XI, P-159.
- 41. Al-Mejellah Section 36.
- 42. Al-Mejellah Section 40.
- 43. Al-Mejellah Section 44.
- 44. Al-Mejellah Sections 43 and 45,
- 45. Al-Mejellah Section 37.
- 46. Al-Mejellah Section 38.

Urf (i.e. practice) of the people changes from place to place, age to age and society to society and with it the requirements of law (47). Obviously with the change of *urf* the types and conditions of *Musharaka* change.

As the *illat* (cause and basis) of the types and conditions of *Musharaka*, is the *urf* from Islamic point of view and *urf* changes from place to place and age to age, it is, therefore, not un-Islamic to follow the *urf* of types and conditions of *Musharaka* prevailing to day instead of *urf* of types and conditions thereof prevailing in the early period of Islam mentioned in the books of *Fiqh*, as recognised by jurists e.g.—

- (i) "Had the *urf* change in the life of the Prophet (S.A.W.S.) he would have ordered to act according to the changed *Urf*." (48).
- (ii) "If the *illat* (cause) of the rule of *Nass* (injunction of Qur'an or Sunnan) is *urf*, it (*urf* of the age) will be followed, whatever the age may be." (49).
- (iii) "A Mujtahid deduces his propositions on the basis of *urf* of his own age and had he been alive in the circumstances and *urf* of any other age, he would have opined according to changed circumstances and *urf*" (50).
- (iv) "Many rules change with the change of *urf* of the age. If with the change of *urf* a rule of Ijtihad relating thereto is not changed it will increase the hardships and sufferings of the people and this will be against the principles of *Sharia*' formulated on the basis of curtailment of hardships, easiness, doing away with the harms and *fasad* (peacelessness)' (51).

47. Al-Mejellah Section 39.

48. Ibnul-Abideen, Raddul-Mohtar, Vol, IV, P-251.

49. Ibid.

50. Ibnul-Abideen, Rasail, Vol. II, P-125.

51. Ibid.

- (v) "By these examples it has been proved that a *Mufti* (jurist or lawyer) should not be so rigid so as to cling with what is in *Zahir-ul-rawayat* (apparent meanings of *Hanfia Fiqh* expressed by Imam Muhammad) without having regard to the requirements of the age. In that event he will make to lose the rights of persons having these rights, and its loss will be greater than its advantage" (52).
- (vi) "That which has not been stipulated by *nass* (i.e. *Qur'an* and *Sunnah*) will be considered as based on habits of the people, as these habits have also guiding force" (53)
- (vii) An *alim* (i.e. jurist), who does not know about the people (i.e. practice of people) of his age, is *jahil* i.e. ignorant (54),
- (viii) Nature of capital of *Musharaka* changes according to *urf* of different places (55).

From the above we can, safely, conclude that according to principles of *Sharia* we have to follow the types and conditions of *Musharaka* prevailing to day and not those mentioned by our jurists living centuries ago in different *urf* of *Musharaka*. Had these jurists been alive today, they would have adopted the commercial practices of today. This is why some jurists, e.g. *Al-Sarkhasi*, *Al-Kasani* and *Ibnul-Qudama* validated many practices of *Musharaka* of their age simply on the ground that those are practices of merchants, without any reference to *Qur'an* and *Sunnah* (56) and *Ibnul Abideen* had to stipulate that "It is not for the *Mufti* and *Qazi* to decide according to *zahir-ul-mazhab* (i.e. that which is in books of *Fiqh*) and quit the *urf*" (57). He further says "Don't you see that we validated the

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52. *Ibnul-Abideen*, *Rasail*, Vol. II, P-131.
53. *Al-Marghinani*, *Al-Hidaya*, Vol. III, P-127.
54. *Ibnul-Abideen*, *Rasail*, Vol. II, P-132.
55. *Al-Sarkhasi*, *Al-Mabsoot*. Vol. XI, P-159.
56. *A-Sarkhasi*, *Al-Mabsoot*, Vol. XI, P-159.
Al-Kasani, *Badaius-Sanai*, Vol. VI, P-58, 68, 69, 71, 72.
Ibnul-Qudama, *Al-Mughni*, Vol. V, P-16. 17.
57. *Ibnul-Abideen*, *Rasail*, Vol. II, P-115.

transaction of *istisna'* (استصناع) on the ground of practice of people in spite of the prohibition by the Prophet (S.A.W.S.) of sale of a thing not in possession of the buyer (58).

When we examine the *urf* and the technique-ways of commercial activities of the *Arabian* Society of the first and the second century (and down to fifth century) of *Hijra*, we can conclude that nearly ninety percent problems and propositions of those days have lost their significance due to being redundant by change of technique-ways including currency, accounting procedure, office procedure, taxation, import and export limitations and formalities, insurance, transportation, packing, advertisement, stock and share, public financing, public trade, banking and legal formalities. Old forms of *Musharaka* have disappeared and new forms have emerged. We have nothing to fully resemble with the practices of nearly ten centuries ago.

Guiding Principles

While entering into a contract of Partnership and settling the conditions thereof we are guided by the following principles :

- (i) The Holy *Qur'an* says, "O you who believe. Squander not your wealth among yourselves in vanity, except it be a trade by mutual consent." (58A). This *Qur'anic* Verse stipulates that any agreement relating to trade by mutual consent on any condition is valid in *Islamic* Law (obviously if not clearly against *Islamic* Injunctions as laid down in *Qur'an* and *Sunnah*), even if it is against an opinion of a jurist.
- (ii) The Holy Prophet (S. A. W. S.) said "A condition not in the Book of God is invalid" (59). *Maulana Zafar Ahmad Usmani* explains the word "condition" in this *Hadis* as "A condition which has been prohibited by the Book of God or *Sunnah* of the Prophet (S. A. W. S.), but the condition, in respect of which Book of God and *Sunnah* of the Prophet (S. A. W. S.) are silent, is valid" (60).

58. *Ibnul-Abideen, Rasail, Vol. II, P-116.*

58-A. *Al-Nisa : 29.*

59. *Al-Bukhari, Muslim.*

60. *Maulana Zafar Ahmad Usmani, Ila-us-Sunan, Vol. XIV, P-95.*

- (iii) On an other occasion the Holy Prophet said, "the Muslims are bound to act according to conditions settled by them except the conditions causing *haram* to be *Halal* or *Halal* to be *Haram* (61).
- (iv) The Holy Prophet (S. A. W. S.) further told, "the matters on which there is silence (i. e. regarding which there is no injunction of *Qur'an* and *Sunnah*) are excusable". In the words of *Al-Shatbi* these matters relate to habits i.e. practice of the people (62).
- (v) Urf (i.e. practice) of the business community.
Al-Kasani lays down a principle that *Al-Shirkah (Musharaka)* is constituted according to custom (establishment practices) of businessmen (62A).

Opinions of Jurists on Musharaka

It is generally assumed that the opinions of jurists given in the books of *Fiqh* on *Musharakah* practice prevailing during the age of these jurists, are the rules which are to be followed in all the following ages. This wrong assumption can lead a person to think that *Islamic Law* has lost its practicability. As a matter of fact the jurists of early period of Islam expressed their opinion in the context of the *urf* of their own age, place, and society and on the different forms of *Musharaka* and conditions thereof in vogue during their own age (and not the forms and conditions of *Musharakah* in vogue today). Such jurists never claimed their opinions to be true in all *urfs* of all the places and ages. Even if they claimed, their claim is not ratified by *Quran* and *Sunnah*.

The *Qur'an* and the Prophet (S. A. W. S.) being silent, the jurists validated the types and conditions of *Musharaka* prevalent in those days on the ground that the people had accustomed to them and if they are asked to depart from them, they would suffer hardships which is not the aim of *Sharia'* (as discussed earlier). On the same analogy

61. Abu Dawood. A-Hakim, Ahmad, Darqutni.

62. A-Shatbi, Al-Mavafaqat, Vol. I, P-144-145.

62-A. Al-Kasani, Badaius-Sanai, Vol. VI, P-69.

we can retain those forms of *Musharaka* to which the people are familiar and accustomed today, and if they are asked to quit them and adopt the practices of centuries ago, the people would be in hardship which is not the policy of *Sharia*'. We, however, cannot, totally, ignore the opinions of old jurists. These opinions enlighten our minds and can help us to form new opinions, as hereinafter discussed.

Types of Modern Musharakas

The modern business concerns being run on the basis of *Musharaka* (as defined hereinbefore) are as under :

1. Partnership. It is regulated by—
 - (a) Partnership rules framed by the Government,
 - (b) Business practices prevailing in the business community.
2. Limited company. This type of *Musharaka* is strictly controlled by the statutory rules framed by the Government. Its commercial activities are, however, influenced by the business practices (*urf*).
3. Co-operative Societies. This *Musharaka* is also governed by statutory rules. Its commercial activities are influenced by the practices prevailing in the business community.

Conditions of Modern Musharakas

The above modern *Musharakas* principally resemble (although not fully resemble) with *Shirkat-ul-Inan*. The details are, however, considerably different due to change of (*urf*) and other factors including modern commercial techniques, economic conditions and legal requirements. Let us discuss the details of conditions of *Musharaka*, which are those of *Shirkat-ul-Inan*. Other types of *Musharakas* mentioned by jurists are nearly obsolete now-a-days.

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63. Syed Sabiq, *Fiqhus-Sunnah*, Vol. III, P-357.
 Al-Khateeb Al-Sharbeeni, *Mughnil-Mohtaj*, Vol. II, P-214.
 Ibnul-Qudama, *Al-Mughni*, Vol. V, P-15, 23.
 Al-Kasani, *Badaias-Sanai*, Vol. VI, P-62.
 Al-Marghinani, *Al-Hidaya*, Vol. II, P-630.

Capital to be invested by the partners may be unequal (63). To majority of the jurists the capital should be in the shape of currency and not in the shape of goods (64). The condition of capital to be in the form of currency only was imposed when it was difficult (if not impossible) to refer to the goods in terms of currency in the days of barter system during the age of the jurists, but now the goods are generally referred or accounted for in terms of currency. This condition should, therefore, be waived. As Imam Malik did (65) *Al-Sarkhasi* points out that the forms of capital changes from place to place according to *urf* of the place (66) and *Al-Kasani* says that if the practice of the people is to invest the capital in the form of currency, the matter shall be decided according to it and if the practice of the people is to invest the capital in the form of goods, the matter shall be decided accordingly (67). In limited companies and co-operative societies the capital is invested in the forms of equal units of currency called shares and the intended partners buy these shares as many as possible unproportionately. This practice has universally been accepted as *urf*, and is therefore according to *Islamic* principles.

The partners should mix their capitals, as according to *Al-Shafi'i* the basis of *Musharaka* is to mix the capitals (68).

In *Musharaka* business a partner is admitted into *Musharaka* with the consent of others. All steps affecting structure and entry or exist of any member are possible only with the consent of all the partners (69).

In some modern *Musharakas* i.e. limited companies and co-operative societies there is a practice (*urf*) among the businessmen that consent of existing members (share-holders to any entrant is presumed and no formal consent is needed. According to a maxim

64. *Al-Kasani*, *Baadius-Sanai*, Vol. VI, P-59, 61.

65. *Al-Kasani*, *Badaius-Sanai*, Vol. VI, P-59.

66. *Al-Sarkhasi*, *Al-Mabsoot*, Vol. XI, P-159.

67. *Al-Kasani*, *Badaius-Sanai*, Vol. VI P-59.

68. *Al-Kasani*, *Badaius-Sanai*, Vol. VI, P-58.

69. *Ibnul-Qudama*, *Al-Mughni*, Vol. V, P-16.

of *Islamic* law, a thing known among merchants is like a condition agreed upon by them (70). It is, therefore, not *un-Islamic* if no formal consent is got on the entry of a new member (i.e. shareholder) into limited companies and co-operative societies.

Managment :

Musharaka is run and managed by the *will* and *equal rights* of participation of all partners (71). Different aspects of *Musharaka* business are as follows :

1. Every partner is an agent to others (72), as all the partners are benefitted by the *Musharaka* business. When a contract of *Musharaka* is made the condition of agency is automatically presumed to be in existence in the contract (73). The actual possession of a partner over a property of *Musharaka* business is constructive possession of other partners in as much as, if a partner purchases half portion of a thing for himself and half portion thereof for the *Musharaka*, when takes possession of that thing, this possession will be considered as possession of all the partners (74). If however,

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| 70. | Al-Mejallah | Section 44. |
| 71. | Al-Halli, Sharal-ul-Islam, Q. II, P-130-131.
Al-Syed Sabiq, Fighus-Sunnah, Vol. II, P-357.
Al-Khatib, Al-Sharbeeni, Mughnil-Mohtaj, Vol. II, P-213- | |
| 214. | Ibnul-Qudama, Al-Mughni, Vol. V, P-16. | |
| 72. | Al-Marghinani, Al-Hidaya, Vol. II, P-630.
Al-Sarkhasi, Al-Mabsoot, Vol. XI, P-169.
Al-Kasani, Badaius-Sanai, Vol. VI, P-60.
Ibnul-Abideen, Raddul-Mohtar, Vol. III, P-465, 466.
Ibnul-Qudama, Al-Mughni, Vol. V, P-16.
Al-Khateeb Al-Sharbeeni, Mughnil-Mohtaq, Vol. II, P-214, | |
| 215. | Ibnur-Rushd, Bidayatul-Mujtahid, Vol. II, P-189. | |
| 73. | Al-Sarkhasi, Mabsoot, Vol. XI, P-174.
Al-Kasani, Badaius-Sanai, Vol VI, P-60.
Ibnul-Abideen, Raddul-Mohtar, Vol. III, P-465 | |
| 74. | Al-Sarkhasi, Al-Mabsoot, Vol. XI, P-171. | |

a partner purchases some thing for himself only, it is exclusively for him and not for *Musharaka* business (75). According to Muslim jurists, a partner is an agent of other partners in all forms of *Musharaka*. But he is not liable to indemnify an outsider on behalf of other partners for a loss during such agency. The matter of indemnification is not the same in the different forms of *Musharaka* e.g.

- (i) In *Shirkat-ul-Mufavadha* a partner is *wakil* and *kafil* (agent and indemnifier of other partners (76).
- (ii) In *Shirkat-ul-Inan* a partner is *wakil*, but not *kafil* (agent, but not indemnifier) of other partners (77).
- (iii) In *Shirkat-ul-Wujooh*, a partner is *wakil* (agent) of other partners, but is *kafil* (indemnifier) of other partners to the extent, he stood for as surety (78).
- (iv) In *Shirkat Sanai* the partners are agents to each other, but question of indemnification does not arise in this *Musharaka* as there is niether any capital nor any property of *Musharaka*.

Al-Kasani contends that the matter of indemnification i.e. *Kafalah* (كفالة) is based on and regulated by usage of the people i.e. *urf* (79). It means that if in a society some type of partnership has a presumptive and potential condition of indemnification as a common usage, the condition will be considered as valid. All types of *Musharckas* of today have an inherent condition of indemnification as a common usage. This condition will therefore, be taken as valid one.

2. Every partner enjoys equal rights in all respects in the absence of any condition to the contrary (80)

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75. Al-Sarkhasi, Al-Mabsoot, Vol. XI, P-173, 174.
 76. Ibnul-Abideen, Raddul-Mohtar. Vol. III, P-466.
 77. Al-Marghinani, Al-Hidaya, Vol. II, P-630.
 78. Ibnul-Abideen, Raddul-Mohtar, Vol. III, P-482.
 79. Al-Kasani, Badais-Sanai, Vol. VI, P-3.
 80. Al-Sarkhasi, Al-Mabsoot, Vol. XI, P-158.

- (i) To invest the *Musharaka* capital on *Mudharba* (81)
 - (ii) To make any person an agent of *Musharaka* (82)
 - (iii) To keep the property (or a part thereof) of *Musharaka* with any person as *amanat* (83)
 - (iv) To travel on the expense of *Musharaka* (84)
 - (v) To become a partner in any other *Musharaka* on behalf of his own *Musharaka* (85)
 - (vi) To mix the property of *Musharaka* to that of his own (86)
 - (vii) To mortgage the property of *Musharaka* (87)
 - (viii) To accept the mortgage of property of any outsider on behalf of his *Musharaka* (88)
 - (ix) To spend any sum out of *Musharaka* property. This right is invalid on the basis of *Qias* (قياس), but the great jurist *Muhammad* (the disciple of *Imam Abu Hanifa*) validated this right on the basis of *Istihsan* as it is urf i.e. practice of the people in the business community and it is like a condition settled between the parties before hand (89)
3. Any condition regarding participation in and administration of a *Musharaka* and variation in the share in the profit on

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81. Al-Kasani, *Badai-Sanai*, Vol. VI, P-71.
Al-Marghinani, *Al-Hidaya*, Vol. II, P-635.
 82. Al-Marghinani, *Al-Hidaya*, Vol. II, P-635.
 83. *Ibid.*
 84. Al-Kasani, *Badaius,-Sanai*, Vol. VI, P-71.
 85. *Ibid.*
 86. *Ibid.*
 87. *Ibid.*
 88. *Ibid.*
 89. Al-Kasani. *Badaius-Sanai*, Vol. VI, P-71-72.

this ground is valid (90). The contract of *Musharaka* is not invalid on the ground that a condition of "non-participation in the *Musharaka* business but share in the profit" exists (91).

4. Every partner has a right to participate actively in the affairs of *Musharaka* if he wishes so (92).

In all modern forms of *Musharaka*, the partners have equal rights as mentioned here-above. In the limited companies and co-operative societies the share-holders delegate their powers (right in respect of administration etc.) to some of them to be called directors or any other appropriate name. In a partnership concern the partners, by a mutual agreement, distribute among them their responsibilities, duties and jobs. As detailed above these practices are valid being *urf* of business community.

Distribution of profit :

The bases for entitlement to the profits of a *Musharaka* are capital, active participation in the *Musharaka* business and responsibility (93). A partner or share-holder may be entitled to more profit as compared with other partners if he performs more duties and takes more responsibilities than the others. According to jurists variation in the share of profit is valid on the basis of work (94). Different aspects of distribution of profit on these principles are as under :

1. The shares of profit may vary even if the capitals are equal (95).

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90. Al-Sarkhasi, Al-Mabsoot, Vol. XI, P-158.
Ibnul-Qudama, Al-Mughni, Vol. V, P-23.
Al-Kasani, Badaius-Sanai, Vol. VI, P-76.
 91. Al-Sarkhasi, Al-Mabsoot, Vol. XI, P-158.
 92. Al-Kasani, Badaius-Sanai, Vol. VI, P-71-72.
 93. Al-Kasani, Badaius-Sanai, Vol. VI, P-76.
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Al-Sarkhasi, Al-Mabsoot, Vol. XI, P-155, 159.
 94. Al-Kasani. Badaius-Sanai, Vol. VI, P-76.
 95. Al-Marghinani, Al-Hidaya, Vol. II, P-631.

2. A partner may agree to have less profit with more work than the other partners (96).
3. The profit can be distributed according to conditions settled by the partners irrespective of capitals, work and responsibility (97).

Limited companies and co-operative societies distribute their profit according to capitals of share-holders. If any shareholder participates actively in these modern *Musharakas* he is paid for it and such payments are regarded as expenditure of *Musharakas*. This is modern *urf* and there is nothing un-Islamic in this *urf*. In partnership business the profit is distributed according to agreed conditions having regard to capital and work.

Liability of loss :

All the jurists are, unanimously, of the view that the loss shall be borne by the partners according to their capitals (98). In all forms of *Musharaka* (i.e. limited companies, co-operative societies and partnership) the loss is borne on capital basis. According to modern commercial practices the loss does not cut down the respective capitals of the partners or share-holders, but remains as it is in the accounts books of the *Musharaka* in order to be adjusted against the future profits. This practice of the business community has not been discussed by the old jurists, and can be considered as valid being an *urf* and *urf* unless contrary to *Qur'an* and *Sunnah*, is valid source of Islamic Law. It is pertinently notable that while adjusting the loss against future profits the accounting procedure automatically works in a manner so as to bear on the capitals consequently.

Withdrawal of members :

During the ages of old jurists the *Musharaka* were generally formed on short terms basis, mostly of joint venture type. It was,

96. Ibnul-Qudama, Al-Mughni, Vol. V, P-23.

97. Al-Sarkhasi, Al-Mabsoot, Vol. XI, P-156, 158.

98. Ibnul-Qudama, Al-Mughni, Vol. V, P-28.
Al-Sarkhasi, Al-Mabsoot, Vol. XI, P-158.

therefore, quite easy for a partner to withdraw from a *Musharaka*. The withdrawal did not create much problems such as taxation, capital expenditure, continuous nature of business activities and goodwill. This is why the old jurists did not feel to impose any restrictions on withdrawal of a partner, but in the present amplicated commercial practices, legal requirements and public control entangle a *Musharaka* for a considerable period so vastly deeply and firmly that no partner or share-holder can be let absolved of his liability as such. So according to a modern *urf* the share-holder of a limited company cannot withdraw from it and receive back his capital invested therein. He can, however, sell his share to any person desirous to become share-holder of that company. In a partnership business a partner can be permitted to withdraw and receive his capital back after fulfilling his liabilities as partner according to terms and conditions settled between the partners. These practices fulfil the requirements of a valid *urf*.

Dissolution of *Musharaka* :

To the jurists, a *Musharaka* is a contract which is although valid but is not of binding nature (99). Its dissolution takes place in any one of the following situation (100) :-

- (i) when any partner withdraws from a partner or dissolve the *Musharaka*,
- (ii) when any partner dies,
- (iii) when any partner becomes mad,
- (iv) when the whole of the *Musharaka* capital is exhausted or lost,
- (v) when any partner is prevented or prohibited from exercising his legal powers over his property.

By introduction of, comparatively, permanent (or at least long-term) nature of *Musharakas* with innumerable partners the matter of incoming or outgoing of partners has considerably been mitigated

99. Al-Kasani, Badaius-Sanai, Vol. VI, P-77.

100. Ibnul-Qudama, Al-Mughni, Vol. V, P-18.

Al-Kasani, Badaius-Sanai, Vol. VI, P-77.

and the modern *Musharakas* such as limited companies, co-operative societies remain unaffected by such minor changes. This modern *urf* has given much stability and smooth running to these *Musharakas* resulting more benefits than from the old *Musharakas*. The modern *Musharakas* can, however, be dissolved by the majority of the partners or by order of the court of law, the both ways being not *un-Islamic*.

Limited liability :

A distinguished feature of modern *Musharakas* (except the partnership) is the limited liability of their share-holders. They cannot be held liable for more than the amount of share of capital. This requirement necessitates to regard the *Musharakas* an entity separate from the individuality of the share holders. This common *urf* has given way to safe and stable *Musharakas* resulting big commercial organizations and flourishing business. The principle of limited liability can be deduced from the saying of the Holy Prophet (S. A. W. S.), "whoever is liable for loss, is entitled to profit" (101) and, naturally, upto the same extent and proportion.

Other conditions :

Most of the other terms and conditions mentioned by the old jurists are not, now, according to *urf* of this age. These conditions can, therefore, be avoided and such avoidance will be strictly according to *Islamic* jurisprudence as discussed earlier.

Conclusion

From the above discussion we may come to the conclusion—

- (i) Out of all forms of *Musharaka* mentioned by the jurists *Shirkat-ul-Inan* is the only form practicable in these days, with slight change.
- (ii) According to *Islamic* jurisprudence, we may adopt new forms and practices of *Musharaka*, if those are in vogue these days as *urf*, instead of forms and practices mentioned in books of *Fiqh* being practised as *urf* in the days of old jurists.

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IJARA AND MODERN APPLICATIONS***

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1. Definition

In the terminology of FIQH, IJARA is a contract that permits the ownership of a lawful and certain usufruct derived from a lawful article (good & service) hired on a certain return.¹

This definition sets the following features of Ijara :

- (i) It is different from sale, gift and SADAQAT (Charity) as they result in the ownership of the object sold or gifted, and also of its usufruct.²
- (ii) The contract of Ijara (hire) always permits the ownership of the usufruct of a hired article for a specific period on a specific return, so that vagueness of either of the usufruct or of the article hired or of the period may not cause dispute among the parties involved in the contract of Ijara, and consequently render it invalid according to Shariah.³

2. Legality of Ijara

Ijara (hire), being a useful contract of mutual help and cooperation amongst the different members of the human society, has been

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unanimously approved by the prominent jurists of the recognized schools of the Islamic Shari'ah. They opine that the need of the usufruct of different articles (goods and services) is like the needs of these articles themselves. When the contract of the sale of such goods and services is permitted, then as its corollary the contract of their usufruct should also be admitted.⁴

Imam Sarakhsi stating the lawfulness of this institution writes :

“The contracts and dealings approved by the Shari'ah before Islam are to be carried out by us if there is not any text against any of them..... The Holy Prophet (Sallalloho Alaihe Wasallam) was sent as the Prophet and the people, at that time, used to lease and hire and he approved of that practice and constituted its principles’.⁵

SAHABA practised all lawful forms of Ijara. Hadrat Sa'ad ibn Abi Waqqas reported that in the age of the Holy Prophet (Salalloho Alaihe Wasallam) the owners of the lands used to let their lands on rent.⁶

3. Kinds of Ijara

Islamic jurists have classified Ijara differently according to their mode of thinking and the nature of subject under their discussion. Some prominent classifications are being enumerated here :

1st Classification ⁷

(i) IJARAT AL-AIN

Hire or requisition of the usufruct of real goods i.e. land, houses, machines, tools etc. Modern economists have termed the very kind of Ijara as hire or requisition of goods.

(ii) IJARAT AL-DIMMA :

Ijara for the services such as the hire of an animal for a specific service or the hire of someone's services for some work indicated in a general manner. In modern economics the same kind may be termed as hire of services.

2nd Classification⁸

(i) IJARA AL-FARD :

When only one person hires any good or service.

(ii) IJARA AL-MUSHA :

When a group of persons jointly hire a good or service. (Abu Hanifa (R A.), however, maintains that joint hire is not valid because its collectivity may create dispute amongst the group of the lessees regarding the ownership of the usufruct).

4. Rules Governing Different Kinds of Articles Valid for Ijara

4.1 Shops and Houses

Rules pertaining to the hire of shops and houses are as follows :

1. Their hiring is valid without mentioning their use by either of parties involved.
2. The lessee himself or any other with his permission, by payment or without payment of a part of rent, may abide in the hired house.¹⁰
3. The lessee cannot rent the same hired good or article to its lessor-the owner.
4. When a lease holder hires a house with a specific return, he cannot lease it to any other on higher return. However, he can do so if he adds any thing from his own property to the hired house/shop or he makes ammendments and alterations to the house or shop hired or he hires it out with the kind of return other than he paid.¹¹

However, Shafi's maintains that the lessee is allowed to receive higher rent form his lessee, while subletting the hired good whether or not he adds any thing to it. As a matter of fact Shafi'i takes Ijara for sale and so he applies the principles of profit appertaining to sale to Ijara.¹²

5. The lease-holder is allowed to make such necessary ammendments and alterations in the house or shop as may not result in any deterioration to it.¹³

4.2 Land for Cultivation and Construction

Lease of land for cultivation or plantation or construction may be undertaken in the light of the following principles :

1. The usufruct of the hired land should be specified whether it is for cultivation or construction of buiding. If it is for cultivation the nature and terms of cultivation should be mentioned.¹⁴
2. The lessee would be entitled to use the means of irrigation (i.e. well, water canal or water course, tubewell etc.) that exists in the part of land hired. He is also entitled to use the approach that is owned by the lessor, and leads to the hired land.¹⁵

4.3 Animals and Beasts

Rules pertaining to the contract of hiring animals for riding and the beasts of burden are as under :

1. In the contract of hiring an animal for riding, the name (names) and number of the rider (s) should be specified and if any person other than the mentioned will mount the hired animal, he will be asked to pay a part of the hire.¹⁶
2. When a beast of burden is hired for carrying burden, the quality and quantity of the burden should be stated. If the lessee loads with the burden more or other than the specified, he will be called to compensate.¹⁷
3. If the hirer beats or uses the hired animal unusually and without the permission of the lessor, and it causes its death, the hirer will be considered as misappropriater and be called for compensation.¹⁸

4.4 Hiring of the Article of Every Body Use

Islam permits the hiring of the articles of every day use i.e. clothes, ornaments, tents, utensils, machines etc. The rules¹⁹ governing such contract of hiring are as follows :

1. The hirer is bound to use these goods properly and *usefully*,

and if he utilize these articles improperly or misappropriates them, and, thus, spoils or destroys these goods, he is obliged to compensate their owners.

2. If these goods get destroyed or spoiled without any transgression on the part of the lessee or they were in such a condition that they destroyed before their use or during their use, in this case the lessee will not be called for any compensation.

5. Articles Which are not Valid for Ijara

Islamic Shari'ah has prohibited hiring of such articles and goods which perish while benefitting their usufructs. Thus, hiring of drinking water, bread for eating, pasture for grazing cattles etc., are prohibited. As a matter of fact the hiring of only those articles is valid which remain intact even after the use of their usufruct.²⁰

6. Dissolution of Ijara Contract

The contract of Ijara can be dissolved either on account of the Right of Option or under compulsion.

6.1 Dissolution on the Basis of Right of Option

Ijara contract is liable to be dissolved if any one of the contracting parties has the right of option. There are three types of rights of option (a) option of condition, (b) option of seeing, and (c) option of defect.

6.1.1 Option of Condition

Each of the parties involved in the contract of hiring, has the right to enjoy the option of condition, according to which the owner of the option of condition can dissolve the contract of hiring. It should be noted that the period of the option of condition is three days.²¹

6.1.2 Option of Seeing

The lessor and the lessee, both or their agents have the right to approve or dissolve the contract of hiring after seeing the hired article.²²

6.1.3. Option of Defect

According to this option, if the lessee finds any defect in the hired article after signing the contract of hire, he is entitled to dissolve it, if this defect effects the usufruct of the articles being hired.²³

6.2. Dissolution Under Compulsion

Another reason which permits the dissolution of the contract of hire is the emergence of such pressing need which compels the lessor to sell his articles.²⁴ The compulsion can be in any one of the following forms.

1. *Death of Contracting Parties*

If one of the contracting parties dies and the hirer had entered into the contract of hire on his own account, it is dissolved; because if the contract were still to remain in force, it would follow that the usufruct or rent then becomes the right of a person who was not party to the contract, namely, the heir, which is unlawful. It is otherwise where a person enters into a contract of hire on behalf of anyone else other than himself, such as agent or executor or the procurator of a wakf: for in that case the contract is not annulled, since if the contracting party dies, the contract is then transferred to him in whose behalf it was executed, and he consequently becomes, by construction of law, the contractor.²⁵ This is the opinion of the Hanifites, whereas the jurists of the other schools of thought maintain that the contract of hiring remains intact even after the death of any of the contracting parties because their rights and responsibilities, like their inheritances, are transferred to their heirs.

2. *Government Intervention*

The contract of hiring can be dissolved if the government enjoins upon citizens to stop all such activities and forms of transactions as include the article (good and service) being hired or the government cuts-off or destroys or abolishes all the means and ways that make possible the materialization of the contract.²⁶

3. *Maturity of the Contracting Parties*

When an immature, in whose behalf the contract was signed, attains maturity, and he declares his agents dealing null and void.²⁷

7. *Advantages of Ijara*

The traditional means for acquiring funds for investment by enterprise in plant and equipment are usually owned capital and external funds such as borrowings, capital increase, debentures and deferred payments.

The primary advantage of Ijara over the conventional form of borrowing to finance equipment is that the ownership of the asset remains with the lessor. The financing is largely unrelated to the size of assets and capital base of the lessees and depends principally on the ability of his cash flow to service payments of lease rentals.

Ijara is probably the most suitable means to raise investment funds especially for industries where rapid technological innovation is either underway or desired and for top class firms which are quickly expanding their business or small and medium enterprises and firms which have normally insufficient assets and capital bases to meet normal collateral requirements of most other forms of long term financing. The basic security under the Ijara arrangement is the "ownership of the equipment". The title of ownership to the equipment remains with the leasing company and in case of a serious default the equipment is repossessed.

8. *Modern Concept of Ijara*

Leasing is the modern technique that can be compared with the Islamic technique of Ijara. Leasing is based on the same fundamental concept of Ijara according to which one does not have to own an asset in order to enjoy the benefits of it. This has been accepted readily enough over the years in such matters as the renting of houses and more recently in the hiring of typewriter etc. It is now being applied on a large scale to business activity. There are obvious examples of course of businesses which have benefitted from their investment in fixed assets over the years. Some businesses have made

substantial capital profits from the sale of assets or have been able to improve the look of their balance sheets by the revaluation of assets. In countless instances, a strong asset base has enabled businesses to borrow for working capital and development purposes. But the reverse is also true. Some businesses would have traded more profitably if their capital had not been locked up in fixed assets and in many cases the proprietors have seen their capital assets, often of a specialist or purpose-designed nature, depreciate over the years. In the main, the profitability of a business lies in the use to which resources are put. It is the use, not necessarily the ownership, which matters. Once a business decision i.e. the investment appraisal, has been made on some new venture, the choice of purchasing or leasing is partly a matter of arithmetics, partly a question of the availability of capital and partly question of whether or not there is a case for taking finance outside the balance sheet.

It follows that to run an airline one does not need to own the aircraft, to carry oil one does not need to own a tanker, to computerize a business one may lease the hardware, to equip an office one may lease the desks and chairs. The same applies, albeit for different reasons, to non-profit making bodies. To equip a school a local authority may lease the furniture ; a hospital may lease its beds.

A comparison between lease and other similar forms of transactions, such as rental, will give a clearer picture. "Rent" as is shown by the rent-a-car business, is a contract according to which the objects are leased to individuals or a number of users for a much shorter period than their actual useful life.

In contract, the "rental contract" specifies the lease and usage for an indefinite period. A typical example is IBM's computer sales system. This system was initiated by the company which has an over-whelming world market share to promote sales in an attempt to outstrip its competitors, in the belief that it could control the progress of technological innovation of computers. While the users of the equipment leased on a rental system are major enterprises and their usage is continuous, the rented equipment is usually used in a transient manner. Whether the case is "rental" or

"rent" the lessor is charged with the responsibility for maintenance. Especially, in the case of "rental" the lessor is also charged with the responsibility for coping with the products obsolescence; so that it may be termed a service-oriented business.

8.1 Hire Purchase

Hire purchase is a recent development of instalment credit through which the manufacturers or whole-sellers sell consumer and semi-capital goods such as sewing machines, furniture, radio, T.V. and cars etc.

Hire-purchase or instalment credit is much in practice in the western countries and hire-purchase laws exist to protect customers from onerous terms in hire-purchase contracts. Only the depreciation on the items hired under the taxation laws is allowed to the lessors. Full rent of the leased assets is, however, allowed to the lessees as a tax expense. Thus, from the taxation point of view, the users of the equipment prefer lease over hirepurchase as the rent is normally bigger tax deduction as compared to depreciation.

8.2 Leasing

There are various forms of leasing. One is "lease with service" offered together with software services including system engineering, management, and maintenance when the equipment is leased and the other is "lease without service" offered solely in the form of hardware. Lease with service is usually called "maintenance lease" or "service lease".

From the view point of credits to be recovered by the leasing companies, or from that of obsolescence to be risked by the lessees, the lease can be classified into 'finance lease' and 'operating lease.' In the former case, the lessors enter into a contract by which all the cost invested can be recovered, and accordingly, the lessees use the leased equipment as if they have purchased them with loans provided. In the latter case, the lessors do not necessarily expect to recover all the costs invested when entering into a contract.

Under the finance lease system, the lessees are furnished with

the equipment without financing the procurement with loans or their own funds because it is, so to speak, a "loan in kind". The contract term is relatively long and almost equal to the service life of the leased equipment. It is impossible for the lessees to cancel the contract before it expires even if they find the leased equipment unnecessary during the term. Generally, there is a provision for cancellation if the lessees pay a penalty to the leasing companies. It naturally follows that the lessees assume the risk of obsolescence and incur the maintenance expenses of the leased equipment during the contract term. By leasing the machinery and equipment on a long term contract basis, this lease system is designed to assist the lessees in raising funds and improving their financial conditions.

On the other hand, the lessees can use the machinery and equipment only for a desired period by utilizing the operating lease. In this case major consideration is given to the use of the equipment. Unlike the finance lease system, the lessees can cancel the contract before it expires without paying any penalty. (Generally such cancellation is admitted only after a certain fixed period has elapsed and is subject to advance notice. Under this form of contract, the leased equipment is restricted to that which can be universally used, placed on the second hand market, or passed on to other lessees. This lease, therefore, takes mostly the form of a contract in which the leasing companies take charge of the maintenance of leased equipment. Offering such a service, the leasing companies are able to keep the leased equipment in good conditions so that they can circulate them in the market or sell them to other users without a loss.

The maintenance lease is represented by the finance lease accompanied by various forms of services. The lease rent may appear to be high because the service charges are included, but are not actually so high considering the fact that lessees receive the benefit of expert service. One of the best illustrations of this lease system is the maintenance lease of automobiles. The leasing companies offer all the necessary services to the lessees for automobiles such as procurement, registration, taxation and insuring. Other services include checkups, maintenance, repairing substitution and settlement of accidents.

There are four main types of financial leases :

(a) Without purchase option :

(i) Lessor retaining residual interest. The U.S. "true" lease under which the lessee has no right to a share of the proceeds of the sale of the leased asset to third parties at the end of the non-cancellable lease period and no bargain renewal option. For the contract to be designated a financial lease, the lessor will typically price the residual lease, the lessor will typically price the residual sales value at 10% to 20% of the equipment cost.

(ii) Lessees enjoying residual benefits. The normal U.K. lease under which the lessee has the right to share in sale proceeds and or renew the lease at a nominal rental.

(b) With purchase option :

(i) The French *credit-bail* under which the lessee has an option to purchase the equipment at the end of the lease term at agreed, but nominal, price and other options as in (a) (ii) above.

(ii) Lease-purchase (or hire purchase or rental purchase) under which the lessee or hirer has an option to purchase the equipment at the end of the lease term for a nominal price. The contract normally has no alternative options on the basis that the purchase option is invariably exercised, giving the lessor purely a security interest in the equipment.

9. Islamic Rules Relating to the Validity of Ijara Contracts.

In order to determine as to what extent the modern practices of leasing conform to the Islamic principles of Ijara we need to understand the Islamic rules relating to the validity of Ijara & contracts.

Besides the conditions of sanity, adolescence, freedom and mutual consent of the contracting parties (without which no contract

can come into existence), the following conditions are specifically required for an Ijara Contract to be valid.

- (i) The goods to be rented should be present and capable of being handed over to the lessee after the completion of the contract of hire.²⁸
- (ii) The usufruct of the goods or services, being hired, should have value.²⁹
- (iii) The rent of hired goods should be specifically fixed. According to the jurists, rent will be due when the following conditions are met :
 - (a) Complete acquisition or attainment of the usufruct of the hired good or capital equipment.
 - (b) Ability of the lessee to use the usufruct of the hired good (though he may not enjoy it actually).
- (iv) The contract of Ijara should not comprise any such condition according to which the rent or wages might be paid from the article manufactured or wrought upon the rented goods.³⁰ Similarly, the contract stipulating the rent consisting of a similar usufruct is invalid. If a person hires land to cultivate, in return for the right (on the part of the lessor) or cultivating other land, it is invalid. However, if two articles of two different usufructs are thus exchanged in the contract of hiring, it is valid.³¹
- (v) The usufruct of the hired article must be specified. Specification of the usufruct includes the following items :
 - (a) The period of the use of the usufruct. The lessor may lease his goods or services for a long period. The property of WAKF, however, may not be hired out for more than three years.³²

Imam Malik (R.A.) maintains that a long period for the use of the usufruct is not advisable, because it may cause dispute and tussle.³³ According to some Hanblites,

there is no need of stating the date of start and that of end of the term of usufruct.³⁴

- (b) The purpose of the hired good (whether, for example, the hired land will be for cultivation or gardening).³⁵
- (c) Rent (its nature and amount).
- (d) The article being hired should be physically fit for hire,³⁶
- (e) Any excuse, from Shari'ah point of view, should not creep into the contract of hiring which will invalidate it.³⁷
- (f) That the lessor should hand the hired article over to the lessee in its complete form and shape.³⁸
- (g) The lessor must have full possession and legal ownership of the article he is hiring out.³⁹
- (h) Existence of the hired article should continue throughout the contract period.⁴⁰

10. Economic Role of Ijara

Lease financing because of its special features can supplement the existing conventional forms of financing and further accelerate investment in the private sector.

10.1 Balancing, Modernization and Replacement of Industry

There is a large requirement of balancing and modernization of the existing industry. As a supplementary source of term credit, lease financing through balancing and modernization of the existing industry, will improve.

- (a) Capacity utilization ;
- (b) Quality ;
- (c) Production cost ;
- (d) Profitability ;
- (e) Internal generation of cash for future investment, and
- (f) International competitive capability to increase exports.

The existing industry appears to be collaterally over stretched.

and does not find much favour with the present collateral oriented financial system. The investment in the BM&R projects is relatively more productive as compared with the investment in new capacity. The BM&R projects take less time in planning, implementation and coming on stream. The BM&R programmes are, therefore priority investment from the national and corporate point of view.

Lease financing is most suited to the programmes of balancing, modernization and replacement. It would involve small dosage of investment which would carry relatively smaller investment risk but would result in a quick value added production. It would increase capacity utilization and thus contribute to the growth of the economy.

10.2 Local Capital Goods Industry

The local capital goods industry deserves support and assistance for marketing its products. The existing financial institutions concentrate on financing the imported equipment. More than 90% of the effective advances of the major Development banks in the private sector are foreign currency loans for the import of foreign machinery and equipment.

The Leasing of local equipment under the "lease financing" arrangement can play a major role in the promotion of the local engineering industry.

10.3 Medium and Small Sector

The small and medium sector is reported to accommodate 85% of the total labour force. The small and medium sector is a rich ground for the development of technology. (It has substantially contributed to the industrial development in Japan and South Korea).

It is, however, reported that only 3% of the total investment in this sector has been contributed by official and semi-official agencies. This can be attributed to the collateral oriented lending by the banking system. The small and medium sector is generally not in a position to meet the collateral requirements of the existing financial system.

Since under lease financing, more importance is attached to cash flows and management capability of the lessees than under the collateral system it is best suited to meet the financing requirements of the small and medium sector.

10.4 Off Balance Sheet Finance

There are a large number of enterprises whose balance sheets because of very high debt/equity ratios are no longer bankable. On the other hand, these enterprises require finances for expansion, balancing, modernization and replacement, and their future cash flows would present a good investment risk after the implementation of the BM&R programmes. Most of the rapidly expanding and some "Sick" enterprises in the private and public sectors would fall under this category of industries. Lease financing is based more on cash flows and assessment of the management capability than on the capital structure of the enterprises reflected in their balance sheets. It is thus more suitable in meeting the financing requirements of the rapidly expanding and some sick enterprises whose balance sheets are not bankable for raising additional finances but otherwise present good investment risk.

10.5 Transport Sector

In most Asian countries like Pakistan, the Government manages a major part of the public transport system. There is, however, a large involvement of the private sector in public transport. The buses and taxis are mostly financed by the leasing companies. The lease finance arrangement can, therefore, be helpful in leasing the buses and taxis in the private sector to improve public transport facility in the country.

A recent NDFC brief survey of bus transport indicated that 85% of the buses plying on the roads in the country have been leased by the private investors to the operators (drivers and conductors).

The unofficial rate of interest being charged by the private investors from the operators is around 26% and 43% for buses and taxis, respectively. (For second hand taxis, the rate of interest works out to almost 100%). The survey also revealed that on an average

a new bus created employment opportunity for 8-10 workers. A taxi on the other hand provides employment to 2 persons.

Lease financing of the buses and taxis through charging a reasonable rate of return would not only improve the transport system but shall create employment. It will also mitigate exploitation of the operators of buses and taxis by the private investors.

10.6 Agricultural Sector

The agricultural mechanisation policy of the Government envisages that necessary incentives would be provided to induce the private sector to purchase heavy earth moving machinery for land development. It has also been proposed that the Government will maintain a fleet of bulldozers for hiring out to farmers for land reclamation.

At present virtually no bulldozer hire facility exists in the private sector for land development and reclamation. There is also no organised facility for hiring tractors and other agricultural implements for the small and medium land owners and farmers.

Lease financing can play a major role in creating hiring facilities in the private sector for bulldozers, tractors and other agricultural implements and the equipment for land development and reclamation and management of land by the small and medium land owners and farmers. This is expected to augment the efforts of the Government to develop the agricultural sector.

10.7 Professional Class of Entrepreneurs

There is a large class of professionals who have a rich experience in the management of industry. They cannot enter industry because of their meagre financial resources. Such newcomers have normally a lower creditability rating with the banking system. Lease financing can be helpful to this class of entrepreneurs to start an industry with their limited resource capability. This would promote professional management of the industry.

10.8 Development of Technology

Last but not the least, "lease" is probably the most suitable

means to raise investment funds especially for industries where rapid technological innovation is under way like computers, office machines and communication and electronic industry etc. Lease financing of this type of equipment would help generate a modern technology momentum in the industry.

11. Institutional Requirements:

11.1 Legal Framework

At present, there is no specific legal framework which regulates leasing in the country. It is the opinion of the legal experts that although a lease agreement between a lessor and a lessee can be treated as a contract enforceable under the Contract Act but it does not meet the specific requirements of leasing. Most important of these would be the repossession of the leased assets by the lessor after a lessee goes into a default. Proper maintenance and repossession of the leased assets in case of a default is critical in leasing as the leased assets is the basic security and is the property of the lessor. The process of repossession of the leased assets is to be expeditious without lengthy legal proceeding. Besides, the lessor should have a legal cover to recover all the outstanding rent and dues from the lessees.

It would also contribute to a healthy growth of leasing if it is promoted and managed by a competent management group. It is a new financial delivery vehicle and requires adequate expertise in industrial finance to promote it on healthy and ethical business strategies. Besides, it requires large financial resources. Thus, the management group should not only possess the required expertise but good financial strength.

In order to avoid the experience of the previous finance companies, the leasing companies should be properly registered and licensed by the Government.

The Law should also provide for registration of the lease agreements and the assignments thereof to establish, without third party claim whatsoever, a clear title of ownership of the lessors in the leased assets.

Since the leased assets are used by the lessees, their selection as to the technical specifications and price etc. are normally determined

by the lessees. The interest of the lessors should be protected under the law with regard to the technical defects later discovered either after delivery of the equipment or during its use by the lessees.

11.2 Fiscal Measures

(i) Import Duty Relief

Presently, only the industrial undertakings are allowed full or partial exemption from import duty under certain categories of imports of equipment namely for balancing and modernisation and if the machinery and equipment is installed in the specified underdeveloped regions of the country. Since the equipment to be leased will be imported and owned by a leasing company it would be necessary that the leasing company be treated at par with an industrial undertaking for the purpose of import of equipment to be later leased for exemption of full or partial payment of duty as may be allowed by the government from time to time under the import policy.

This will not increase the cost and rental of the equipment if purchased on account of a leasing company and later leased to industrial undertakings and establishment located in the import duty relief areas as compared to normal import of equipment against cash payment or loans from the financial institutions.

(ii) Import of Equipment

Under the existing Import/Export Control Act, the import of equipment is allowed in the name of industrial undertakings for their own use or commercial establishment for trading in the local market. A leasing company will be importing the equipment establishment. For the purpose the import licence will be issued in the name of a leasing company. The Government may allow a leasing company to import the equipment in its name for subsequent leasing to a client.

(iii) Credit Ceilings

Provisions for credit ceilings may be made in the next credit budget by the Government and State Bank for the new leasing company to raise long term money from the banks and financial institutions to fund its operations.

12. Some Issues for Consideration Relating to the Use of Ijara as a Financing Technique.

The first issue that needs consideration is whether various forms of leasing currently in vogue conform to Islamic rules. The attributes of various forms of leasing being in vogue in modern times have already been described in the foregoing pages. Special attention needs to be given to the of leasing called finance leasing. Under this form of leasing, an asset cannot be returned to the owner during the lease period. Situations can arise when the lessee is unable to make productive use of the leased asset for reasons beyond his control such as obsolescence of leased machinery due to technical change or some irreparable technical default in the machinery. The question is whether the lessor should be obliged to go on paying rent even in such situation.

A related question is whether payment of fixed rent should be insisted upon even in situations where it can be demonstrated that the lessee has incurred sizable losses on account of unforeseen factors. Would it be desirable to develop some institutions which might help reduce the hardships of the lessee in such cases?

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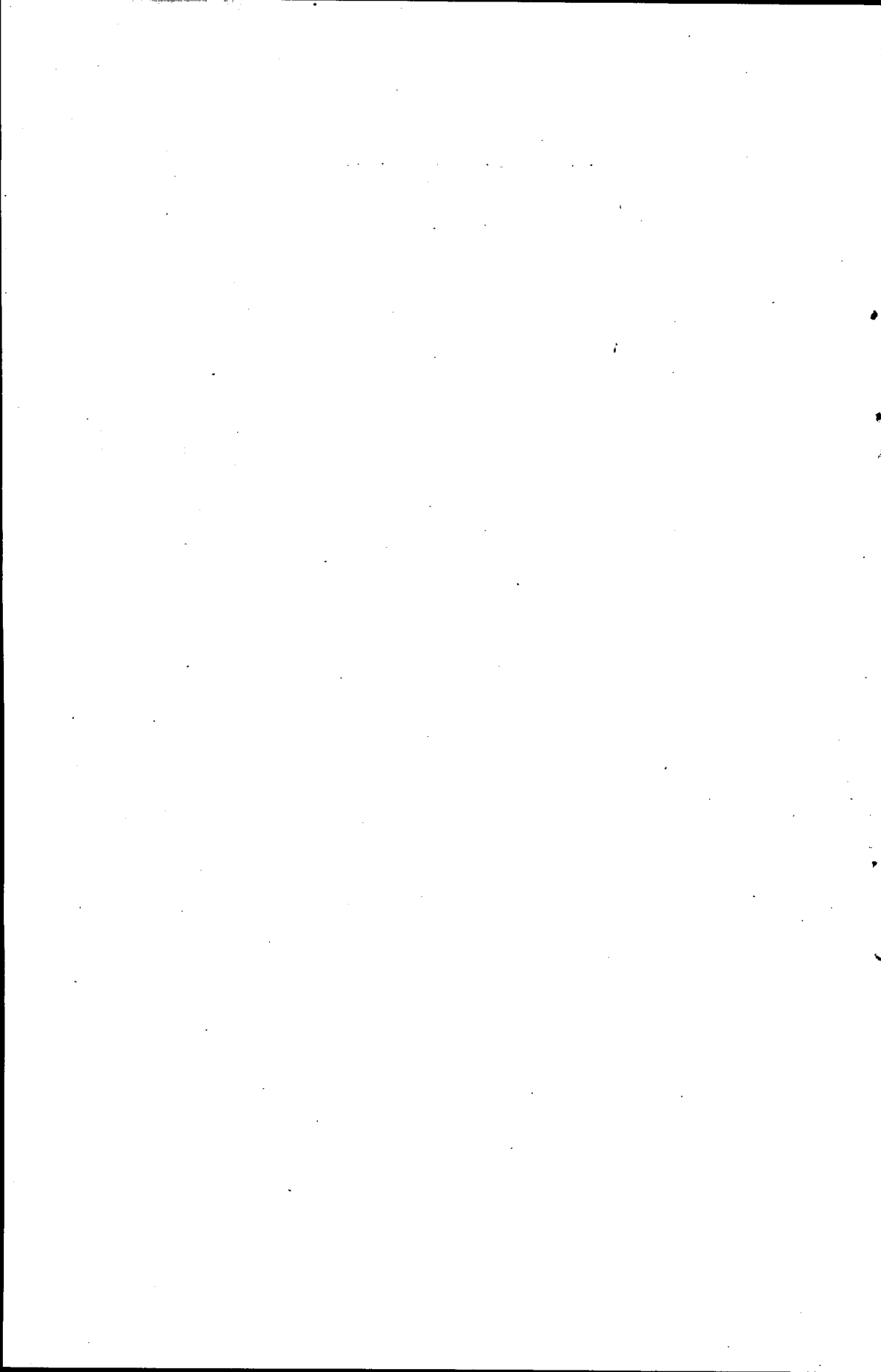
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الفسخت الأجرة
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AN ECONOMETRIC ANALYSIS OF PRIVATE CONSUMPTION FUNCTION IN PAKISTAN (1959/60—1978/79)

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The Pakistan Institute of Development Economics undertook a study to prepare an econometric model of Pakistan's Economy in 1982¹ in which the private consumption was explained in terms of disposable income, inflation (forced saving hypothesis), rate of interest, remittances from abroad, real balances and foreign aid. In 1983², another effort was made to improve upon it.

The regression equation for private consumption as estimated in "The P.I.D.E. Macro-econometric Model, 1983" is given as follows :—

$$C_P = 750.39 + 0.73 Y^d + 2.32 R$$

(28.77) (9.05)

$$\bar{R}^2 = 0.993 ; D.W. = 1.74 ; F = 1368.31$$

where

C_P = Private consumption,

Y^d = Disposable income adjusted for remittances ; and

R = Remittances.

This equation shows that private consumption is significantly and positively affected by net disposable domestic income and remittances.

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The marginal propensity to consume is 0.73, while the propensity to consume out of remittance income is much higher due to some kind of "remittance illusion"—i.e. the acquisition of the remittance income by individuals which seems to have tended to change their consumption behaviour in a manner not warranted by an equivalent change in real disposable income. Such consumption behaviour is reasonable in the short run. However, with the passage of time the propensity to consume out of this kind of income may decline as such remittance inflows become more regular. The equation fits the data well in that it explains 99.3% of the variation in private consumption and no autocorrelation is indicated.

MODIFICATION

The Macroeconometric model ignored foreign aid as there was little theoretical basis for hypothesising a direct causal relationship, positive or negative, between the two variables. Moreover, interest rate and real balances were not taken into account as there was a correlation between them.

In our view there was no need to ignore the rate of interest as the 1982 estimates show a significant effect of the rate of interest on private consumption. According to the Life Cycle hypothesis, a high rate of interest may tend to increase consumption. So the positive coefficient of the rate of interest variable appears to confirm the Life cycle hypothesis.

Many empirical studies have also shown that the rate of interest is a significant determinant of aggregate consumption. Colin Wright³ (1967) and W.E. Weber⁴ (1970) in their studies have shown the effects of rate of interest on consumption. They found that the interest rates significantly affected the aggregate consumption and that an increase in the rate of interest increased aggregate consumption.

The inclusion of rate of interest in the consumption function has policy implication for Pakistan's economy as the rate of interest still exists even with a different name. People in Pakistan can still earn fixed money by keeping money in the bank without any labour.

The consumption function in the present study looks as follow :—

$$C_p = t(Y^d, R, r)$$

where

Y^d = disposable personal income, adjusted for remittance

R = Remittances.

r = Average Interest rate.

The data we have used is the same as used in the Macroeconomic model. However, the data for the rate of interest was taken from the Econometric model, 1982.

**PRIVATE CONSUMPTION AND DISPOSABLE INCOME
(AT CONSTANT PRICES OF 1959-60)**

(Million Rupees)

Years	Consumption (C_p)	Disposable Income (Y^d)	Remittances (R)	Average Interest rate (r)
1959—60	13408.4	16496	31	2.67
1960—61	13895.3	17316	29	3.01
1961—62	14541.9	18311	35	3.21
1962—63	14642.4	19591	36	3.20
1963—64	15325.4	20394	103	3.20
1964—65	17750.2	22866	115	3.52
1965—66	17708.4	24584	186	3.96
1966—67	18990.2	25374	161	4.15
1967—68	18913.9	27147	230	4.59
1968—69	21616.8	28864	389	5.09
1969—70	23616.5	31638	379	5.32
1970—71	23759.6	31655	233	5.57
1971—72	23590.9	32058	306	6.21
1972—73	24670.0	34711	894	7.36
1973—74	29380.3	37527	703	8.44
1974—75	30357.6	39133	1004	8.96
1975—76	32170.6	40686	1164	9.28
1976—77	33920.0	42204	1783	9.54
1977—78	38486.2	46675	3404	9.65
1978—79	41485.4	49187	3891	9.66

The regression function estimated on the basis of the above data is :

$$C_P = 2308.5 + .559 Y^d + 1.697 R + 487.15 r.$$

$$\bar{R}^2 = 0.9908. \quad D.W. = 2.31, \quad F = 682.15$$

INTERPRETATION AND CONCLUSIONS

The new regression equation estimated fits the data well in that 99.1% of the variation in private consumption is explained. The value of \bar{R}^2 is also 99% although compared with the P.I.D.E. function, the degrees of freedom are reduced as there are four parameters to be calculated against three. There is no autocorrelation as suggested by the Durbin—Watson statistic which is about 2.

The equation shows that private consumption is significantly and positively affected by net disposable income, remittances and the rate of interest.

Since the rate of interest is in different units compared to consumption, income and remittances, we have used the elasticity method to know the explicative powers of the various variables. The results are as follows :

$${}^eCY = 0.72$$

$${}^eCR = 0.05$$

$${}^eCr = 0.12$$

Where eCY , eCR and eCr show elasticity with respect to income, remittances and the rate of interest respectively.

This shows that the rate of interest has more explicative power compared to remittances as 0.12 is greater than 0.05. So the P.I.D.E. should replace remittances in their equation with the rate of interest.

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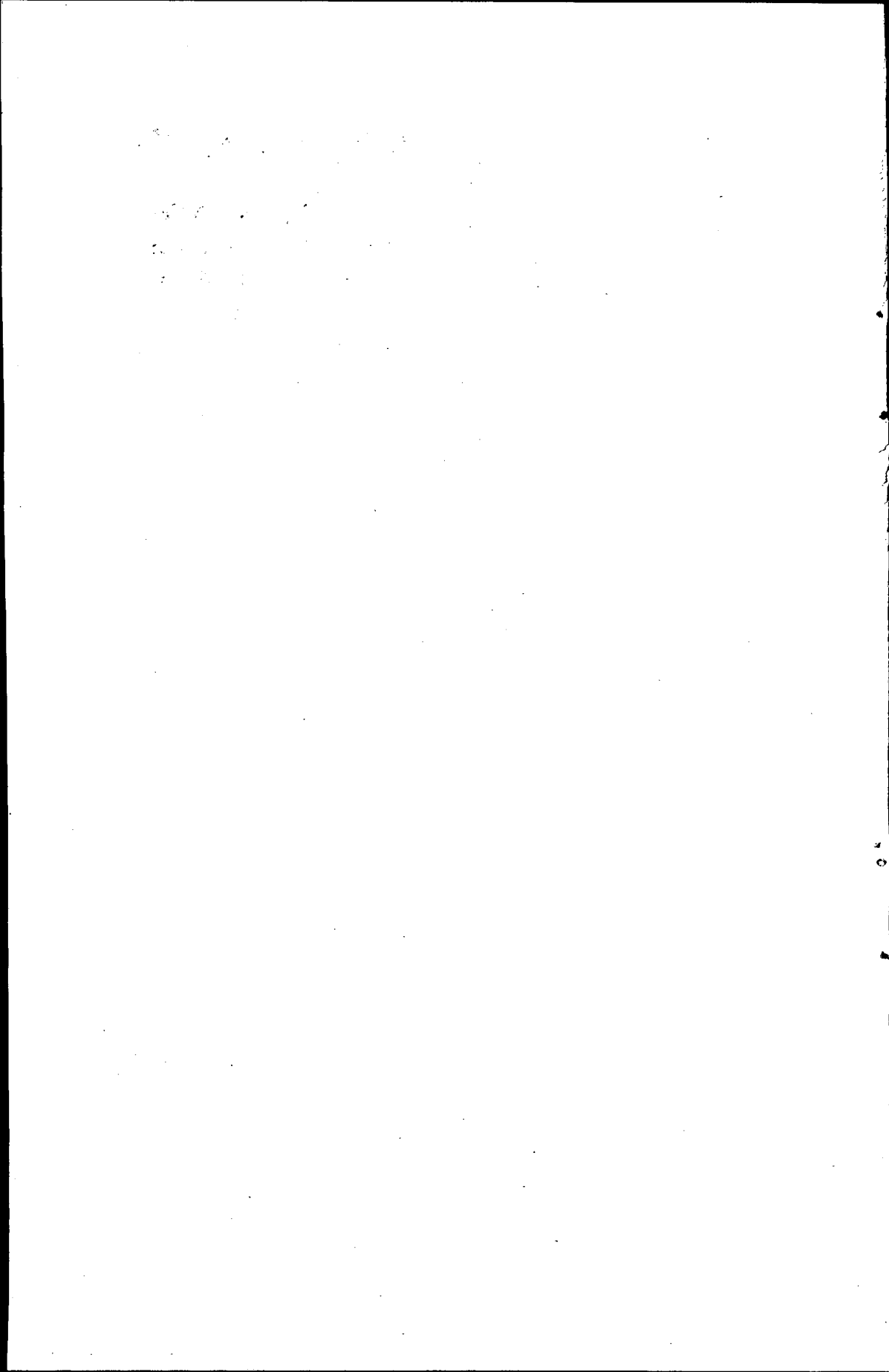
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Determinants of the Balance of Payments in Pakistan (1975/76—1983/84)

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MOHAMMAD ASLAM*****

Introduction

Most of the developing countries are facing the problem of deficit in their balance of payments. Experts and policy makers are trying to improve the situation by using various instruments of the different policies i.e. Monetary Policy, Fiscal Policy and Commercial Policy, but the problem is getting more and more serious. Unfortunately, it is the experience that the total value of exports is less than the total value of imports in the less developed countries (LDCs). Economists have given numerous reasons for this mishappening among them, the following is the most important, which has been discovered by Raul Prebisch (16, 1950) Hans Singer (14, 1950) and Myrdal (10, 1956). They argued that less developed countries had to export increasing amounts of their primary products in exchange for imports of manufactures from the industrially advanced countries.

There are several studies related to the topic of balance of payments. All these studies search for exogenous variables which may have significant effect on the balance of payments. Yet international price ratio, rate of growth of national income and total expenditures have crucial effect on this endogenous variable among the series of related independent variables.

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In the concerning debate, there is much controversy about the rate of growth, and the opinions are on the opposite poles. Some experts argue that the balance of payments is positively related to the rate of growth of national income. They have estimated the effect of rate of growth on the balance of payments and they found positive correlation between these two variables, i.e. with the increase of rate of growth in national income, balance of payments is also improved (Mundell, 1968). Another group of scholars accepts this relationship, but holds it true only for a short period of time (Wein, 1974). Keynesian followers totally refute this hypothesis (positive correlation between rate of growth of national income and the balance of payments) and they agree to the standard Keynesian result (Traditional Hypothesis) that an increased income decreases the balance of payments by imports (Purvis, 1972)

Mundell's model is as follows

$$X - M = R \quad (1)$$

where R is the change in reserves, which he identifies as the change in the money supply, and X and M are the values of exports and imports respectively.

$$Y - E = \dot{L} \quad (2)$$

The above relationship results from the "Community sectoral restraints" where Y is income, E is domestic expenditure, and \dot{L} is the growth in the demand for money. The demand for money itself, at a given rate of interests, is

$$L = KY \quad (3)$$

where K is constant. Therefore

$$\dot{L} = \dot{K}Y = KY \lambda \quad (4)$$

where ' λ ' is the rate of growth of Y

Equation (2) & (4) imply

$$Y - E = K\dot{Y} \quad (5)$$

$$E = (1 - K\lambda) Y \quad (6)$$

Exports are assumed to be exogenous and the import function is given

$$\text{by } M(t) = a + m E(t). \quad (7)$$

$$\text{with which (6) Yields } M(t) = a + m(1 - K\lambda) Y(t) \quad (8)$$

so that $B(t)$, the balance of payments, is

$$B(t) = X(t) - m(1 - k\lambda) Y(t) - a \quad (9)$$

Mundell, then, states his conclusion as :

“This equation shows that the rate of growth of income, affects the balance of payments favourably”.

Douglas D. Purvis (2, 1972) has criticised the standard Keynesian analysis and explained the positive behaviour of the rate of growth of national incomes on the balance of payments. According to his analysis exports would be expected to increase if there is no change in domestic absorptions. In his model he has not treated the exports as exogenous. His model supports Mundell's result that an increase in growth must improve the balance of payments. However, he postulates that two basic problems remain. One is related to the specification of the source of growth and the other is about allocation for domestic monetary policy. Only change in the Mundell's framework made by Purvis (2, 1972) is as follows :

$$X(t) = Y(t) - [E(t) - M(t)]$$

substituting from equation (6) and (7) we have

$$X(t) = a + (K + m - mk\lambda) Y(t) \quad (10)$$

substitution of equation (10) into (9) we have

$$B(t) = K\lambda Y(t) \quad (11)$$

Wein, J (6, 1974) reconsidered the Mundell's model and replaced λY by \dot{Y} to obtain

$$B(t) = X(t) - mY(t) + mk\dot{Y}(t) - a \quad (12)$$

and then differentiated this function to get

$$\dot{B}(t) = \dot{X}(t) - m\dot{Y} - mk\ddot{Y}(t) \quad (13)$$

This shows that the rate of change of the balance of payments depends on the growth of exports and income, and on the rate of change of income growth. Kuska, E.A. (7, 1978) demonstrated the standard equilibrium condition for the home-goods market.

$$Y = E + (X - M) \quad (14)$$

$$\text{Implying } B = L \quad (15)$$

Equations (4) and (15) then imply

$$B = K\dot{Y} \quad (16)$$

This equation may be rewritten either as

$$B = K\lambda Y \quad (17)$$

where λ is the proportional rate of change in Y or as

$$B/Y = K \quad (18)$$

Equation (16) and (18) then yield the following proposition: suppose the demand for money is proportional to income and there is no domestic credit creation, then

- (i) The balance of payments is proportional to the rate of change of national income.
- (ii) The ratio of the balance of payments to national income is proportional to the percentage change in the latter variable, i.e. its rate of growth

Bhagwati (1, 1958) supported another phenomenon called immiserizing growth; that is, a growing country may become worse off with growth, but the condition is that growing country must have open

economy. Balance of payments varies from economy to economy and also according to the expenditure pattern of the society. However, no scientifically acceptable answer can be given and the debate will continue.

Pakistan's economy like other developing economies, is also facing the problem of deficit in the balance of payments and attempts are being made to improve the situation through numerous injections. The objective of this study is to test these conflicting hypotheses and to see in the context of Pakistan.

- (i) To what extent our rate of growth of national income has been responsive to the changes in the balance of payments.
- (ii) The effect of terms of trade and the total expenditures on the balance of payments.

The paper has been organized in the following manner; Section I presents a survey of the literature on relationship between growth of income and the balance of payments. In Section II, a model has been developed in brief, also the data and the variables have been discussed. Section III, gives results obtained from the regression analysis. Finally in section IV, conclusions have been drawn from the analysis.

SECTION I

The purpose of this section is to review the theoretical and empirical literature on growth and balance of payments and to summarize the state of our knowledge on the subject. The relationship between rate of growth of national income and the balance of payments has been tested empirically and can be represented in a wide variety of formulations. However, these can be grouped according to two broad specifications. Robert A. Mundell (12, 1968) demonstrates that the balance of payments is positively related to the rate of growth of national income.

Khan, Mohsin (9, 1973) has empirically tested the two alternative hypotheses, i.e. traditional and Mundell's point of view. He has

treated the export as a function of income instead of being exogenously determined. On the basis of cross-country regression analysis, he concluded that the increase in the rate of growth would lead to a deterioration in the current account balance.

The standard Keynesian models have always assumed that increase in income will increase imports and worsen the trade balance. Johnson and Jones (4, 1953 & 5, 1957) constructed models in which increases in income worsen the trade balance and improve capital account. Morina (8, 1967) and Komiya (13, 1969) found that the movement in the trade balance will depend on the situation of the economy. Naqvi (15, 1973) is of the view that within the framework of growth strategy adopted in Pakistan, there has been an excess demand for imports, which mainly takes the form of capital goods imports, inflating the capital output ratio and at the same time deteriorating the balance of payments position.

There is much controversy in the literature on this area and we may not have definite idea about the correlation between balance of payments and the rate of growth of national income. Moreover, in the next section we will test Mundell's and Keynesian hypotheses and after estimations we shall derive some specific conclusions.

SECTION II

The Model & Variables.

The accounting balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and the residents of the rest of the world over a specific period of time.

Balance of payments is calculated by deducting the exports of goods and services from the imports of goods and services.

Balance of payments, however, depends on the following :

- (a) Rate of growth of national income.
- (b) Terms of Trade.
- (c) Total domestic expenditures.

We have the following system of the determination of the balance of payments.

$$B = f(Y, P, E, \dot{Y})$$

$$B = X - M \text{ and}$$

$$E = I + C$$

where

$$I = G + S$$

$$C = C_{pr} + C_{pu}$$

where

X = Values of the exports of goods and services

M = Values of the imports of goods and services

B = Balance of payments

E = Total Domestic expenditures

I = Total gross national investment = G + S

C = Total consumption

G = Gross Domestic Fixed
Capital Formation

C_{pr} = Private consumption

C_{pu} = Public consumption

P = International price ratio (Terms of Trade)

Y = Income

\dot{Y} = Growth in the income

m = Marginal propensity to import

S = Change of stock

All values are expressed in terms of constant Pakistan million Rupees, with 1975-76 as base year.

Data came from various publications of the Government of Pakistan and World Bank such as :

1. Pakistan Economic Survey (Various Issues)
2. Statistical Bulletin (Various Issues)
3. Statistical Paper Series, PIDE
4. World Bank, World Tables

For further details see the following tables.

SECTION III

The results of estimation.

Our analysis is based on the ordinary least squares technique. The figures in paranthesis are the computed 't' values. The 't' and 'f' values with asterisk (*) or double asterisk (**) are significant at 95% and 90% confidence level respectively. The estimated equation for the balance of payments is given by

$$\begin{aligned}
 B &= 12.89 - 8.9 \text{ GNP} + 2.5 \Delta \text{ GNP} \\
 &\quad (12.8)^* \quad (-2.42)^* \quad (2.30)^* \\
 R^2 &= .92, \quad F = 29.61^* \quad DW = 2.331 \quad (1)
 \end{aligned}$$

This shows that real GNP and change in real GNP have significant negative and positive effect respectively on the real balance of payments. The same holds for the following equation, where we have estimated the effect of real GNP and change in real GDP on the real balance of payments

$$\begin{aligned}
 B &= -17.2 - 2.5 \text{ GDP} + 4.4 \Delta \text{ GDP} \\
 &\quad (-2.4)^* \quad (-2.89)^* \quad (2.25)^* \\
 R^2 &= .79, \quad F = 29.69^* \quad DW = 2.06 \quad (2)
 \end{aligned}$$

Signs of the co-efficients suggest that higher level of income deteriorates the balance of payments while a higher growth rate improves it. While considering the balance of payments, we should consider the International price ratio. The estimated equation is

$$\begin{aligned}
 B &= -5.8 - 5.8 \text{ GDP} + 4.4 \Delta \text{ GDP} + 3.8 \text{ P} \\
 &\quad (-3.2)^* \quad (-2.9)^* \quad (2.01)^{**} \quad (2.89)^* \\
 R^2 &= .98, \quad F = 42.48, \quad DW = 2.08 \quad (3)
 \end{aligned}$$

$$\begin{aligned}
 B &= -7.93 - 5.5 \text{ GDP} + 4.2 \Delta \text{ GDP} + 7.8 \text{ P} \\
 &\quad (-2.68) \quad (-2.48)^* \quad (2.58)^* \quad (2.94)^* \\
 R^2 &= .87, \quad F = 30.36^*, \quad DW = 2.04 \quad (4)
 \end{aligned}$$

All the independent variables are significant in all cases. The positive regression co-efficients of terms of trade indicate that export supply is more responsive than import demand.

We have also estimated the effect of real domestic expenditures on the real balance of payments.

$$B = -16.17 -9.2 \text{ GNP} + 3.8 \Delta \text{ GNP} -2.5 E$$

$$(-2.4)^* (-2.02)^{**} (2.07)^* (-2.95)^{**}$$

$$R^2 = .95, F = 14.8, DW = 2.02 \quad (5)$$

$$B = -11.13 -2.5 \text{ GDP} + 4.14 \Delta \text{ GDP} -2.9 E$$

$$(-4.4)^* (-2.25)^{**} (2.90)^* (-2.95)^*$$

$$R^2 = .85, F = 12.8^*, DW = 2.09 \quad (6)$$

Now all the variables are highly significant. Gross National product and Gross domestic product and their changes have same effect on the balance of payments which we have seen in eq (1), eq (2), eq (3) and eq (4). The interesting results are achieved by the estimation of expenditures. The signs of the co-efficients of expenditures are negative in eq (5) and eq (6). This shows that Pakistan's society is consumption-oriented society and there is also great demand of the foreign capital, these two elements have negative effect on the balance of payments.

SECTION IV

Summary & Conclusions

The analysis leads to the conclusion that the real balance of payments is improved with the positive change of the real GNP and GDP, while on the other hand, the real GNP and GDP have adverse effect on the real balance of payments. This proves the Keynesian hypothesis that with the increase of income there is more demand

for the imports and also for the exported product, which worsens the balance of payments. The effect of rate of change of income shows that there is improvement in the product of import competing industry as well as that of export industry. Whereas the effect of international price ratio shows that improvement in the international price ratio is favourable for the balance of payments, the expenditure effect determines that the more demand for imported capital and consumer goods has negative effect on the balance of payments.

*Determinants of the Balance of Payments
in Pakistan (1975/76—1983/84)*

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TABLE I
At Current Prices (Million Rupees).

Year	Balance of Payment (Current A/C)	GNP	GDP	Private Consumption	Govt. Consumption	Total Gross National Investment.
1975-76	-8185	124415	121423	104911	14343	22770
1976-77	-8935	143299	137819	121098	15816	27421
1977-78	-4838	173888	161749	146276	17977	29961
1978-79	-9740	194548	180015	165592	19139	33355
1979-80	-8635	231655	213371	198887	22127	41376
1980-81	-7420	273665	250973	236799	27331	45503
1981-82	-11493	317471	292122	270740	32477	63044
1982-83	-2065	368190	328727	304070	39694	63044
1983-84	-8387 E	416198 P	375693 P	346856 P	46951 P	70581 P

E : Estimated

P : Provisional

Total Gross National Investment = Gross Domestic Fixed Capital Formation + Change in Stock

Source : Federal Bureau of Statistics.

TABLE II
At Constant Prices (Million Rupees)

Year	Balance of Payment*	GNP	GDP	Aggregate Consumption	Gross National Investment.
1975-76	-8185	41410	40699	A 119254	B 119254
1976-77	-7757	43161	41866	118870	120629
1977-78	-3462	47697	45022	177525	123303
1978-79	-6229	50596	47530	118137	124608
1979-80	-4637	54132	50980	118697	125769
1980-81	-3373	59126	54311	120080	127790
1981-82	-4504	60750	57906	118929	126036
1982-83	-698	65497	61413	116160	126977
1983-84	-2507	68537	64143	177230	127277

* Deflated by GNP Deflator

A Deflated by GNP Deflator

B Deflated by DDP Deflator

Gross National Investment is deflated by Investment deflator.

TABLE III
(1975-76 base)

Year	GDP Deflator	GNP Deflator	Terms of Trade	Investment Deflator*
1975-76	100.00	100.00	100.00	100.00
1976-77	113.50	115.18	108.91	113.81
1977-78	133.21	139.76	105.31	132.84
1978-79	148.25	156.37	126.18	150.40
1979-80	175.73	186.20	111.41	183.25
1980-81	206.69	219.96	97.00	219.53
1981-82	240.58	255.17	89.18	251.38
1982-83	270.73	295.94	89.19	286.13
1983-84	309.41 P	334.52 P	93.04 P	351.51 P

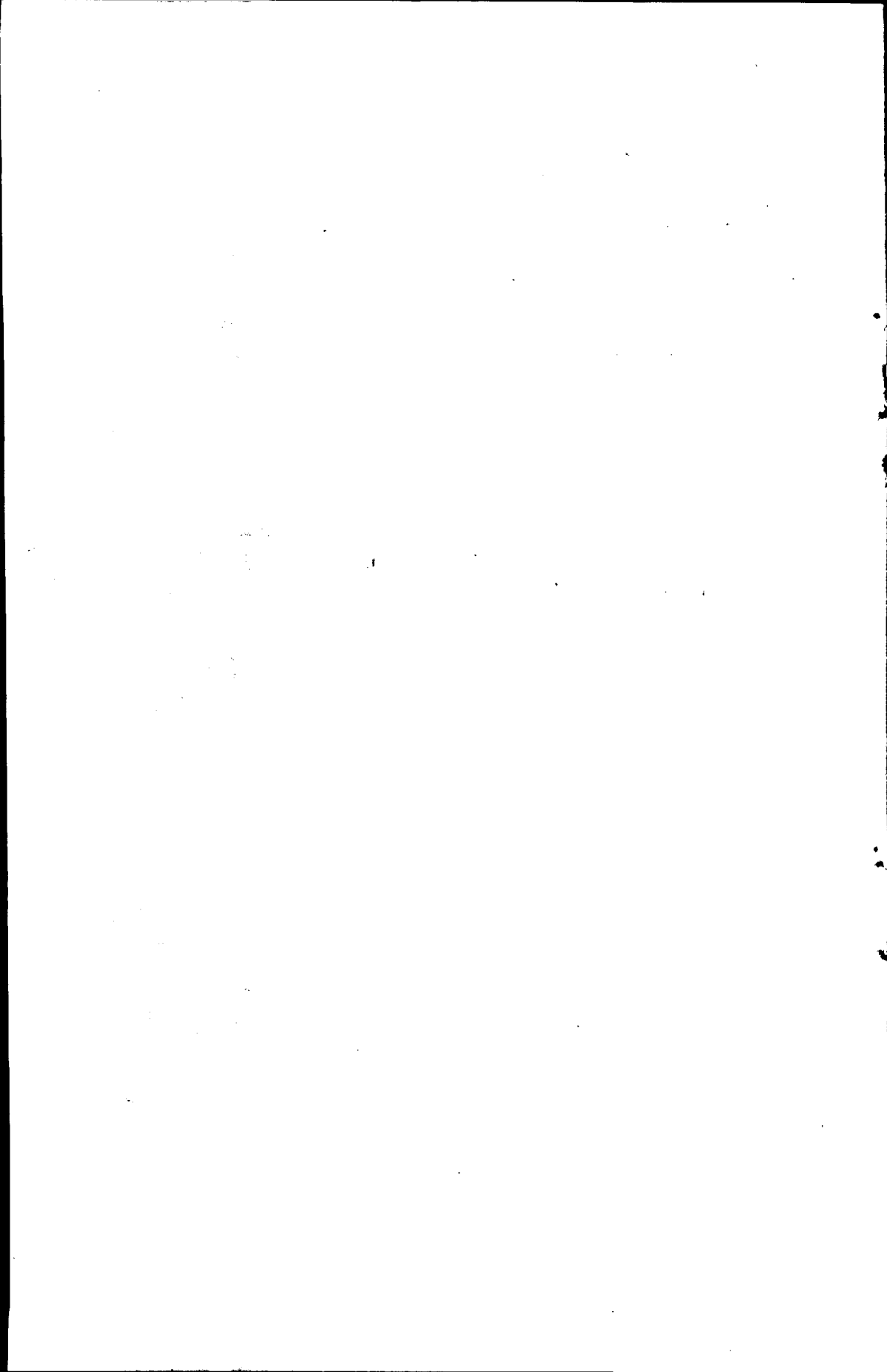
P Provisional

* Investment deflator is the weighted average of the machinery Price Index and the construction Price Index.

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Analysis of Household Consumption in Pakistan

SHAHNAWAZ MALIK* AND RAFIQ AHMAD**

1. Introduction

The main objective of economic planning in underdeveloped countries like Pakistan is to achieve a rapid increase in the real income of individuals. Such rise in real per capita incomes is usually accompanied by an increase in the demand for different commodities. In this situation it is useful to have a knowledge of the future demand for different consumer goods. The need for such a knowledge is further heightened by the fact that in developing countries the increased incomes in the hand of poor people shall generate demand for consumer goods rather rapidly and unless the available supplies match this increased demand, inflationary tendencies will appear. This is likely to hamper the smooth functioning of the process of economic growth.

The determination of the magnitude and direction of future demand requires a knowledge of number of factors, such as prices, population, consumer behaviour and incomes. In this study our attention is focussed on the analysis of consumption patterns in Pakistan taking into account both rural and urban areas.

The findings of the study are likely to prove useful in the following ways :

- (i) It will make an empirical contribution towards the desirability of making demand forecasts.
- (ii) The results of the study may prove useful to policy maker both in the industry and in the Government.

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In our analysis we assume that the prices paid by the consumers belonging to the various expenditure classes and regions are the same. This is rather a difficult assumption to justify since normally urban prices, on the average, are higher than rural prices. However, this limitation may be justified to considerable extent on two bases. Firstly, the fact is that though the urban prices are higher than rural prices yet these differences are not substantial. Secondly, as Brown & Deaton² point out, in many planning and forecasting situations it is possible to ignore the effect of prices and deal with income effect only since the economist often has a much clearer idea of the future course of real income than he has of likely change in relative prices. Since the findings may be used in case of Pakistan's planning and forecasting models the argument becomes valid in the present context.

2. Analysis of Engel Elasticities

II-I Theoretical Frame Work :

The static theory of consumer behaviour tells us that the demand by consumer for each commodity can be expressed as a function of the consumer's income and all market prices. Mathematically, we can write this relation as :

$$q = q(y, P)$$

where q = quantities vector (1)
 P = prices vector, y = income

if prices are held constant we have the relation :

$$q_i = q_i(y/P) \quad (2)$$

which is homogeneous of degree zero. Here demand has been expressed solely as a function of the consumer's income, a relation which is now generally known as the consumer's Engel curve for commodity, i .

In order to estimate a function of type (2) from cross section data we have to assume that, on average, the differences in consumption patterns between rich and poor households can be ascribed to their

differences in current income. Since prices are assumed constant the budget must be collected over the shortest possible period of time and from sufficiently small region for geographical differences in prices to be negligible.

At this stage we must mention the problem of aggregation. This is especially serious in respect of time-series studies. As for as cross section data is concerned (as in the present case), Fisher³ reported that in the presence of many degrees of freedom it is unlikely that aggregation will pose any problem. In the same way Cramer⁴ pointed out that the data with extended range of observation to the extremes was a satisfactory solution and that the efficiency could further be improved by increasing the number of observations among the mentioned properties. As our data satisfy this criteria we can assume that the aggregation problem would not arise in our case.

The simple two and more than two parameter Engel curves which are commonly used for cross-section analysis may be derived from mathematical forms such as lognormal distribution functions and the logreciprocal function. Over the range in which elasticity is greater than unity the double logarithmic or constant elasticity form of following type is useful :

$$\log q_i = \alpha_i + \beta_i \cdot \log y \quad (3)$$

This functional form is quite popular as it gives the elasticity directly. In the region where the elasticity is around unity the linear form :

$$q_i = \alpha_i + \beta_i y \quad (4)$$

is a good approximation. This form assumes that the (mpc) is constant. If the intercept is positive this function would suggest an increasing elasticity whereas in the case of negative intercept the elasticity would be declining for necessities.

In the first part of the range of necessities the semi-logarithmic form ;

$$q_i = \alpha_i + \beta_i \log y ; \alpha_i, \beta_i > 0 \quad (5)$$

is useful since its elasticity continuously declines towards zero.

For items for which one expects a saturation level a hyperbolic or a loginverse form is better suited. A hyperbolic form

$$q_i = \alpha_i + \beta_i/y ; \beta_i > 0 \quad (6)$$

has the property that there is an initial income below which an item is not purchased. The log inverse form

$$\log q_i = \alpha_i + \beta_i/y ; \beta_i > 0 \quad (7)$$

retains the basic characteristics of the hyperbolic function. Since an item may be luxury at rather low levels of income with elasticities substantially greater than or equal to unity a necessity or near necessity at a little higher level of income with elasticity less than unity and an inferior item at relatively high levels of income with negative elasticities, it is found useful to employ some hybrid equation combining two or more simple equations to take into account such a behaviour. The semi log inverse form

$$q_i = \alpha_i + \beta_i \log y + r/y \quad (8)$$

and the double-log inverse form

$$\log q_i = \alpha_i + \beta_i \log y + r/y ; r < 0 \quad (9)$$

are such type of functions.

All these forms have the property that simple regression technique can be applied after the appropriate transformation so that the basic model may easily be elaborated in other directions.

II-2 : Estimation

For computing Engel elasticities formulation of the type (3)-(9) are fitted. In these relationships we have assumed that all or most of the variation in the consumption of an item depends on total household expenditure. This assumption is justified on the ground that in developing countries income is less satisfactory variable than expenditure since a large number of households, in short run, live on borrowed money at the lower levels of expenditure. Further, due to nonavailability of data on income and prices we have to confine our study to household expenditure (used as proxy for income) as the main determinant of expenditure on a particular item.

For estimating the Engel elasticities the method of (OLS) is used on the basis of both common practice as well as convenience. A Multivariate regression representing the above forms of the Engel functions can be written as

$$q = y\beta + \mu \quad (10)$$

When 'q' is vector of 'n' individual observations on the dependent variable of the particular Engl function, 'y' is the $n \times v$ matrix of 'n' observations on the 'v' independent variables and ' μ ' is vector of 'n' disturbances.

We assume that original 'n' observations are grouped into 'w' expenditure classes giving arithmetic means of different expenditures in each class.

In order to make choice of the most suitable functional from we used the following distance function which was first used by Jain and Tandulkar⁵.

$$D_i^2 = \frac{1}{w-v} \sum_{j=1}^w f_i (q_{ij} - \hat{q}_{ij})^2 \quad (11)$$

Where q_{ij} is the observed level of consumer expenditure on the i-th item in the j-th expenditure class, \hat{q}_{ij} is the corresponding expenditure estimated from a given functional form, $(w-v)$ the number of degrees of freedom. The functional form which gives the least value of the distance function is considered to be superior on this criterion. Furthermore we also take into consideration the smallest percentage bias as culculated by Kakwani⁶ and the signs of the estimated parameters which are observable on the basis of economic Theory.

3. Empirical Results

The analyses have been carried out with the help of Engel elasticities using the published data as obtained through the Survey of Current Economic conditions in Pakistan (Household Income and Expenditure) and collected by Central Statistical Office of Pakistan for the year 1979.

The expenditure elasticity (at mean values of 'y' and q) is estimated for seven expenditure items. These are presented in tables 1-3. A perusal of these tables indicate some well-known features. First we find that the elasticity estimates based on different forms of Engel functions differ considerably. These differences arise because of the following reasons :

- (i) We have computed the elasticities at the mean values of total expenditure. As the relevant variables in the Engel function are the logarithms in most of the Engel forms we require the geometric and harmonic means of the individual observations. The grouped data which are available in our case give only the arithmetic means within each income class in proxy for the geometric and harmonic means.
- (ii) As indicated by Kakwani (1977) different Engel forms have different residual variances which may have a significant effect on the estimates of elasticities.

Furthermore, the hyperbolic and loginverse forms indicate elasticities which do not appear to be plausible. Their explanatory power is very low. The reasons may be that the estimates are based on grouped data and as such the differences are due to the extent of bias. The calculations made by Kakwani (1977) show that hyperbolic and loginverse forms result in the highest percentage of bias. On this basis these two functional forms go out of consideration. The functional forms, namely, Semilog, Doublelog and double-log inverse appear quite suitable. Even linear function is not too bad. To choose the most suitable functional forms we apply the criteria as mentioned in Section II and find that double log inverse form is the most suitable. The elasticities based on this form are presented in table.4.

A perusal of these elasticities show that apart from a few exceptions, rural households tend to have larger values than their urban counterparts. It is difficult to conclude from this that urban households are nearing saturation levels. This may partly be because of the fact that rural households are still struggling to improve their

consumption levels as far as food is concerned. In case of non-food group of items, it is likely that higher expenditure elasticities are the result of substitution in favour of more expensive goods. We find three expenditure groups, namely, food and drinks, clothing and foot-wear, and fuel and lighting showing expenditure elasticities below unity in respect of all three regions and thus depicting a necessity. The remaining four items show the elasticities more than unity. In case of house rent, furniture and utensils and miscellaneous items it is substantially high.

Analysing rural-urban differentials we find that disparities in the consumption in rural households are narrow as compared to urban households. This is presumably because of the fact that rural sector is much more homogeneous in its population and the nature of its economic activity. The higher income groups are concentrated in the urban sector, the rural sector has larger proportion of the lower segment of the income structure within which there is less scope for dispersal.

TABLE 1

Expenditure Elasticities by Items for Rural Pakistan, 1979.

Item	Linear	Semi log	Duble log	Log Inverse	Hyper-bolic	D.L. Invers
(1) Food & Drink	0.781	0.791	0.864	0.491	0.966	0.803
(2) Clothing & Footwear	0.862	0.846	0.898	0.501	1.087	0.883
(3) Personal Effects	1.484	1.334	1.636	0.909	1.963	1.623
(4) House Rent	0.949	0.903	0.928	0.504	1.218	0.975
(5) Fuel & Light	0.660	0.665	0.686	0.383	0.813	0.670
(6) Furniture & Utensils	1.650	1.378	1.401	0.761	2.183	1.475
(7) Miscellaneous	1.429	1.265	1.389	0.763	1.884	1.519

TABLE 2

Expenditure Elasticities by Items for Urban Pakistan, 1979.

Items	Linear	Semi log	Doble log	Log Inverse	Hyper- bolic	D.L. Inverse
Food & Drink	0.756	0.746	0.828	0.459	0.905	0.930
Clothing & Foot- Wear	0.861	0.823	0.902	0.491	1.061	0.863
Personal Effects	1.377	1.216	1.600	0.896	1.784	1.319
House Rent	1.229	1.092	1.188	0.620	1.603	1.279
Fuel & Light	0.594	0.590	0.625	0.348	0.688	0.559
Furnitur & Uten- sils	1.423	1.208	1.256	0.227	1.901	1.511
Miscellaneous	1.326	1.165	1.321	0.699	1.735	1.378

TABLE 3

Expenditure Elasticities by Items for All Pakistan, 1979.

Items	Linear	Semi log	Double long	Log Inverse	Ayper- bolic	D.L. Inverse
Food & Drink	0.746	0.747	0.820	0.461	0.899	0.746
Clothing & Foot- Wear	0.839	0.814	0.873	0.480	1.039	0.848
Personal Effects	1.462	1.279	1.525	0.835	1.910	1.504
House Rent	1.314	1.179	1.279	0.686	1.726	1.405
Fuel & Light	0.605	0.603	0.625	0.348	0.718	0.589
Ferniture & Utensil	1.458	1.255	1.339	0.708	1.919	1.446
Miscellaneous	1.267	1.193	1.339	0.725	1.751	1.363

TABLE 4

Expenditure Elasticities Based on Double Log Inverses From
of Engel Function, 1979.

Items	Rural	Urban	Combined
Food & Drink	0.803	0.930	0.746
Clothing & Foot Wear	0.883	0.863	0.848
Personal Effects	1.623	1.391	1.504
House Rent	0.975	1.279	1.405
Fuel & Light	0.670	0.559	0.589
Furnitur & Utensils	1.475	1.511	1.446
Miscellaneous	1.519	1.378	1.363

4. Concluding Remarks

We examined regional differences in the share of expenditures devoted to food and various non-food items and found that urban households, on the average, are better off than their counterparts in rural areas. While the share of expenditure on food items tends to decline with increasing level of household expenditure, this share shows an increasing trend for non-food items. This is in accordance with Engel law.

We found rural-urban differentials in patterns of consumption. We also found that rural sector is much more homogeneous in its consumption than urban sector. Among different consumption items food and drinks, clothing and footwear and fuel and lighting appeared to be necessities. Housing showed an elasticity which is substantially higher than unity and thus a luxury. This is something one should expect since rising incomes would finance substitution in favour of better quality housing.

The demand for miscellaneous group which covers expenditure on education and medical-care appears to be much greater than unity. This implies that well-to-do section of the population spends proportionately much more than the poorer section who can hardly provide education and medical-care to their children after meeting their bare needs of life.

FOOTNOTES AND REFERENCES

1. In urban areas prices of agricultural commodities increase due to transportation costs. Although commodities produced in urban areas are more expensive in rural areas, yet on balance the urban prices become slightly higher as food products account for a larger proportion of the consumption.
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