Chapter 40

Sukuk as an Alternative Source of Public Debt

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ABSTRACT

Public debt is a prime source of government revenue to finance budget deficit. Developing countries have been relying on public debt to cater the needs of fiscal expenditure. With the emergence of Islamic banking and finance across the globe, Muslim governments have introduced Sukuk (Islamic Bonds) to generate funds by the governments to meet their expenditure. The present study aims to discuss the possibilities of introducing Sukuk as an alternative way of financing public expenditure in Pakistan by replacing other conventional modes of financing in the future. The study will discuss the viable options available to the Government of Pakistan to offer Sukuk instead of bonds as a means of raising funds from abroad.

INTRODUCTION

Public debt is considered as a prime source of revenue for any government to finance budget deficit. It is perceived as the accumulation of annual budget deficits.

Developing countries generally face twin deficit viz. fiscal deficit and current account deficit. In order to bridge the twin deficit gap, these countries have been relying on public debt to cater to the requirements of fiscal expenditure. Researchers do not consider public debt a stigma on the economy. It is seen by the modern monetary theory as private income that is generated through private investment via private wealth and interest payments on debt. Foreigners find it very safe to invest in a country’s growth by buying different modes of financing. The option of going for external finance can be best explained by Adegbite, Ayadi & Ayadi (2008) who support the dual gap theory that better explains the reasons for external borrowing for sustainable development. The dual gap theory states that developing countries face the saving investment gap and are deficient in funds to meet the investment needs of the country to achieve the desired economic goals. Therefore, the need is felt by the developing countries to borrow from abroad. It is suggested that if the return on investment is higher than the cost of borrowing, the developing countries should invest in these projects through foreign funding.

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Many arguments are given in favor of public debt (see Ventura & Voth 2015; Uzun, Cagatay, Burhan & Selcuk 2012; and Glick & Homi, 1986). If it is spent correctly on development projects, it can contribute to the economic growth and improve the standard of living. Adegbite, Ayadi & Ayadi (2008) opine that in an optimal condition, the impact of debt on growth will be positive because of the greater or equal marginal return on investment than the cost of borrowing.

The neoclassical growth theory suggests the positive direct effect of debt on economic growth. According to the theory, public debt, if used optimally is anticipated to increase investment. The government can utilize public debt in improving infrastructure, education, job trainings and health. All such expenditures boost economic growth of the country.

Nevertheless, public debt, if taken beyond the limits, can be detrimental to the economy. If the country is unable to pay off her debt over a period, then it becomes a threat to the economy and may lead to debt default. The permitted threshold of public debt is gauged in terms of debt-to-GDP ratio which is an indicator to measure the capability of the country to pay off the debt.

Debt overhang hypothesis in theoretical literature suggests that there is a positive impact of foreign borrowing on investment and growth of a country up to a certain threshold level; beyond this level, however, its impact becomes adverse on economic growth. It is stated that external debt slows down growth only after its face value reaches a threshold level estimated to be about 50 percent of GDP (Clements, Bhattacharya, & Nguyen, 2003).

In the long run, if a country is unable to repay the large volume of public debt, it can have severe repercussions on the progress of the economy. Consequently, the interest rate rises because of the greater risk of default and impacts the components of economic expansion, making them more expensive. With the rise in interest rates, the cost of servicing the debt also rises. Hence, it is suggested that the public debt must be large enough to drive economic growth but small enough to keep the interest rates low (Amadeo, 2019).

Given that public debt is a requirement of developing countries, the question arises what should be the mode of raising foreign debt. The conventional way of generating foreign funds has been in the form of treasury bills, certificates, and government bonds. Over the last three decades, the Islamic financing system has been recognized as an alternative to the conventional financing system. According to Mizushima (2014), increase in Islamic population and the development of Islamic nations have paved the way towards the rapid growth of Islamic financial system. Islamic products are now available both in Muslim as well non-Muslim countries (Rammal, 2010). In the Islamic capital market, Sukuk play a key role and are very important Islamic debt instruments introduced based on Shari’ah principles.

The introduction of Sukuk in the capital market entails many benefits. Sukuk can diversify the source of funds for different projects, especially in developing countries and benefit the society at large. Investment opportunities can be offered to new groups. Organizations can raise funds in a Shari’ah compliant fashion. As Sukuk enjoy greater liquidity as compared to conventional bonds, investors who seek liquidation in investments in the secondary market find Sukuk useful (Rafay, Sadiq & Ajmal, 2017). Sukuk can be sold and investors can receive the cost of these certificates. Zin et al., (2011) suggest that investors who require fixed investment return with low risk find Sukuk to be ideal. Moreover, Sukuk can be used to meet the growth and development targets of developing countries. In the long run, because of alternative financing options to the investors, socio economic projects can be initiated benefitting the masses of the country. Sukuk are also considered a safe alternative mode of finance mainly because of their backing up with actual assets. Malikov (2017) in his empirical study compared the economic, state