

# GOVERNMENTS & MARKETS: AN ISLAMIC PERSPECTIVE

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## INTRODUCTION:

الحمد لله رب العالمين، والصلاة والسلام على سيدنا محمد خاتم المرسلين، وقائد الغر  
المحجلين، وعلى آله وصحبه أجمعين، ومن تبعهم بإحسان إلى يوم الدين.

Excellencies, scholars and distinguished guests,  
Dear brothers and sisters,

السلام عليكم ورحمة الله وبركاته

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# CH I: ECONOMIC THEORY OF POLITICAL PROCESSES

## POLITICAL FAILURES: NATURE AND REMEDIES

### I. POLITICAL FAILURE

1. A political failure occurs when:
  - 1.1. Policies chosen by the political process fail to be efficient using second-best efficiency as a benchmark<sup>1</sup>.
  - 1.2. Resources used to determine policy, fail to produce a selection from the second-best Pareto frontier so that, in principle, all citizens can be made better off.

### II. SOURCES OF POLITICAL FAILURE

#### A. RENT-SEEKING OR LOBBYING ACTIVITIES, CAMPAIGN FINANCING<sup>2</sup>.

1. Coordination difficulties among voters to choose between competent and incompetent candidates<sup>3</sup>.
2. Legislative policy making: failure in the bargaining procedure used to make decisions<sup>4</sup>.

#### B. STRATEGIC USE OF POLICY. EXAMPLES:

1. Running deficits to reduce the policy flexibility of future incumbents<sup>5</sup>.
2. Privatization to create a class of stakeholders committed to voting in favor of particular kind of government<sup>6</sup>.

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<sup>1</sup> \*Besley, T. and S. Coate (1998). Sources of Inefficiency in a Representative Democracy: A Dynamic Analysis. *American Economic Review* 88(1), 139-156.

<sup>2</sup> Besley, T. and S. Coate (2001). Lobbying and Welfare in a Representative Democracy. *Review of Economic Studies* 68 (1), 67-82.

<sup>3</sup> Besley, T. and S. Coate (1997). An Economic Model of Representative Democracy. *Quarterly Journal of Economics* 112(1), 85-114.

<sup>4</sup> Weingast, B., K. Shepsle, and C. Johnsen (1981). The Political Economy of Benefits and Costs: A Neo-classical Approach to Distributive Politics. *Journal of Political Economy* 89, 642-64.

<sup>5</sup> Tabellini, G. and A. Alesina (1990). Voting on the Budget Deficit. *American Economic Review* 80, 37-49.

<sup>6</sup> Biais, B. and E. Perotti (2002). Machiavellian Underpricing. Forthcoming in the *American Economic Review*. Weingast, B., K. Shepsle, and C. Johnsen (1981). The Political Economy of Benefits and Costs: A Neo-classical Approach to Distributive Politics. *Journal of Political Economy* 89, 642-64.

### **III. HOW TO REMEDY A POLITICAL FAILURE**

1. Constitutional reform.
2. What type of government? Three choices:
  - 2.1. The Western Models
  - 2.2. Democracy:
    - 2.2.1. Direct (participatory)
    - 2.2.2. Indirect (representative)
3. Socialist totalitarianism
4. Islamic Shura
5. Obviously, the choice should be between democracy and Shura.

### **THE WESTERN MODELS OF DEMOCRACY**

#### **I. DIRECT DEMOCRACY**

1. Citizens make proposals and vote on which proposal to implement via majority rule,
2. Workable only in very small societies, where community members are well informed about issues and they know each other,
3. Partially practiced in Switzerland through recurrent use of plebiscites,
4. Naïve and erroneous attempts to apply in Libya,
5. it is too costly and therefore inefficient for countries with size that is larger than a small village.

#### **II. REPRESENTATIVE DEMOCRACY**

1. Citizens do not exercise their political power directly, but through policy makers,
2. Policy makers are selected from the group of citizens who present themselves as candidates for public choice,
3. Candidates are generally associated with political parties, each with a platform.
4. What do candidates maximize?

- 4.1. Political power → wealth?
- 4.2. Party interests → long-term personal interests
- 4.3. Realize an ideal or a vision, altruistic

## ECONOMIC THEORY OF POLITICS (MODELS OF DEMOCRACY)

### I. IDEAL & REALISTIC EXPECTATIONS

1. The democratic method is that institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote<sup>7</sup>,
2. In the real world, individuals, as such, do not make social choices. They seem limited to choosing "leaders," who will, in turn, make social decisions.

### II. THE MEDIAN VOTER THEOREM

1. Two parties offer voters different platforms.
2. Parties care about winning and implementing their proposed policies if elected.
3. One-dimensional issue space, and single-peaked preferences,
4. Parties will offer the policy preferred by the median citizen<sup>8</sup>.
5. The theorem fails to predict when issues are multi dimensional and preferences are not single peaked.

### III. THE PROBABILISTIC VOTING MODEL

1. Voters' decisions as probabilistic.
2. The probability of a particular individual voting for a party increases with the utility gain from having that party in power
3. Ability to predict requires restrictive assumptions about the

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<sup>7</sup> Schumpeter, Joseph, [1954], *Capitalism, Socialism and Democracy*, Harper: New York, p 269. Buchanan, James M., [1967], *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice*, Chapel Hill: University of North Carolina Press, p v.

<sup>8</sup> Downs, Anthony, [1957], *An Economic Theory of Democracy*, New York: Harper Collins.

probability of voting functions<sup>9</sup>.

#### **IV. POLICY MOTIVATIONS OF PARTIES**

1. Parties care only about winning and are willing to implement any policy to do so.
2. The ruling party gravitates to median policy preferences.
3. This is a case on non-existent government<sup>10</sup>.
4. Parties have policy preferences<sup>11</sup>.
5. Dynamics of developing policy preferences within each party.

#### **V. POLITICAL COMPETITION**

1. political competition should give rise to efficient policy choices.
2. Economics does not have a satisfactory theoretical model of political competition to rigorously investigate these arguments<sup>12</sup>.
3. Empirically, in many instances, Western democracy failed to produce efficient choices.

#### **VI. POLITICAL AGENCY MODELS**

1. Citizens choose between incumbents and challengers,
2. Irresponsible or incompetent incumbents are thrown out of office.
3. Characteristics of the incumbent or challenger are left unexplained<sup>13</sup>.

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<sup>9</sup> Coughlin, Peter, [1992], *Probabilistic Voting Theory*, Cambridge: Cambridge University Press.  
Usher, Dan, [1994], "The Significance of the Probabilistic Voting Theorem," *Canadian Journal of Economics*, 27, 433-45.

<sup>10</sup> Brennan, Geoffrey, and James M. Buchanan, [1980], *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, Cambridge: Cambridge University Press.

<sup>11</sup> Alesina, Alberto, [1988], "Credibility and Policy Convergence in a Two-Party System with Rational Voters," *American Economic Review*, 78(4), 796-806. Wittman, Donald, [1983], "Candidate Motivation: A Synthesis of Alternative Theories," *American Political Science Review*, 77, 142-157.

<sup>12</sup> Becker, Gary, [1985], "Public Policies, Pressure Groups and Dead Weight Costs," *Journal of Public Economics*, 28, 329-347. Wittman, Donald, [1989], "Why Democracies Produce Efficient Results", *Journal of Political Economy*, 97, 1395-426.

<sup>13</sup> Austen-Smith, David and Jeffrey Banks, [1989], "Electoral Accountability and Incumbency," in Peter C. Ordeshook, ed, *Models of Strategic Choice in Politics*, Ann Arbor: University of Michigan Press.

- 3.1. The models are not altogether helpful for making policy predictions.

## **VII. MODEL OF REPRESENTATIVE DEMOCRACY**

1. Candidates are citizens with policy preferences; they run for office to influence policy outcomes, rather than parties that maximize votes.
2. Citizens weigh up costs and benefits of political involvement.
3. Interest groups offer transfers to selected policy makers, they try to influence incentives to run for office and voter preferences over candidates.
4. Characteristics of incumbents and challengers are derived endogenously, and the disciplinary role of elections is considered<sup>14</sup>.
5. Dynamics can be introduced.

## **VIII. IMPLICATIONS OF DEMOCRACY MODELS**

1. Non-alignment of preferences between legislator and society.
2. Alignment requires perfect competition in politics. Barriers of entry are bountiful for it is costly to be a candidate and run a campaign.
3. Election campaigns are costly and require financing.
4. A candidate must withstand pressures from interest groups

## **IX. PROBLEMS WITH REPRESENTATIVE DEMOCRACY**

1. The incompetent candidate
  - 1.1. A good politician (wheeler dealer)
  - 1.2. Does not understand the socioeconomic effects of political decisions
2. Interest groups and lobbyists
  - 2.1. Pressure legislators for or against certain policies.
  - 2.2. They represent (active or rich) minorities
  - 2.3. They try to counteract majority preferences with

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<sup>14</sup> Timothy Besley and Stephen Coate (1995), An Economic Model of Representative Democracy, CARESS Working Paper #95-02, January 23.

incentives to legislators.

2.4. The relationship between interest groups and the media requires special scrutiny.

2.5. The most effective media, TV, Films and newspapers can be easily controlled by interest groups.

### 3. EVIDENCE

3.1. Modest credentials of American and many European heads of states and/or prime ministers.

3.2. The role of lobbyists in the American politics.

3.3. The repeated involvement in unpopular wars by some Western countries.



## CH II: ISLAMIC POLITICAL SYSTEM

### SALIENT FEATURES OF SHURA

The Islamic political system is based on the principles and processes of *Shura*. This introduction summarizes the salient features of this political system and how it is different from democracy.

The word *Shura* signifies both the name of the system and its processes. Characteristics of *Shura* include:

1. It is a process of reaching decisions by a Muslim community.
2. The decisions include both the choice of rulers (representatives, decision-makers) as well as all decisions of communal interests to all.
3. It is obligatory on all community members (وأمرهم شورى بينهم).
4. All community members have the right to and must participate in choosing decision makers.
5. All decision makers must participate in making the decisions relevant to their purview.
6. Decision makers are chosen from a subgroup of the community who are known by most community members have decision-making abilities and inclination (أهل الحل والعقد), meaning that they possess the following three qualities:
  - 6.1. High religious morals and integrity
  - 6.2. Knowledge and expertise,
  - 6.3. Leadership
7. At the time of the Prophet (ﷺ), such group included the closest companions of the Prophet (ﷺ), who possessed the following qualities:
  - 7.1. High integrity emanating from deep faith and their

- emulation of the Prophet (ﷺ),
- 7.2. Knowledge and expertise,
  - 7.3. Being prominent as community leaders,
8. At our time, such group should include people with the following qualifications:
- 8.1. PhD in one of the disciplines,
  - 8.2. Experience in the practice of his/her discipline either academically through teaching or research or practically; both types of experience would be preferred.
  - 8.3. High moral values and integrity,
  - 8.4. Showing leadership ability
9. The main difference between Shura and democracy is the fact that while everyone has the right to choose, not everyone has the right to be chosen. A process of prequalification must precede the process of nomination and election of leaders.
10. As processes generally change from time to time according to changes in technology, the first two sources of Shari'a have not specified particular processes. The process used to elect the first Caliph has been very close to participatory rather than representative Shura. It would be difficult to apply such a process today, where populations are much larger in size and the use of information and communication technology is possible. Therefore, the process itself is left to the community to decide and evolve according to contemporary circumstances.

## PRACTICE OF SHURA

1. Muslims lived under a system of that was closer to participatory than representative Shura until the Fourth Caliph.
2. Until that time, the shape of a representative government had not been developed by Shari'a scholars.
3. After the Fourth Caliph, the Muslim government deteriorated

from Shura into monarchy.

4. Muslims spent vast resources trying to reform the system through military struggle against the Umayyad and the Abbasid regimes, but the power of the executive was too overwhelming
5. Tyranny and oppression lead Shari'a scholars to say little about the shape of the Islamic government.
6. The Saqifa experience has been:
  - 6.1. Ignored by Muslims who deny that Islamic has any political teachings, as such experience can be taken as proof of the existence of an Islamic political system.
  - 6.2. Attacked by those who find that it did not result in the election of their favorite candidate, which led to years of *Fitna*.
7. Scholars with integrity advised rulers against tyranny and encouraged reform which came as cosmetic and did not touch upon the structure of government.
8. The treatise of Mawardi appeared in the 11th century, rather late.
9. Scholars who wrote about government focused on two issues:
  - 9.1. Imamah, the choice of the Caliph,
  - 9.2. Hisbah, how to keep society within Shari'a boundaries,
10. There are some political activists and writers who think that once a Caliph is elected, everything else should turn to be fine. This appears to be naïve.
11. We must therefore try to extract a modern shape of the Islamic political system from the spirit of Islam embodied in Qur'an and Sunnah.

## A MODEST ATTEMPT TO DEFINE THE SHAPE

# OF ISLAMIC GOVERNMENT<sup>15</sup>

## I. SHURA IN ISLAM

Shura can be considered to contain the following elements:

1. Supervisory Mechanism (مرجعية) to insure that:
  - 1.1. All legislation is Shari'a compliant.
  - 1.2. All government actions are Shari'a compliant.
2. Citizens' right as well as obligation to choose their rulers.
3. Identify the People of Decision (أهل الحل والعقد), who are most qualified to serve in government branches.
4. Criteria:
  - 4.1. Religious commitment (piety & trust),
  - 4.2. Knowledge, e.g., academic degree in all fields of knowledge, proper distribution between different fields
  - 4.3. Experience, like holding certain positions related to specialization for a certain period
5. Citizens elect the Head of State from among (أهل الحل والعقد)
6. Citizens elect legislators from among (أهل الحل والعقد)
7. The Head of State appoints members of the legal branch of government from among the People of Decisions, specialized in Shari'a (with a PhD in Shari'a), or
8. The People of Decisions specialized in Shari'a elect from amongst themselves the members of the legal branch.

## II. FURTHER REQUIREMENTS

1. Political parties with platforms,
2. Rules of governance for political parties:
  - 2.1. Each party must practice Shura within itself,
  - 2.2. Party platform must be Shari'a compliant.

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<sup>15</sup> Synthesizes and draws from numerous writings in Arabic and the following two references available in English. Imam Khomeini, Governance of the Jurists (ولاية الفقيه): Islamic Government, the Institute for Compilation and Publication of Imam Khomeini's Works, Tehran Imam Muhammad Shirazi, The Islamic System of Government, Translated by Z. Olyabek, Second Edition 2001, Fountain Books, London. (Arabic original, 1969).

3. Rules to keep media independent from foreign or government influence,
4. Economic policy that aims at:
  - 4.1. Basic needs for the poor,
  - 4.2. Growth, full employment and social justice,
  - 4.3. Keep market structure Shari'a compliant.
5. A Reba-free banking and financial system.

### **III. REFINEMENTS**

6. Maximum term on head-of-state service.
7. Maximum limit on the incumbency of legislators,
8. Guarantees of civil liberties within the boundaries of Shari'a,
9. Safeguards against corruption and nepotism in the executive branch of government,

### **IV. IMPLEMENTATION**

1. We can construct an Islamic political system that can outperform Western democracy.
2. Implementing such a system would be a challenge for:
  - 2.1. Interest groups that benefit from current systems.
  - 2.2. People with lax moral values who would prefer to live in societies that allow drinking, gambling, Reba, etc.
  - 2.3. People who believe in secularism and have the wrong perception that an Islamic government would be a theology, which is far from the truth.
3. Implementation would not be easy, as it would require educating the public and placing safeguards for proper implementation.
4. But, it would be very rewarding. As Islamic finance has been the most important contribution of Muslims to human civilization in the twentieth century, an Islamic political system would be a contribution of similar stature in the twenty-first century.

## CH III: MARKETS

### MONOPOLY & COMPETITION

#### C. SCOPE OF MONOPOLY IN FIQH

1. The Malikis and Abu Yusuf from the Hanafi School extend the scope of prohibition of *Ihtikar* pt monopoly (احتكار) to all goods. The Imamis appear to share this opinion.
2. The Hanafis, Hanbalis and Shafi's limit the scope to food stuff. In addition, Muhammad Ibn Al-Hassan includes both food stuff and cloths.
3. The opinion that extends the scope of prohibition to all goods, whose withholding would be harmful to the public, seems to be more credible.
4. It relies on several Hadiths that decree such generality. The specific mention of food stuff in other Hadiths can be interpreted as to give an example.
5. In Fiqh methodology, when statements both general and specific are found in relation to a particular question, the general statements would take precedence to the specific. The important aspect of the prohibition of monopoly in Islam is that some would become exclusive producers or holders (sellers) of certain goods.
6. This would deprive the market from competitive fair play and allow sellers to exploit buyers through the appropriation of their consumers' surplus through monopolistic tactics.
7. Fiqh scholars, on the one hand, limit *Ihtikar* to the mere purchase of a good from a certain market and withholding it for a period for the purpose of raising its price in the same market.
8. On the other hand, they place in the same category what they call *labor Ihtikar*, or what modern economics know as monopoly in services.
9. Specifically they prohibit the collusion among the suppliers of services, like real estate surveyors, lest they raise their prices. Here we can see a complete equivalence between

Ihtikar and monopoly.

10. In addition, the Fiqh scholars prohibited a form that we can call in modern economics monopsony, or having the exclusive right to purchase certain goods, especially when it is for the purpose of holding the exclusive right to sell the same goods.
11. This fact gives a credible reason to consider the topic of Ihtikar in fiqh to be equivalent to the topic of monopoly in economics.
12. In general, goods that should not be subject to Ihtikar include any goods which are needed by people and whose withholding would cause harm.
13. In particular, food, cotton, and linen textiles are mentioned by Fiqh scholars.
14. It is interesting to note that all goods that are lawful to consume or used for producing lawful goods are considered needed by economists as long as they are people who are willing to pay for them.
15. The view of Fuqaha' that the prohibition of Ihtikar is not limited to food stuff only is parallel to the consensus of economists that monopoly is harmful regardless of the market in which it is practiced.

#### D. CRITERIA FOR MONOPOLY PROHIBITION

1. There are two criteria offered by Fiqh scholars regarding the prohibition of Ihtikar:
  - 1.1. There is a demand for the good withheld
  - 1.2. The lack of substitutes for it
2. Both criteria are equivalent to the existence of an inelastic demand curve for the goods withheld.
3. Ironically, this is the case where monopoly in the economic sense is most likely to be found.

## E. PRICE FIXING BY GOVERNMENT

1. The arguments in Fiqh against fixing prices by the government add an interesting dimension to the above.
2. Such action by the government is generally unlawful, allowed only in exceptional circumstances when public interest is at stake.
3. Exchange in Islam is considered to be a voluntary contract in which two parties agree on their volition to buy and sell.
4. Pricing by government decree violates the voluntary aspect of the exchange contract
5. Therefore, the general rule of prohibiting government pricing can be safely interpreted as a rule to protect competition in the market.
6. It must be added to the other rule of prohibiting Ihtikar or monopoly as policy tools available to the government to institute competitive markets in an Islamic economic system.
7. Barring cases of wars and natural disasters when commodity rationing becomes a necessity, the government can then force the monopolist to set his price equal to his marginal cost.
8. We can therefore conclude that the government is given the right to fix prices as an anti monopolistic policy.
9. Sometimes monopoly is inevitable, as in the case of natural monopolies.
10. In such case, the option of fixing the price by the government becomes a viable alternative to protect consumers from being exploited by monopolists.
11. In addition, when the government fixes prices, it must consider the cost of sellers.
12. This is another reference to what economists know as the equality between marginal cost and marginal revenue in competitive pricing.



F. THE PROHIBITION OF EXCHANGE OUTSIDE THE MARKET PLACE.

13. It is unlawful to intercept suppliers of goods before they reach market premises.
14. such suppliers are predominantly small farmers and merchants who bring goods to the market for selling.
15. Their interception would have two effects.
16. Being uninformed about market conditions, they would sell at prices which would appear unacceptable, once they reach the market place.
17. Voluntariness would be incomplete.
18. Their failing to reach the market reduces the number of agents therein and affects the quality of competition.
19. Again we find that there is another rule that strengthens market competition

# **RISK SHARING & MARKET STRUCTURE**

## **A. MARKET STRUCTURE IN MUSLIM COUNTRIES**

1. Many issues of market structure in Muslim countries have not all been resolved to our satisfaction
2. Further developments are still required
3. Long periods of totalitarian economics in some Muslim countries breed several apologies for market controls both from religious scholars as well as economists.
4. Ways must be found to keep markets free, without falling into the trap of sellers' or buyer's collusion.
5. More tools must be given to governments to implement social justice, without market interference.

## **B. RISK SHARING AND MARKET STRUCTURE**

1. An Islamic economy has a wider scale of risk sharing than a conventional one.
2. How risk sharing influences market structure is not yet settled.
3. One direction of thinking is that Islamic finance provides "products" that have "self-mitigation" of risk.
4. In lease finance, the leased assets are owned by the fund supplier during the time of the lease, and serve as security.
5. The same applies to asset-based securitization.
6. Risk sharing would be manifested in the relationship between both fund suppliers as well as fund users from one side and financial intermediaries from the other side.
7. It would also be manifested by greater integration of markets within each Muslim country and among Islamic countries, if:
  - 7.1. The Islamic principle of free trade among Muslims is applied,
  - 7.2. Trade is carried out, using Shari'a-compliant modes.

8. It would be difficult to justify any sort of trade barriers between Muslim countries, as the teachings of Islam in the field of international trade does not allow restricting trade among Muslims of different countries.
9. Presumably, capital movements would also enjoy the same freedom. Capital markets would therefore be highly integrated among Muslim countries, when the edicts of Islamic economics are truly applied.
10. The integration of capital markets would create by itself a degree of risk sharing, as Muslim nationals of some countries would hold portfolio investment in firms working in other countries, thereby sharing risk across the border.

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