Budget Deficits and Public Borrowing Instruments in an Islamic Economic System

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In this rapidly changing world, several countries and political movements, especially in the Middle East, are calling for the establishment of an Islamic economic system. This paper seeks to explain the area of public borrowing in such a system and to explore its use in today's world.

In the literature, the term "budget deficit" denotes the gap between public revenues and expenditures. Revenues normally come from taxation and public property, while expenditures may cover development projects and current governmental expenses. In general, such a deficit is bridged by increasing revenues, reducing expenditures, internal borrowing (i.e., from the public commercial banks or the central bank), and by external borrowing. In the past, governments used to borrow from their rich citizens only to meet the financial needs associated with wars and natural calamities. Today, however, public borrowing has become a major feature of contemporary economies in both developed and developing countries.

This paper consists of four sections: the principles of financing in Islam, the Islamic point of view on the provision of public goods, various instruments for public resource mobilization that can be developed on the basis of Islamic principles of financing, and a conclusion.

The Principles of Financing

There are several recorded cases of public borrowing during the time of the Prophet, as well as others by the 'Abbāsid and the Ottoman governments (Siddiqui 1992). This practice has persisted into the modern era, as evidenced by Egypt and the Ottoman Empire during the middle of the

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nineteenth century. Such borrowing usually came from external sources, mainly foreign governments and bankers.

While borrowing by the Prophet and the 'Abbāsids did not result in the issuance of any debt instruments, it is possible that the 'Abbāsid treasury ministers responsible for such matters may have issued IOUs to the lenders. Historical sources mention that the transactions of the government treasury (*bayt al māl*) were recorded and documented. However, there are no reports available on the negotiability of such IOUs, if they ever existed. Public borrowing was also known to the classical writers of Islamic jurisprudence. For instance, al Māwardī talked about resorting to borrowing for payments of dues on the treasury and argued that successive rulers are bound to repay such loans.

As the Qur'an prohibits interest in very clear terms, an alternative form of financing had to be used. The method approved by the Qur'an (2:275) is sale. While the following verses mention charity and giving a period of grace to the debtor, as there is no expected financial return, these methods cannot be considered as true alternatives to interest-based financing. Another alternative, based on the practice of the Prophet, is the principle of profit and loss sharing and output sharing.

The Sale Principle of Financing. This principle is seen in action when the physical factors of production, intermediate inputs, or consumption goods and services are provided against deferred payment. Thus the object of financing can be either goods or services, regardless of whether they are used for production or consumption. This financing mode can be used by financial intermediaries (i.e., Islamic banks), factory owners, producers, and other economic agents and intermediaries (Kahf and Khan 1993).

Such financing may take the form of sale or lease. There are, however, a few differences as regards their respective legal conditions. Sale includes deferred payment sale—usually a sale at mark-up to the purchase orderer—*(murābaḥah)*, order purchase with deferred payment (*istiṣnā'*), and deferred delivery sale (*salam*). Lease financing (*ijārah*) is also practiced in the form of leasing to the purchase ordered.

It is argued that, unlike interest-based financing, mark-up sale and leasing do not create a situation in which the financier's return is known in advance (Khan 1992). The rationale behind this is that the seller/lessor-cum-financier assumes certain risks (i.e., a voided contract, defective merchandise) when he/she purchases and owns, sells, or leases the item in question. Moreover, in the case of lease, the item in question remains in the financier's ownership for the contract's duration. Like interest-based financing, sale financing creates a debtor/creditor relationship between the two parties. But in contrast to interest-based financing, sale-based financing is committed to a complete or perfect correspondence with the physi-

cal or real market, and involves the financier in commodity-based relationships, rather than in pure financing, in the strictest sense of the term.

The Profit and Loss Sharing Principle. Profit and loss sharing covers partnership (*sharikah*) and limited partnership (*muḍārabah*). This Islamic principle implies that profit may be distributed among partners according to prior agreement, which may differ from their shares in the capital, but that losses must always be distributed in accordance with capital shares. A limited partnership is a special form of partnership in which the capital share of the managing partner is zero, meaning that he/she does not share in the loss (Khan 1992). A partnership also requires the financier to share both capital and management or, in other words, to take an active role in the decision-making process, whereas a financier involved in a limited partnership only provides the capital and has no voice in managerial decisions. This latter restriction on the financier's role is perhaps the main reason why most Islamic banks have failed to use this mode of financing courageously when it comes to the investment side of their activities.

The Output Sharing Principle. A third principle of financing is derived from crop sharing, which is an ancient agricultural practice approved of and allowed by Islam and the Shari'ah. In this arrangement, output (not profit) is shared. One party provides land and trees, while the other provides labor. Seeds, fertilizers, pesticides, and machinery may be provided by either partner. Output-sharing financing requires the financier to own durable productive assets. These are given to the manager, who makes managerial decisions in return for a certain percentage of the gross output. The issue of expenses on other inputs seems to be of lesser importance, for, according to the Shari'ah, either party may pay for them (as in crop sharing), provided that it is taken into account when determining the distribution of output shares. Output sharing has not made serious headway among the modes used by Islamic banks today, for it requires the financier to own land and equipment for a long period of time.

The Provision of Public Goods

The contemporary phenomenon of public borrowing in many Muslim countries is not always caused by conditions of necessity similar to those which caused the Prophet to borrow. Chapra (1992) cites four major areas of excessive public spending that cause most Muslim governments to borrow: high defense expenditures, price subsidies, an inefficient and large public sector, and corruption and wasteful spending. One may argue that even if these problems were solved, there might still be valid reasons for an Islamic economy to resort to public borrowing.

In the case of providing social goods, what, from an Islamic perspective, should be done when the market fails to provide an efficient mechanism for the production and distribution of certain goods? This can be caused by two practices: non-rivalry and non-excludability. As both are subject to technological and social influences, it is possible for a non-rival to become a rival. For instance, wildlife protection regulations make hunting a rival good, for each prospective hunter must compete with other hunters for a seasonal hunting license. Also, the installation of a toll gate and toll both transforms a non-excludable good (driving on that particular highway) into an excludable one. This also involves rivalry, for the right to set the price for using the highway can be sold to the highest bidder.

Moreover, the choice of which goods the public sector will provide is very often political, for certain rival and excludable goods may be provided by virtue of political choice. The most obvious examples are public concerts and education.[1] A close look into the public finance of the early Islamic state, especially during the life of the Prophet when revenues were tight, may indicate that the main services provided by his government were defense, the judiciary, and running the state's administrative affairs. Thus any public borrowing by the Prophet, either in cash or in kind, may be assumed to have been for payment for such services. On the other hand, drinking water, mosque construction, feeding the poor, freeing slaves, and meeting some defense and foreign guest expenses were provided by philanthropic action in response to calls by the head of state. When public revenues became abundant under 'Umar ibn al Khaṭṭāb, the government stopped asking for voluntary contributions and even provided various rival goods, such as food, to private consumers.

History indicates that philanthropy might have been instrumental in providing public goods. For example, until the introduction of western systems of education, an Islamic education was provided free of charge, by the Islamic institute of *waqf*, to those who wanted it. When certain rulers wanted to support education, they channeled their help through the *waqf*. Good examples of this are the Ayyūbid and the Mamlūk *waqf* institutions for schools in Palestine (Islamic Research Center 1982).

The public sector's provision of social goods is one cause of budget deficits. It can be argued that for each feasible level of public revenue, there is a level of provision of public goods that does not cause any budget deficit. Thus, stretching the provision of social goods beyond the government's available resources creates a budget deficit. The provision

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[1]Education may be considered a mixed good, for the benefit of adding one educated person to one's colleagues may be impossible to internalize. One may also argue that a conversation with an educated person may be made a rival good and that all its cost may be internalized through a 900 charge-call number.

of social goods by agents not requiring public funds (i.e., voluntary organizations or individuals or profit-motivated elements of the private sector) lessens budgetary pressures and may therefore be viewed as an alternative to public borrowing.[2]

The provision of public goods by voluntary agents has been a characteristic of Islam from the beginning. Upon the Prophet's arrival in Madīnah, a mosque was built by voluntary labor and material. Defense activities started on a voluntary basis, as the faithful volunteered labor and weapons. The provision of lights in the mosque and food to the poor were also provided on a voluntary basis. The Prophet even called upon the Muslims to buy a local well from its owner and then allow the other Muslims to take its water for free. The institution of *waqf* (nonprofit trust) was also established to provide free drinking water to the poor and the inhabitants of Madīnah as well as to oversee certain local agricultural lands and wells (Al Amin 1989). The *waqf* eventually became the main provider of education, health care, construction and maintenance of both mosques and border defense posts, and giver of financial aid to the poor.

Nonprofit voluntary organizations have achievement incentives in the form of bonds linking their workers to the organization's objectives. They also have access to free (voluntary) labor and can thus avoid the bureaucratic structure of government (Brooks, Liebman, and Schelling 1984). The provision of public goods by nonprofit organizations is now common, especially in education, health care, and water supply (Roth 1987).

Public goods can also be provided on the basis of profit considerations. Whenever market mechanisms can be activated, efficiency ideas do not provide support for public provision. Therefore, if smaller government leads to decreased public borrowing, the private provision of public goods becomes a good alternative to lowering the budget deficit. This idea could be put to good use in education, health care, water supply, communication, electricity, and garbage collection.[3] These traditional public goods can now be produced and provided by the private sector.

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[2]There are some restrictions: law enforcement cannot be provided by private or voluntary agents. Certain other social goods cannot be subjected to market forces on social grounds, such as giving religious opinions or visiting a mosque.

[3]Technological and organizational change reduce externalities and allow providers to charge users for all costs of provision and to eliminate all non-excludability conditions. Where market size is small and economies of scale or characteristics of natural monopoly (i.e., one source of some factors of production) prevail, tax subsidies, pricing, and other regulatory means must be used, while the provision of social goods is kept in the private sector. Cases of market failure due to the impossibility or difficulty of avoiding the free-rider problem remain a public sector concern. This is also true when dealing with political and social preferences for the public sector's provision of certain goods. See Roth (1987).

Two important points deserve our attention. First, the scope of the private provision of public goods is flexible and depends upon two factors: a) Islam prevents the market-based production of a small number of goods, such as spaces in a place of worship, the exercise of political rights, and the implementation of law and order. Beyond these, most goods and services may be privatized. For instance, a person may use a court official or a private judge to settle a dispute (Qur'an 4:35), and b) the source(s) of public revenues affects how the resulting revenue can be used. In other words, if the government has revenues that it can use at its discretion, such as returns from public property, it can allocate them to the provision of public goods. If, however, the government does not have such flexible revenues and has to tax citizens for revenues, then necessary public goods (i.e., public administration, law enforcement, defense) must be provided. Second, like other religions, Islam provides individuals with moral and spiritual incentives to undertake social work and produce public goods on a voluntary basis. In Islam, this is further supported by the concept of individual responsibility for social duties *(farḍ al kifāyah).*

More importantly, Islam allows the government to offer a third-party guarantee in order to encourage investment in socially desirable sectors. This is critical, for the legal framework of all forms of partnership does not allow the partner/entrepreneur to guarantee the principal or any profit to the partner/financier. However, it has been argued that if such a guarantee is granted by a third party, it may become permissible. A third-party guarantee is therefore a pledge given by a person, who is not part of the partnership, to the financier assuring him/her that if the investment fails to return the principal and/or produce a certain profit, the guarantor will compensate the financier for his/her loss and/or anticipated profit.[4]

The government may offer this guarantee to private investors so that they will fund projects that would otherwise have to be funded from public sources. This guarantee lessens the demand for public funds and may therefore be treated as an alternative to increasing the budget deficit. The use of taxpayers' money to provide this guarantee has its own pros and cons, however, but such a discussion is beyond the scope of this paper.

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[4]Islam's acceptance of third-party guarantee is beyond doubt. This practice was approved, in 1977, by the Religious Committee of Jordan's Ministry of Religious Affairs. A published opinion of the Islamic Fiqh Academy of the Organization of Islamic Conference states:

> There is nothing in the Shari'ah that prevents the inclusion of a statement in the prospectus of the *mudārabah* certificates about a promise made by a third party, totally unrelated to the two parties of the contract, in terms of legal personality or financial status, to donate a specific sum, without any counter benefit, to meet losses in a given project, provided that such commitment is independent of the partnership contract (Islamic Fiqh Academy 1990).

What is clear is that governments have used and will continue to use this technique for one reason or another.

Public Borrowing Instruments in Islam

This section takes it for granted that an Islamic government has a variety of needs that will have to be financed, such as providing public goods free of charge or at cost through subsidies or surcharges. Other needs are related to developmental projects and current expenditures.

Based on the discussion in the previous section, it should now be obvious that as the financier in profit-and-loss-sharing and output-sharing agreements is a partner, as opposed to a creditor to the working partner, and that the lessor in a leasing agreement is an owner of the leased assets and not a creditor to the lessee, the application of these principles of financing does not create any public debt. Hence modes of financing derived from these principles are, in fact, alternatives to public debt. A governmental guarantee to private investors concerning the production of public goods is another alternative. On the other hand, sale-based financing creates debt, and instruments derived from sale-based financing are instruments of public debt.

Since the Shari'ah does not prohibit interest-free borrowing by the public sector, instruments and modes of public borrowing which fulfill its conditions should also be included in the category of public debt creating instruments.

There are several non-debt public financing instruments approved of by Islam. This category essentially consists of certificates issued on the basis of allowing the financier a certain return. They are also negotiable, which means that they can be traded on a secondary market. However, not all modes of financing have these two characteristics, as shall be explained later.

From the Islamic point of view, a certificate must represent (i.e., be a title of ownership of) physical commodities or property in order to be sold at a price other than its face (purchase) value. Therefore, the instruments discussed below represent real or physical income-generaing properties.

Leasing Instruments. There is only one form of negotiable financing instruments based on the sale principle: leasing (*ijārah*). The way a leasing instrument works within an Islamic system is as follows:

> Certificates are issued to the public as titles of ownership of real estate, machinery and equipment, airplanes, ships, or any other long-living assets. These fixed assets are then leased to the

government. Certificate holders receive their share of the return in proportion to their holdings of total certificates.

As owners, certificate holders bear full responsibility for what happens to their property. They are also required to maintain it in such a manner that the lessee may derive as much usufruct from it as possible. Suitable arrangements to take over these responsibilities can be made by means of insurance and granting the power of attorney to the lessee or anyone else. The negotiability of these instruments is unquestionable, provided that the issuing body accepts, in the prospectus, that holders may sell the property without any effect on the lease relationship between lessee and lessor. Moreover, lease instruments are sold at market prices, which obviously reflects the market valuation of the stream of income connected with each instrument.

A variety of leasing certificates may be issued. These include:

1. Perpetual or renewable leasing instruments, in which capital consumption (amortization) or replacement allowance is used to preserve the value of the asset and to replenish it when needed;
2. Temporary leasing instruments, in which no amortization allowance is made and the instrument gradually loses its value at regular intervals. Such instruments may be suitable for investments in which rapid technological changes are expected, such as computer equipment; and
3. Declining leasing instruments, in which the lessee desires to own the property after a period of time and assigns installments of the property's value to be paid to the lessor along with the rent.

Leasing instruments may be used to finance income-producing projects (i.e., an electricity plant) as well as projects that produce no income (i.e., those connected with mute infrastructure). Fixed assets and installations (i.e., a commercial or military airport) may be financed by leasing certificates. Such certificates may be used to bridge budgetary gaps (i.e., leasing instead of buying office furniture), to finance the building of schools, laboratories, machinery and other projects designed to support and enhance national development, and for construction and defense projects, as long as the assets involved have a long life span and can be identified for a rental relationship.

Certificates may be issued to represent one asset that has a long-term life span or a group of assets put together in one or more projects (diversification), as long as they are covered by one leasing contract. Assets of different life spans may be combined to provide this instrument with the possibility of having either fixed or declining returns. Leasing certificates may also be issued against fixed assets rented by the government or a

governmental body having an autonomous budget and identity (i.e., local governments, municipalities, government-owned economic enterprises, or government-supervised *waqf* institutions). They may be issued for assets that have a relatively short-, medium-, or long-term life span, as long as they are not themselves consumable.

Lastly, it should be noted that lease financing does not change the provider of public goods. When resorting to this form of financing, the government retains the power to decide on the provision of the goods it supplies. Therefore, lease financing can be applied irrespective of the public choice regarding who provides the public goods. The issues of privatization or government size do not arise.

Partnership and Limited Partnership Instruments. Partnership (*sharīkah*) instruments are similar to common stocks in almost all aspects, provided that they do not have any prohibited conditions such as a preferential or guaranteed return (Islamic Fiqh Academy 1992). This mode of financing does not offer much freedom to the public sector, as it gives shareholders equal shares in the enterprise's management. By using such an instrument for financing projects, the government surrenders its management rights to the shareholders. In this respect, partnership financing is essentially a form of privatizing public projects that may be applied to both new and existing projects.

A partnership arrangement may therefore suit mixed corporations in which the public sector desires to benefit from the managerial skills of private businessmen. In such a case, private shareholders provide managerial skills and finance, and the government gets its project established and entrusted to a skillful management team while maintaining a certain degree of control. The government may increase or decrease its stake in the enterprise through the secondary market or preserve its majority right by holding a sizeable percentage of the stock.

On the other hand, a limited partnership (*muḍārabah*) arrangement is a good method of financing for income-earning public sector projects, as it limits the financier's role to providing money and receiving a return (gain/loss), while the government manages the project.

The empirical experience of Islamic banks over the last fifteen years has shown that such financing can mobilize deposits. This success, along with the limited ability of most Islamic banks to use this mode of financing on their assets side, may, to a certain degree, be due to a) the corporate form of the managing partner (the bank), which reduces the moral hazards, and b) factors related to trust in the management and religious feelings, which may be higher among depositors than the usually more pragmatic businessmen (Khan 1992). Thus limited partnership financing has a good chance to succeed in mobilizing resources for income-earning

public sector projects, if the government takes practical steps to offer managerial skills that increase the prospective financiers' confidence.

This method of financing also fulfills the function of equity shares, with the result that shareholders are not exposed to losses exceeding the entire values of their shares. If the enterprise is profitable, the shareholders must receive their portion, based on the number of shares held, as stipulated in the prospectus. Their money may be directed toward a specific investment(s) or project(s) under the management of one managing partner, provided that it/they can be identified in such a way that the exact amount of profit/loss can be known (i.e., its accounts must be kept separate from other projects in which the managing partner is involved).

Both of these financing instruments have several features in common: a) They may be issued, for short-, medium-, or long-term investment (i.e., for a definite or a perpetual period), by the government, local executive branches, municipalities, government economic enterprises, fund users, an intermediary managing agency, or other bodies. They can also be issued by specialized institutions that first raise the funds on a limited partnership basis and then use them to supply goods for deferred payment goods to the government, or to combine goods and services to provide financing to the government on the basis of contracting work against deferred payment (*istiṣnā'*).[5] They are therefore extremely flexible; b) They can be sold at market prices, as they are fully negotiable; c) Their value may decrease if the prospectus allocated a certain proportion of the managing partner's profit share to buy up the financier's shares, or if the assets exploited have no end-of-productive-life value, such as an oil well or a fixed-term franchise; d) The pools of funds raised by these two financing techniques may make a closed pool, as in a common stock company with a fixed principal, or an open pool similar to that of open capital companies and to the investment pool deposits in Islamic banks (Hamoud 1989); e) The transferral of instrument ownership is greatly eased by records in the issuing institutions, endorsement on the certificates, or even by handing the certificates over if they were made out to specific bearers[6]; and f) Both instruments may be backed by a government guaranatee if they are issued by corporations and/or institutions having legal and financial independence from the government. Such a

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[5]In a contract dealing with manufacturing or construction on order, in which the supplier of the order may provide payment, payment will be made upon or after delivery. The nature of the contract allows financing to be given to the producer by the orderer.

[6]At a workshop organized in Bahrain (25-28 November 1991) by the OIC Islamic Fiqh Academy, IRTI, and the Islamic Bank of Bahrain, it was stated that the Shari'ah permits the issuance of bearer shares. This was approved by the plenary seventh annual meeting of the Islamic Fiqh Academy in Jeddah during 1992.

guarantee may cover certain kinds of risks, expecially noncommercial, but it may also cover commercial risks.

Output Sharing Instruments. This principle permits sharing the output provided that no valuation of capital is needed, as such a valuation is subject to value judgment. Hence, the income-generating property must be handed over to a manager on the basis of sharing the output.

An output sharing certificate may take the following form:

> The government sells an existing income-earning fixed asset, such as a toll bridge or a highway, to certificate holders. The proceeds of the sale are needed for another governmental project, whatever it may be, and the purchasers have nothing to do with this matter. Certificate holders may assign a governmental bridge authority (or any other body they may choose) to run the property on the basis of output sharing, while all running expenses are borne by the managing authority. Of course, expenses are taken into consideration in determining the rate of output sharing.
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> Alternatively, a private contractor may issue shares and invite investors to construct a toll bridge which will be managed by the governmental bridge authority on the basis of output sharing. The bridge authority may also be the construction contractor as deputed by shareholders.

This means that certificates may be offered for an existing or a new project with or without a gestation period. In new projects, however, there will be two forms of relationship, at two consecutive stages, between the bridge authority and the certificate holders. In stage one, the authority will act as the certificate holders' agent, while the bridge is being built. In this capacity, it may be paid a certain fee(s) for services provided, or it may act voluntarily until the bridge is completed. In stage two, when the property is ready to generate income, the authority will become a managing partner, as in the case of crop sharing.

As regards negotiability, it should be noted that output sharing certificates represent property actually owned and legally possessed. They can thus be sold at market prices. For new projects, there may be a certain waiting period until cash funds are substituted for physical property and/or construction material. This is based on the ruling of the OIC's Fiqh Academy that the sale of such instruments at a price other than the purchase price is only permissible after a majority of the property in question takes the form of physical commodities and assets instead of cash (Islamic Fiqh Academy 1990).

Output sharing certificates, like common stocks, do not necessarily have any inherent process of redemption or amortization, as they represent the full ownership of fixed assets. They also expose holders to risks resulting from natural calamities as well as commercial risk.

A large variety of output sharing certificates may be issued to accommodate a multiplicity of output-yielding public projects that need financing, especially in infrastructure and transportation. Like the partnership and limited partnership instruments, output sharing certificates may represent projects in which an allowance for amortization of capital may or may not be made. In the latter case, the periodic distribution of output shares represents both a portion of the principal and a return. This approach may be suitable for projects based on exploiting a franchise or when there is a condition for transferring ownership of the project or its assets to the public sector after a certain period.

To sum up, several general remarks may be made. First, these instruments represent properties owned by the financier. This ownership has several implications, of which the most important are: a) These instruments are fully negotiable at market prices, because their sale means the sale of the property they represent. They can be issued to a specific name or shareholder; b) In principle, the government does not have to repay the principal of these instruments, unless this is specified in the conditions of the financing agreement (i.e., as in diminishing leasing, partnership, or limited partnership). Thus the issue of intergenerational equity does not arise; c) Public ownership of government projects is a form of privatization, although the government retains managerial control of all projects (except partnerships) financed by these instruments. And so the provision of these projects' output is kept public, as opposed to private, making it a special form of privatization that differs quite a bit from the traditional definition. I view this as a "democratization" of public project; and d) Except in diminishing leasing, the government must pay the market price if it wants to regain ownership of projects financed by these instruments. In diminishing leasing, the price paid is contractually determined.

Second, the issue of who provides what in public goods is irrelevant to these forms of financing. This implies that these financing instruments are neutral as far as the size of government is concerned. These instruments can therefore be used by a government that wants to provide either a larger variety of goods or one that wants to limit its role to the provision of goods on which the principle of exclusiveness does not operate through the play of market forces.

Third, the issue of whether future taxes and/or fresh borrowing become inevitable to pay for public financing through these instruments can be tackled from two angles: a) Whether a financed project produces a surplus sufficient to pay for its financing services (principal plus return).

If an efficiently run income-generating project can meet its own expenses, the imposition of future taxes may not be inevitable. Those which cannot meet their own expenses may require the levying of new taxes to pay for their financing services, and b) The form of financing to be applied to the project. In interest-based public debt, future taxation-cum-borrowing is required to pay for the debt services. In all of the financing instruments discussed in this section, the financing agreement may be formulated in a way that does not require future taxation, for there would be no need to pay back the principal financed. In other words, even with leasing instruments used to finance assets that do not generate any income, the government is not necessarily required to pay back the principal: it may rent the leased assets forever.

Fourth, all of these public financing instruments are related to specific projects and usages. In the case of leasing, it is implied that the government can use only the rented fixed assets. In the case of other instruments, the government is obligated to undertake specified revenue-generating projects. This is in contrast with interest-based public borrowing, which does not necessarily involve such one-to-one correspondence with the acquisition of physical assets or the construction of income-producing projects. On the one hand, this linkage with physical assets and the profit incentive in such projects reduces the moral hazards for public officers, for there is the added element of (private) control and, on the other hand, it increases efficiency, for public projects would have to compete with private sector projects for financing.

Fifth, while partnership, limited partnership, and output sharing instruments apply to income-generating projects, leasing may be utilized for all public projects, whether they are income generating or not. Therefore, of the above-mentioned instruments, lease financing is the most flexible.

Sixth, the nature of these instruments allows them to be used for both internal and external resource mobilization. In other words, these instruments are equally fit for external financial resources from individuals, international institutions, and foreign governments.

Public Debt Modes and Certificates

Ownership-based instruments may not fulfill all of the public sector's financing needs. Thus governments may prefer to resort to public borrowing under certain circumstances, such as seasonal needs to bridge the gap in timing between revenue collection and expenditure disbursement, or the inability to formulate certain financing needs under any of the ownership instruments due to certain legalities or their failure to attract investors. Debt-based financing therefore remains a valid alternative and

supplement to ownership-based financing, especially since the debt-based modes are basically geared towards serving short-term financing needs.

In the Islamic system, however, whenever one moves from the idea of ownership to that of debt, the degree of liquidity is affected because of two Islamic conditions: a) Debts may only be exchanged at face value, regardless of the date of maturity, and b) Debts may not be exchanged for debts. In other words, for the exchange to be Islamically permissible and legal, either the price or the commodity has to be present if the other is deferred. As a result of these restrictions, all debt-based modes of financing the public sector are not negotiable. This eliminates the possibility of a secondary market, with all of the negative effects on the primary market itself, and necessitates the search for an alternative approach towards liquidation.

For Muslims this alternative is redemption, which involves the debtor buying back the debt before its maturity. The Shari'ah requires that certain other conditions be met for the redemption to be valid. The most important one is that it should not be part of the original contract that created the debt.[7]

If the government chooses debt financing, it has two options: debt may be acquired from the public voluntarily or by the government's use of its legal authority. With regard to sources of such loans, they may be internal or external.

Voluntary Public Debts. Voluntary public debts must have certain built-in features to make them attractive to potential investors. Islamic law prohibits attaching any fringe benefits (i.e., tax reduction, relaxation of the relevant deadline conditions for tax payment, providing facilities in the sale of certain public goods) to a loan and considers any such benefits a form of interest.

Consequently, attractions for public debt must be designed carefully. Some of these may include appealing to patriotism and religious piety or a profit incentive incorporated in the exchange relationship. This profit incentive may take the form of a mark-up[8] on goods sold to the government for deferred payment, a mark-down on future goods and services sold by the government for immediate payment, or protection against inflation.

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[7]This discount is approved by some Muslim scholars and opposed by others on the grounds that it is a form of interest. See al Miṣrī (1987) and Islamic Fiqh Academy (1992).

[8]The concept of mark-up comes from raising the price of goods, if payment is made at a later date, in recognition of a financing compensation.

Sale-Based Public Debt. The mark-up and mark-down approaches are based on the sale principle of financing. Protection against inflation may take the form of selling goods at current prices but delivering them at a future date. Mark-up may be applied through sale at mark-up to the purchase orderer (*murābaḥah*) or deferred payment (*istiṣnā'*), while mark-down may be applied through deferred delivery sale (*salam*), deferred payment (*istiṣnā'*), or leasing (*ijārah*). There are thus four sales-based financing modes that can be used by the public sector: mark-up, deferred payment, deferred delivery sale, and leasing.

Public-debt creation may take the form of a simple deferred payment sale in which the government gives IOUs for future payment to suppliers. By the same token, leasing may be used for construction, with the understanding that payment will take the form of IOUs due at a point in time subsequent to the date of delivery of the completed project. Since these IOUs are transferable at face value, they do not attract secondary market transactions. A provision may be made so that they can be used for tax payments and other transactions. Debt certificates, which may be of different denominations and maturities, may be redeemed by the government before their due date and, at the time of redemption, the government may seek a discount for early payment.

Another form of public debt may use the mark-up technique with respect to the purchase orderer. Such an arrangment would work as follows:

> The government assigns one of its bodies to work as the agent of the public in acquiring goods on order for the government. These goods shall be paid for in cash from funds obtained from the public to finance the operation. Upon completion of the sale of the goods purchased on order and receipt of small denomination *murābaḥah* bonds from the government for the amount of the contract, the agent will distribute these bonds to the contributors of funds in proportion to their principal.

If the mark-down financing technique of deferred delivery sale is used, indebtedness must be counted in terms of physical goods, as opposed to money. This method can be used by the government to finance the public if the former is able to provide future goods for which the funds are currently being obtained. For example, a government-owned enterprise or farm that produces consumer goods may sell part or all of the output for *salam*-based coupons of indebtedness. These small denominations of quantities of goods may then be issued to purchasers. Although such coupons are non-negotiable (Islamic law mandates that purchased goods cannot be sold before physical delivery), they can be redeemed be-

fore maturity by cancelling the contract if the parties agree. In this way, the purchaser may get his/her money back without any increment.

The case of deferred payment-based public debt is similar to that of deferred delivery. However, there is one major difference: the items for sale are not necessarily identical or standardized commodities. For instance, the goods may include construction or manufacturing works with certain specifications, or cover both material and labor, such as houses and cars. In such a situation, the government might choose to sell future housing units on the basis of certain specifications and delivery dates, spelled out clearly in the prospectus, for one hundred dollars per one-thousandth of a unit. Thus whoever buys one thousand coupons will get a house. Such housing coupons would not be negotiable, but they could be redeemed before maturity by cancelling the contract.

Unlike ownership-based financing, the use of proceeds from these two forms of financing is not tied or restricted to specific goods or projects. Consequently, any resulting proceeds may be used to finance another project, the current budget deficit, the balance-of-payment deficit, and other needs. Such coupons may also be issued by federal, regional, or local branches of the government, as long as the delivery of the item(s) (contracted goods or construction) is feasible for the issuing body.

The incentive used by these certificates is the possibility of a mark-down on current prices or, alternatively, if prices are expected to increase because of expected or persistent inflation, pricing at the present level provides an incentive in the form of protection against inflation.

Another potential financing technique is a public utility warrant to finance public sector utilities. This arrangement is a version of a deferred delivery sale. For example, a public sector utility corporation may contract with its consumers to sell them a certain quantity of electricity in the future at a marked-down price against advance payment. Obviously, the nature of this commodity mandates that delivery is combined with consumption, so the consumer is the party that determines the quantity delivered at each time period.

If lease financing is chosen, such debt may take the form of securities representing a commitment by the government to provide a certain service(s) to the holder or family at a future date. It is therefore a contract to sell a service for advance payment. The services specified in this contract may be provided after a number of years, such as a university education for children or housing usufruct, or they may be provided in the near future, such as garbage collection during the fourth month of the current year.

Like the first two types of public debt discussed above, lease securities are not negotiable. They may be priced at a mark-down or at a price lower than the expected price at the time of delivery. These securities can

be issued by the central government, a university, or a local branch of government, as long as the issuing agency can provide the contracted service(s) in the future. They may be redeemed before maturity for the paid price, and their proceeds need not be tied to a specific use, for the seller of the services may use the resulting proceeds at his/her discretion.

Loan-based Financing. Two kinds of public loans may be mentioned: a) foreign currency bonds, which have the appeal of protecting one's wealth against devaluation and, to a certain extent, inflation (at least in many developing countries where the domestic rate of inflation is higher than the rate of inflation abroad), and b) bonds issued on the basis of appealing to the patriotic and religious sentiments of private citizens (i.e., benevolent bonds).

Foreign currency bonds are bonds issued to a government against foreign currency loans. They may be used when the local currency is expected to decline in value in terms of foreign exchange. The incentive offered is the guarantee of payment in the foreign currency in which the bonds were issued. As they are issued when foreign currency is more stable than the domestic currency, these bonds are a protection against domestic currency devaluation and inflation. Even though the prohibition of yield and negotiability makes them unattractive, they may be demanded by individuals who have no investment opportunities for their foreign liquid assets due to various internal restrictions.

In some cases, the government may try to raise funds by asking its citizens to lend it money out of love for their country and for their desire to protect and promote their nation's religious values and principles. The resulting certificates are known as benevolent bonds. As Islam encourages Muslims to make voluntary contributions in order to perform good deeds, to please God, and to help one attain success in the afterlife, such bonds have a great potential for use in Muslim countries. Since the Qur'an calls upon Muslims to sacrifice their wealth and lives in order to support just causes, why should Muslims not sacrifice their wealth in order to help out their government, especially if such wealth is only sought as a loan?

Involuntary Public Borrowing. Involuntary loans are acquired by the government on the basis of its authority and responsibility. They are a version of taxation but with a pledge of refund. Based on the sources of such funds, forced loans may be classified as loans from individuals and non-banking corporations, loans from commercial banks, and loans from the central bank. As the Shari'ah emphasizes the right of private ownership, any coercive borrowing has to be justified on strong grounds of public interest and distributive justice.

In conclusion, the following points should be noted. First, the modes discussed in this section create public debt. However, while mark-up modes as well as voluntary and involuntary public borrowing create debt in monetary terms, mark-down modes create in-kind debts.

Second, both mark-up and mark-down modes of public borrowing are tightly related to the exchange and production of goods and services. In mark-up modes (*murābaḥah* and *istiṣnā'*), public borrowing is initiated to supply the government with those goods and services that it wants to use for its current and/or developmental activities, regardless of whether the financed projects generate income or not. In mark-down modes, the government prepares to produce goods and services as payment for its in-kind debt. Islamic law prohibits those forms of financing if the debtor cannot supply the contracted goods and services. The link with commodities supplied and produced puts a tab on public debt that does not allow the government to expand it. Thus, mark-up and mark-down public debts avoid one of the major drawbacks of interest-based debt (Al Qārī 1412).

Third, with regards to mark-down modes and voluntary and involuntary borrowing, the public sector has a free hand over the financing's proceeds. It can use the resulting funds, regardless of their source(s), to meet budget deficits, for example. This possibility does not exist with the non-debt financing instruments outlined at the beginning of this paper. In other words, these modes of public debt financing provide the government with the flexibility of using the proceeds as the budget planners see fit. They also resemble most interest-based public debt modes.

Fourth, debts, whether in cash or in kind, have to be paid when due. Therefore, all Islamically acceptable modes and forms of public debt pose the challenge of debt repayment in the future, especially if the goods and supplies obtained in mark-up modes and/or proceeds of other modes are not used for income generating projects. This means that future generations either have to be taxed or asked for fresh loans to repay outstanding debts. Obviously, this calls for a thorough examination of the impact of such modes on intergenerational equity.

Fifth, since all of the public debt financing modes discussed in this section provide the government with either cash or goods and services, the issue of privatization does not arise.

Sixth, as these modes create public debt, the government may provide any form of guarantee or collateral it wishes. The guarantee may be given by the same body that uses the financing, or by another governmental body that may be legally and financially independent of the debtor.

Seventh, except for involuntary borrowing, all public debt-generating and certificate modes can be applied to both internal and external financing. This flexibility allows the government to obtain foreign institutional financing on the basis of mark-up to the purchase orderer (*murābaḥah*),

deferred delivery sale (*salam*), order purchase with delayed payment (*istiṣnāʿ*), and benevolent foreign borrowing. It can also mobilize foreign financing from individuals, citizens, and others on the basis of markdown modes and foreign currency bonds.

Conclusion

Like other free-market sociopolitical systems, the Islamic system foresees goods being provided to the public by the government as well as the voluntary and the private sectors. The Islamic system encourages the provision of public goods by nonprofit organizations and by the private sector and offers moral enhancement as well as material incentives in pursuit of that goal. In general, Islam prefers small government over big government, as it assigns as few goods as possible to be provided by the government. Nevertheless, there will always remain certain public goods that the public sector must provide, either because of their nature, the requirements of the Shariʿah, or because of the nation's political choice.

This paper examined several Islamic economic instruments designed for bridging an Islamic nation's budget deficit gap. It argues that since interest is prohibited, the Islamic economic system accommodates two kinds of instruments to mobilize resources to cover the budget deficit: funds raised on the basis of a financier's ownership of assets made available to the government, and other instruments based on debt creation.

To sum up, three important points are worth remembering:

1. All public debts create future liabilities and, unless the government generates sufficient future income to retire the debts, taxes and/or expansion of borrowing become inevitable. From the point of view of financing instruments, this requires certain elements: a) Ownership-based instruments do not call for redemption, as they do not create any liability for the public sector; b) In-kind public debt calls for future production of contracted goods and services. This requires financing. Unless the public sector's production capacity is expanded sufficiently, the fulfillment of contractual obligations becomes difficult. Default by the government in such a case may result in compensatory damages or other settlements; and c) A cash public debt cannot be rescheduled, for interest is prohibited.

2. The sale of public property is an important source of public revenue that may be tapped to deal with the budget deficit and to retire public debt. This needs to be explored thoroughly. For instance, economic development in oil-producing countries depends on this source. Moreover, the privatization process in the Second World and Third World

countries is capable of generating huge financial resources to pay back public debts and to cater to their future financial needs.

3. The modes and instruments discussed in this paper may be utilized for financial resource mobilization from the internal private sector of the nation as well as from external sources.

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