

PUBLIC DEBT AS A SOURCE OF FINANCING FOR GOVERNMENT EXPENDITURES IN THE PERSPECTIVE OF ISLAMIC SCHOLARS

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PUBLIC DEBT AS A SOURCE OF FINANCING FOR GOVERNMENT EXPENDITURES IN THE PERSPECTIVE OF ISLAMIC SCHOLARS

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Abstract

Purpose of the study: This study aims to examine foreign debt as a source of financing for economic development. This research is expected to provide (1) an overview of debt as a source of funding for state projects, (2) investigate its impacts and (3) offer additional knowledge of its Islamic perspective.

Methodology: This research is a qualitative study using the study literature approach. This research is conducted by analysing books, literature, journals, and magazines with themes related to the focus of the discussion on this study. It is expected that the method used can provide insight, general knowledge, and develop the view of Islam in relation to foreign debt.

Main Findings: The government has to ensure that the state has the ability to pay off its obligations in the future; guarantee that loans have to be free from interest; prioritize taking loans from internal sources rather than external sources. In Addition, debts are not intended for deferred needs and not taking loans that exceed their needs.

Applications of this study: basically the results of this study can be applied to any country that considers the use of public debt, like other Islamic systems.

Novelty/Originality of this study: This research is conceptual research in an Islamic perspective. This study successfully examined comprehensively related to the public debt with the Islamic approach.

Keywords: Public Debt, Foreign Investment, National Expenditure, Waqf, Islamic perspective.

INTRODUCTION

One of the biggest obstacles in the process of economic development, especially for a country that is considered as a developing or undeveloped economy, is the need for large sources of funding to finance every government project. This huge demand is a big concern for policy makers and government officials to look for solutions. Merely relying on country's savings and national's income that are generated from within the country such as tax income and trade gains will not be enough; therefore, the need for funding sources from abroad might be an alternative solution.

The sources of financing obtained from external parties may come in the form of foreign debt. If a country continues to use debt to finance national expenditure, it can lead to accumulation of debt in the long run. Relying on debt as the main source of funding will give the country a great burden and pressure, especially in the time of annual national budgeting. The government is required to establish a budget fund with a high nominal and allocate it to pay for national obligations.

Short-term and long-term debt can have a negative impact and destroy economic stability. Fluctuations in an unpredictable economic environment affect negatively on short-term debt. A shock on one of the economic factors at the macro level will lead to speculative actions, sending alert signals to capital providers and businesses, causing a decrease in motivation for conducting economic activities. As a result, shocks to economic factors will increase the default risk of bond assets and create a business environment that is not conducive (Busse and Hefeker, 2007). Often, the capital providers will compete in the race to withdraw their capital, and this can provide several economic problems such as capital outflows and currency devaluations. This can be seen in recent economic phenomena when the Federal Reserve System of America constantly increase the Federal Fund Rate, this creates conditions that led speculative activities and capital outflow in developing economies. Consequently, many countries suffer from currency devaluations against United States Dollar.

Foreign loans are considered capable of resolving state problems in the short term, by providing fresh funds to finance government projects, both for consumptive interests such as providing subsidies and social securities to productive interests such as building state infrastructure. However, in the long run, debt will plunge a country into poverty and destruction. The budget that should be used to provide health services, improve the quality of education and prosperity of the community, must be used to pay the annual interest and its principal at maturity.

Economists always provide directions for the government to supervise and take full control in accommodating financing sources, especially in the form of debt. Failure to monitor and control outstanding credit in a country can be fatal in the economy. The service of providing loans has a negative relationship to economic growth in a country. Higher level of loan services that are distributed above the reasonable limit, increase the risk exposure of a country. Therefore, services for



providing debt that are not managed properly will increase the likelihood of disruption in a country's economy and financial system (Bengoa and Sanchez-Robles, 2003).

All countries in the world, both large and small, whether they have a Muslim majority population or not, have debts that are usually taken from foreign creditors. The burden of the state that is borne to pay interest is so large and becomes a potential economic instability. The failure of banks in the United States to manage, supervise and take full control of housing loans (mortgages) resulted in the 2008/2009 global crisis (Toarna and Cojanu, 2015). In addition, Greece is a country that has recently suffered from an economic and financial crisis. Fiscal imbalances, which are illustrated by the high level of state expenditures and the failure of the government to repay its debt, are the main causes of these crisis (Baltas, 2013). When a country fails to fulfill its obligations, it destroys political, economic and social stabilities.

This study aims to examine foreign debt as a source of financing for economic development. This research is expected to provide (1) an overview of debt as a source of funding for state projects, (2) investigate its impacts and (3) offer additional knowledge of its Islamic perspective. Governments and business actors in Islamic countries, especially members of Organization of Islamic Cooperation, are the parties who will benefit from this research. This study is projected to emphasize the threats of taking loans and provide guidance or insight for the government in policymaking before considering of taking foreign debts.

METHODOLOGY

This research is a qualitative study using the study literature approach. This research is conducted by analysing books, literature, journals, and magazines with themes related to the focus of the discussion on this study. It is expected that the method used can provide insight, general knowledge, and develop the view of Islam in relation to foreign debt. This research has been arranged in such a way as to achieve the intended purpose.

DISCUSSION / ANALYSIS

National Budget systems

The national budget system in mainstream economies adheres to a system where the expenditure of a country will be estimated in advance, and funding sources to finance all these expenditures will be look afterwards. This system has a tendency to let the government spend more than the projected income to be obtained. Even if the country receives less than the expected incomes, large expenditures will continue to be carried out and this has the potential to create a substantial budget deficit. Overcoming this deficit, the government will implement several policies that cover printing more money or seeking loans from internal or external sources. The loans come from local banks, financial institutions, companies or countries. World Bank, International Monetary Fund, Asian Development Bank, Islamic Development Bank are examples of international financial institutions that has been providing loans to many countries in need. The more money circulating in the economy has the potential to lead to inflation and the more debt borrowed by the state can lead to recession and even depression or economic crisis.

In comparison, the national budgeting system in Islamic countries starts by estimating the expected national incomes, which are then intended and allocated for various expenditure categories. Nominal and categories of state expenditure will refer to the expected national income obtained from *Zakat, Infaq, Shodaqah, Wakaf* (ZISWAF), taxes, and other sources of income. The government will not face a budget deficit since the expenditures will be proportional to the income received by the state. The Islamic system of budgeting does not require to owe money or print more money to finance the deficit. Thus the Islamic state system offers solutions from the threat of deficits, excessive debt, recession and economic depression (Chaudhry, 2016). The budget system that prioritizes the estimation of state expenditure before making sure how much income will be obtained will push the government to take loans to finance the deficits, both from internal and external sources. History proves, Islamic states have never experienced a crisis caused by high debt and state budget deficits, except those caused by political conflicts or the failure of farmers to harvest their crops and agricultural products that caused by bad seasons, disasters and calamity.

Debt as a Source of Funding

Economic growth of a country can be accelerated with the participation of government intervention such as the process of providing infrastructure and services in education, health, transportation and so on. According to a popular macroeconomic theory, specifically the theory put forward by Keynes, governments in a country can implement an expansionary fiscal policy that aims to increase the output of the economy and guarantee economic growth. This policy is carried out in two ways, namely reducing taxes and increasing state expenditures. Lowering taxes is less popular in countries with developing economies since this basis will reduce state income significantly. The only way to solve the problem is to increase spending, but this depends on the income that the country gets. If state income is insufficient to meet the expenditure, then the easiest and often used way is to borrow, both from within and outside the country. This is further corroborated by Keynes (1936) who argues that if a country wants to increase aggregate demand and national income by increasing spending, then the expenditure does not have to be financed by increasing taxes, but alternative debt is able to be the source of the financing. This theory does not stop here, but continues to develop that is if economic growth has been achieved, this growth must be perpetuated by increasing spending and perpetuating it at a higher level. This can be seen



from the trend in national expenditures of countries across the world which is seen to be increasing from year to year. Trust and believe in this theory causes world leaders in developing countries, including many Islamic countries, to take loans in order to finance the national expenditures with the aims of achieving economic growth (Ismail, 2013:3).

Several studies conducted to find out the relationship between public debt and economic growth. Eberhardt and Presbitero (2015) found some evidences to support the negative relationship between public debt and long-run growth across countries. Adegbite et al. (2008) confirmed the negative impact of debt and its servicing requirements on Nigeria's economic growth. Changyong et al. (2012) examined how debt transformation rate and debt ratio to GDP would affect economic performance of the country using the United State data over the period of five years. The study reveals three main conclusions: (1) when the debt ratio to GDP exceeds a certain limit, public debt will become a barrier to economic growth, while (2) high debt transformation rate may facilitate economic growth. (3) If the public debt transformation rate is low when the debt ratio rises over a certain point; economic growth will be hindered and may even trigger economic crisis. Panizza and Presbitero (2014) found some evidences to support the negative relationship between public debt and economic growth. However, the negative relationship disappeared after further examination by excluding the endogeneity and found no causal relationship between the two variables under studied. Looking at the results of these previous studies, it has been highlighted that the public debt can be a hindrance to obtain economic growth of the country.

Islamic Views on Public Debt

Islam is a religion that regulates all the joints of Muslim life and behavior, starting from worship to Allah, friendship with fellow humans and even other beings. Islam is the only religion that regulates and provides norms in dealing with debt. In Islam taking a loan and lending money occupy very important places as explained in Al Quran in Surah Al Baqarah 282-283. These two verses provide guidance on procedures for carrying out debt and receivables. Debt should be written in a document and signed by the indebted individual and the party who becomes a debtor and witnessed by two just witnesses. The document is an evidence, which proves that individual takes a loan from the lender. The document contains some information which include the amount of debt given, payment period, method of payback (whether in cash or credit), the amount of installments that need to be paid, the date of starting and ending debt and how to repay the debt (such as by a transfer in bank account or to receive cash). Other than that, from the two verses above we can draw the conclusion that Islam allows debtors to take collateral to guarantee the payment of debt. These two verses highlighted the ethics in managing debt, for the lender or the borrower. Islam is very strict in terms of debt. Debt payments must be prioritized and must be resolved properly. In the hadith narrated by Muslims, the Prophet said: "*the martyr will forgiven his sins except those who have debts.*" In another Hadist narrated by Imam Bukhari no. 2393, the Prophet said: "*Indeed, most of you are the best in paying debts.*"

There are two views on taking loans from external parties to finance economic development. The first view states that foreign debt is permissible in Islam, provided that the debt is not contrary to the Shari'a and Islamic teachings. Thus, the financing is taken in Islamic schemes of economic activity such as *Mudhorobah*, *Musyarakah* and *Murabahah*. Whereas the second view does not justify borrowing from external parties of the country. This view is preventative, it is feared that the loan will burden the country as it depends on *ribawi* practices (loan with interest). The fact is, most lending countries or capital providers are developed countries with economic power and not Muslim countries. Therefore, the process of lending will involve profits in the form of interest to be borne by the borrower. This certainly will not be justified in the teachings of Islam (Ismail, 2013:225). Islamic economists, Umar Chapra and Munzer Kahf strongly opposed the theory built by Keynes. Chapra (1992) says that large state spending can cause mismanagement in the national budgeting system and waste state revenues. Munzer Kahf (1999) requires every country to have sufficient resources and enough funds to finance state expenditure, in other words, state expenditure can only be done if there is sufficient funding. Consequently, no government spending goes beyond the income expected to receive by the country.

Chapra (2000:370) accepts the concept of a budget deficit and provides a different solution to Mannan. Muslim countries must cover the deficit with taxes, namely reforming the taxation system and remodeling state expenditure programs, not by shortcuts through monetary expansion and borrowing. Chapra agrees more with increasing taxes, since borrowing will lead to usury. Borrowing also eliminates the need to investment. Loans temporarily suspends short-term problem in financing and burden future generations with heavier ones.

Abdul Qadim Zallum agreed with the system of budget deficit, with a similar solution to Umar Chapra. The deficit was overcome by the control of national spending, generating incomes from industries owned by the government and imposing taxes. Nowadays, the state budgets are heavy and big, after the expansion of responsibilities and the increasing number of posts that had to be subsidized. The national income from traditional Islamic sources such as *ZISWAF*, *Ghanimah*, *Fay'i*, *Jizyah*, *kharaj*, *'Usyr* and *khumus* are sometimes not sufficient to meet the country's growing expenditure. Therefore, the state must strive for other means that can cover the needs of state treasury (*baitul maal*). In times of the insufficiency of assets or deficit, this obligation is transferred to the Muslims (Muhajirin, 2016).

Chaudhry (2016:331) believes that the effectiveness of tax collection, alms and other sources of income that are compulsory and voluntary, as well as income from state projects, property and natural resources will make the Islamic state stand in full. Therefore, the country will apply the middle principle (*at tawasuth*), striving for a balanced budget and avoiding unproductive spending. If there is an emergency and a national crisis caused by war or natural disasters and the



government needs funds, then the funds will be obtained through withdrawal of extra taxes or printing money with a note that it will be terminated if the crisis passes. If a very serious situation occurs, the government can issue an appeal to all people to give donations and voluntary contributions. History proves that Muslim communities are not reluctant to make their contributions when the state is in a state of urgency. Motivation carried out by the Prophet, was able to give morals to the companions to contribute in financing the Tabuk expedition, and the Muslims were competing to provide their contributions. If the state fails to raise funds from the methods above, while the crisis still has not passed and the need is getting larger, the country will be forced to take the loans from external parties. However, the loan must be limited to the amount needed and should take precedence to obtain sources from the internal state and be free from interest. The debt taken must be paid off immediately to release the burden of state budget and should not be used as a habit. Any improvident spending is not tolerated to be funded by loans.

Al Ghazali is one of the few Muslim scholars who put debt as a source of state income. According to Al Ghazali, the government can take debt from the public if future state revenues can guarantee its payments. This certainly requires careful calculations, because if the government is unable to ensure that the borrowed funds will be returned, the government has no basis for taking the public debt. At present, the example of debt like this is revenue bonds carried out by the central and local government at the United States of America (Karim, 2012:347).

Al-Mawardi divides state spending into three parts that include, first, spending for the purchase of government goods and services, for example purchasing weapons and paying salaries of state employees. Second, expenditures for the welfare of the community which, if ignored, will have fatal consequences and cause harm to the community, such as the provision of clean water, the supply of basic commodities and the construction of roads that have no alternative. Third, expenditure spent on the welfare of the community that has an alternative, even though the process will experience difficulties such as providing roads to connect between regions (which are closer), while there are other alternative roads that are further away. If a government does not have enough funding to pay its expenditure, the government may only borrow to finance the development of the first type expenditure. For the second-type of expenditure, the government is not allowed to take loans, but may impose higher tax on residents who are wealthy or enforce obligatory loans to groups of rich people. As for those relating to the last type of expenditure, the government can take tax for high income groups (Ismail, 2013: 227).

Al Juwaini also divided the state expenditure into three parts, firstly spending military supplies which are vital for the security of the country and to protect the property of Muslims in the event of an attack from the enemy. Second spending is expenditure related to preparing Muslim forces, such as training military personnel. While the last expenditure is for ordinary spending such as paying the salaries of teacher, judges, spending on *farḍhu kifayah*, support the investigations for fatwa experts and others. Imam Al Juwaini argues, if a country does not have sufficient financing, then the government may not take loans from other parties and allow to impose a low level of tax for the first type of expenditure, moderate levels of tax for the second type of expenditure and high levels of tax for the last type of expenditure. Al Juwaini and Al Mawardi argue that, state expenditures must be balanced with the national income that will be received, and not rely on debt, tax, or forced loans as the main sources in financing the state and national projects. More spending can be granted if the country receives more than the expected income (Ismail, 2013: 227).

According to Mannan (1997:235), a modern Islamic state must accept the concept of a modern budget deficit system, with key differences in terms of handling the budget deficit. Today's Islamic state must begin with the necessary expenditures (as planned in the annual budgeting) and look for new ways to achieve them, either by rationalizing the tax structure or by taking credit (debt) from the domestic or foreign financial institutions. The selection of this budget deficit system will certainly require additional means of borrowing. For this reason, there are three traditional loan sources for most Islamic countries, namely: Central Banks, Commercial Banks and the public (bonds). However, the debt must be made without pressure from the creditor, which will result in the loss of freedom, honor and sovereignty of the Muslim country. Furthermore, what is equally important is that the debt must be without interest (*riba*), which will burden the debtor or creditor.

Al-Maliki (2001:223) argues that loans for individuals are *mubah* (allowed), unless it is intended to fund things that will cause damage and harm. As for the state, it is permissible to take loans in one circumstance, that is, if *baitul maal* has run out of assets in addition to the emergence of national interests that require the state to take debt. These interests are included in matters that are the responsibility of the Muslims and if delayed it will cause damage and harm. Therefore, in this emergency situation, the government is allowed to take loans, while for other interests that are not for the sake of emergency, the state is not allowed to be indebted. Examples of financing that must be sought and hastened are financing for the needy, *ibn sabil* (travelers), for the purposes of jihad (for example the army, police, teachers, judges, government officials) and several conditions that occur suddenly that cause many losses such as natural disasters or sudden enemy attacks.

Financing a state's development programs must avoid sources of debt. Even if it has to happen, the debt to be taken must be obtained from a fellow Muslim country. It must be ensured that domestic financing is no longer sufficient. To balance the budget deficit, one of the innovations and solutions that are currently popular to support the financing of government programs is to use instruments that involve all parties, including the government, the private sector and the public. The financing uses what is called sharia bonds, which are essentially joint financing in the form of investment or buying and



selling schemes? The bonds can be in the form of *Mudarabah*, *Murabahah*, *Salam* or *Istisna'* schemes. Hence, it is hoped that the independence of the state will be created, especially as a result of fiscal independence in the state budget (Sakti, 2007:380).

Several Solutions Worth Considering

Looking at some of the adverse impacts of taking loans to finance government projects makes foreign investment, in addition to domestic investment, an alternative solution, especially for countries that are considered as undeveloped or developing economies. The inward foreign investment will increase state income by providing fund for the development of business and industries. In contrast, foreign divestment or the withdrawal of capital from investments that have been carried out by foreign investors to the country of origin reduces state revenues. As a source of funding, ideal foreign investment transfers capital to support the country's economy and help alleviate social problems such as poverty and high unemployment. Foreign investment has a role to increase technology transfer from foreign companies. Investment is considered as a means to develop new economic activities, create jobs opportunities, reduce unemployment and improve people's welfare. The inflow of foreign capital to the country is considered as an opportunity for local companies and businesses to grow, expanding their business scope and market share by refining the production for its quality and quantity. Ideal foreign investment helps the country in funding country's mega-projects of infrastructure.

The government must pay attention to the various benefits mentioned above and the potential losses that will be experienced by the country. Various problems could arise such as the ownership of foreign investors in assets and wealth of the country. This happens when foreign investors have a greater percentage of ownership than local investors do. More ownership offers foreign investors full authority in determining prices and take control of the asset management, which has the potential to trigger political, economic and social jealousy between local communities and foreign investors. Furthermore, foreign investment carried out both in the capital and money markets has a high dependence on fluctuations in factors that affect the economy. Changes in economic factors that are considered capable of harming investors can have fatal consequences from national, regional and international levels. Rational investors will easily move their investment in a country with a higher investment return. This is often referred to as capital outflow or divestment. The large amount of foreign capital outflow has the potential to reduce the exchange rate of the local currency and have an impact on other economic activities, especially in the process of international trade. When the Federal Fund Rate in the United States increases, investors will make calculations to estimate the level of profits to be gained. If the calculation results in a higher level of profit, investors will withdraw the invested capital and invest it in a country with a higher profit level. Consequently, this will cause a decrease in the value of the currency (local currency devaluation) since the demand for local currency decreases. Observing some of the advantages and disadvantages of foreign investment, the government can provide incentives to encourage the inflow of foreign investment or impose several provisions in the form of regulations and policies that can hinder or even prevent the flow of foreign investment. This is certainly done after going through several observing processes, calculations and considerations, considering on all aspects that affect the flow of foreign investments, in addition to their impacts on society and the country's economy as a whole (Madura, 2010).

In line with foreign investment, *waqf* and *zakah* are better alternative solution. *Waqf* and *zakah* are Islamic financing instruments that have supported the economic and social development of the Muslim community both in the past and in the present (Mahat, Jaafar, and Rasool, 2015, Mawardi, Fauji, Kusuma, Multazam, Santosa, 2018). *Zakah* should become a source of productive fund to fulfill societal needs. Some countries with advanced *zakah* institutions have developed *zakah* to become a pillar of economic development (Widiastuti, Mawardi, Robani, & Rusydiana, 2018).

The potential *Waqf* is a superior funding instrument since the benefits of *waqf* will be channeled to the social interests of the people. This is different from foreign investment that requires all profits from business activities to be channeled to investors and business owners. *Waqf* is oriented for God purposes and the afterlife, while foreign investment is conducted for profit orientation. Productive *waqf* has proven to be a successful source of state funding. The beginning of the country's development period in the era of the Prophet Muhammad PBUH became a witness to the generosity of the companions to spend most of their wealth in the way of Allah SWT. This is conducted to provide the country and local Muslims with funding to finance state expenditures in terms of infrastructure development, financing of war, and fulfillment of needs.

At present, the role of *waqf* in economic development can be seen throughout the world. For example, in Singapore, 170,000 Muslim workers donate \$2- \$11.50 a month. Using the Employee Provident Fund mechanism, which is a contribution of workers earned from salary deductions, this act has raised \$ 6 million every year to be channeled for the God purposes. Apart from cash *waqf*, there are 100 type of *waqf* registered in Singapore. The amount gathered are distributed to mosques, schools, social welfares, funerals, people in need and others. In the UK, the Islamic Relief organization has introduced several *waqf* projects to help Muslims around the world, which include *waqf* of water and sanitation, sacrificial (*qurban*) *waqf*, health *waqf*, education *waqf*, orphan *waqf*, endowments for emergency assistance and others. Among the beneficiaries of various *waqf* projects were Palestinian children, victims of the Bosnian war, poor people in Bangladesh, Mali, Sudan and others. In Kuwait, the Kuwait Foundation established the Kuwait Wakaf Foundation or Kuwait Awqaf Public Foundation (KAPF) in 1993 with the specific aim of endowments and the development of *waqf* projects for Muslim communities. The projects carried out by KAPF have benefited the community. Among the projects are financial assistance for poor students and assisting the Kuwait Autistic Center. Other charitable



activities carried out by KAPF that are in accordance with *waqif* requirements are the provision of free drinks in public places, providing foods during Ramadhan and clothes for needy families (Ab Rahman, 2009).

CONCLUSION

This study has discussed the impact of taking loans as a source of funds to finance national projects and its Islamic view. Debt has a negative impact on economic development; the state has a burden to pay the loan principal and its interest. In the view of some Muslim scholars, the state takes loans if *Baitul Maal* does not have the enough asset to finance emergency needs and if not fulfilled will cause damage. There are several considerations for the government before taking a loan. The government has, (1) to ensure that the state has the ability to pay off its obligations in the future, (2) to guarantee that loans have to be free from interest, (3) to prioritize taking loans from internal sources rather than external sources; it is preferably to take loans from Islamic institutions or countries. In Addition, (4) debts are not intended for deferred needs and (5) not taking loans that exceed the needs. (6) When the government has the ability to repay back, delay is not tolerated and (7) must not considered taking loans as habits. This research limits its discussion on analyzing foreign debt as a source of financing the country's development and provide several alternative solutions such as foreign investment and *waqf*. Further research can analyze sources for funding national expenditures other than foreign debt, foreign investment and *waqf* with all its forms.

LIMITATION AND STUDY FORWARD

This study uses the study of literature as a research method. However, despite the limited textbooks, research has been able to discover how Islamic views are related to public debt.

In further research, it is hoped that empirical studies can be carried out by referring to the results of this study so that it can photograph the country and its impact on state finances.

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