Islamic Finance for Infrastructure Development

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At a time when economic recovery needs more stimuli by the Government of India (GoI), there is also an urgent need to safeguard the economy from the fire of inflation led by debt. In an attempt to find the actual reasons behind high fiscal deficit, and inflationary trend in India, it is observed that the increased debt receipts by GoI to finance revenue expenditures (especially high debt servicing); increased subsidies on food, fuel and fertilizer; and rural development through schemes like NREGS, farmer's loan waiving scheme and Sarva Shiksha Abhiyan are the three most important factor of high fiscal deficit. Since there is need of more stimuli to counter recession in the economy, it is expected that the plan expenditures may further increase. After considering different options it is observed that Islamic finance can substantially reduce the fiscal deficit even though if revenue receipts declines and plan expenditures increases.

Islamic financial products has a great role to play in reducing the fiscal deficit in emerging economies by replacing the debt based investments for infrastructure with funds mobilized through equity based Government Securities for infrastructure projects. Let's see how Islamic finance may help us reduce our present fiscal deficit.

Revised Estimates as presented in Interim Budget for 2009-10

Income Expenditure Estimates for Union Budget	**2008-09 R. E. (in Rs. Crores)**
1. Gross Tax Revenue	627,949
2. Net Tax Revenue	465,970
3. Total Non-Tax Revenue	96,203
4. Total Revenue Receipts	**562,173**
5. Non-debt Receipts	12,265
6. Debt Receipts to finance Fiscal Deficit	**326,515**
Market Loans	261,972
Market loan as % of total debt receipt	80.23%
Debt receipts as % of total receipts	36.24%
Debt receipts as % of total capital receipts	96.38%
7. Total Capital Receipts	338,780
8. Total Receipts	**900,953**
9. Total Revenue Non-Plan Expenditure	561,790
10. Total Capital Non-Plan Expenditure	56,206
11. Total Non-Plan Expenditure	617,996
12. Total-Revenue Plan Expenditure	241,656
13. Total Capital Plan Expenditure	41,301
14. Total – Plan Expenditure	282,957
Total Revenue Expenditures	**803,446**
Total Capital Expenditures	**97,507**

15. Total Budget Support for Central Plan	204,128
16. Total Central Assistance for State & UT Plans	78,829
17. Total Expenditure*	**900,953**
DEBT SERVICING	
18. Repayment of debt**	337,316
19. Total Interest Payments	192,694
20. Total debt servicing (18+19)	530,010
21. Interest Payments as Percentage to Revenue Receipts	34.30%
22. Total Debt servicing as Percentage to Revenue Receipts	94.28%
23. Non Debt receipt as % of total receipts	1.36%
24. Debt receipts as % of total receipts	36.24%
Interest payment on debts as % of total Expenditure	21.39%
Debt Servicing as % of total Expenditure	58.83%
25. Interest Payments as Percentage to Total Receipts	21.39%
26. Repayment of Debts as Percentage to Total Receipts	37.44%
27. Repayment of Debt as % to GDP	10.10%
28. Interest payment as % to GDP	5.77%
29. Total Debt Servicing as % to GDP	15.87%

* Excludes expenditure matched by receipts (Details in Annex-2 to Expenditure Budget, Volume-1, 2009-2010)

** Excludes discharge of 91 days, 182 days & 14 days intermediate Treasury bills, discharge of Ways & Means Advances including overdraft, income and expenditure of National Small Savings Fund (NSSF), investments of NSSF, Reserve Funds and Deposits not bearing interest and suspense transactions. Discharge under MSS met from the sequestered cash balances is not included.

Data source: http://indiabudget.nic.in/

Notably the total revenue expenditure is 142.92% of total revenue receipts reflecting 30.03% revenue deficits. Major cause of this high revenue deficit is high debt service ratio to total revenue expenditures. For a developing economy like India, in the proposed plan we project increasing capital expenditures, but in revised estimates of 2008-09 budget, the revenue expenditure is 89% and capital expenditure is just 11% of total expenditure; all due to high debt servicing ratio (66%) to total revenue expenditure. Notably the interest payment alone is 24% of total revenue expenditures. So, with capital expenditure being as low as just 11% of total expenditure and debt serving being as high as 59% of total expenditure, how can we go planning for foster inclusive growth?

Debt Finances crossed the Planned Estimates:

The debt based finances for investments under 11th five year plan document was proposed to be 48.42% of total receipts for 2008-09, whereas the revised budget estimates reveals that the debt receipts were 96.38% of total capital receipts in 2008-09. This reflects our inability to mobilize targeted amount of non debt receipts, causing high fiscal deficit due to interest payments over borrowed debt receipts.

Source-wise Projected Investment for 11th Plan

(Rs crore at 2006–07 prices)

Sources	2007–08	2008–09	2009–10	2010–11	2011–12	Total 11th Plan
1. Centre	**112,608**	**128,305**	**148,545**	**172,123**	**204,041**	**765,622**
Central Budget	29,416	33,517	38,804	44,963	53,301	200,000
Internal Generation (IEBR)	24,958	28,437	32,922	38,148	45,222	169,687
Borrowings (IEBR)	58,234	66,352	76,819	89,012	105,518	395,936
2. States	**79,499**	**99,022**	**124,998**	**160,232**	**207,186**	**670,937**
States Budgets	52,689	65,628	82,844	106,195	137,315	444,671
Internal Generation (IEBR)	8,043	10,018	12,646	16,211	20,961	67,880

Borrowings (IEBR)	18,767	23,376	29,508	37,826	48,910	158,386
3. Private	**78,166**	**94,252**	**115,724**	**146,762**	**184,687**	**619,591**
Internal Accruals/Equity	23,450	28,726	34,717	44,029	55,406	185,877
Borrowings	54,716	65,976	81,006	102,733	129,281	433,713
Borrowings as % to private	70.00%	70.00%	70.00%	70.00%	70.00%	70.00%
4. Total Projected Investment	**270,273**	**321,579**	**389,266**	**479,117**	**595,913**	**2,056,150**
Non-Debt	138,555	165,875	201,933	249,546	312,205	1,068,114
Debt	131,718	155,704	188,333	229,571	283,709	988,035
Non Debt as % of Total	51.26%	51.58%	51.88%	52.08%	52.39%	51.95%
Debt as % of Total	48.74%	48.42%	48.38%	47.92%	47.61%	48.05%

Data Source: http://planningcommission.nic.in/

According to 11th plan documents, projected investments in 2008-09 should be of Rs. 321,579 crores while total plan capital expenditure in revised budget observed as just Rs. 41,301 crores. So the plan capital expenditure is just 12.84% of targeted investment in 2008-09. This shows our inefficiency to make budget development prone to ensure foster and inclusive growth. So, it is better that GOI reduce debt borrowings which ultimately increases revenue deficits; and shift the focus on infrastructure investments to stimulate the economy at a time when GDP growth rates and employment growth rates are falling.

Actual Debt Receipts is 210% to the planned Estimates:

Since the revised estimates on debt receipts (Rs. 326,515 Crores) is already 210% of estimated requirements of debts (Rs. 1,55,704 Crores) by year 2008-09 as projected in 11th five year plan documents, the GoI should seriously think about this increased debt receipts. The funds utilized for debt servicing (Rs. 530,010 Crores) is already 162% of debt receipts to finance fiscal deficit (Rs. 3.26.515 Crores), the GoI should revisit its budgeting. How good is it to increase the debt receipts at a time when Indian industries are looking for more affordable credits from banks to meet the challenges after the global meltdown?

Likely Sources of Debt as projected by the Planning Commission

(Rs crore at 2006–07 prices)

Likely Sources of Debts	2007–08	2008–09	2009–10	2010–11	2011–12	Total Eleventh Plan
1 Domestic Bank Credit	49,848	63,207	80,147	101,626	128,862	423,691
As % of likely total debt resources	48.69%	49.99%	51.09%	52.00%	52.72%	51.32%
2 Non-Bank Finance Companies	23,852	31,485	41,560	54,859	72,415	224,171
3 Pension/Insurance Companies	9,077	9,984	10,983	12,081	13,289	55,414
4 External Commercial Borrowing (ECB)	19,593	21,768	24,184	26,868	29,851	122,263
5 Likely Total Debt Resources	**102,370**	**126,444**	**156,874**	**195,435**	**244,416**	**825,539**
6 Estimated Requirement of Debt	**131,718**	**155,704**	**187,333**	**229,571**	**283,709**	**988,035**
US$ Billion	32.93	38.93	46.83	57.39	70.93	247.01
7 Gap between Estimated Requirement and Likely Debt Resources (6–5)	**29,348**	**29,260**	**30,460**	**34,136**	**39,292**	**162,496**
US$ Billion	7.34	7.31	7.61	8.53	9.82	40.62

Data Source: http://planningcommission.nic.in/

In year 2008-09 the deficit budget cost an amount of Rs. 192,694 crores to GoI which was paid as interest over the debt receipts borrowed to finance the deficit budget. This may be called as loss to GoI because had there been equity based receipts against debt receipts, GoI would have saved this amount.

Financing Fiscal Deficit through subsidized bank loans is not good

In the 11th five year plan document it was projected that by year 2008-09, to meet the proposed investment needs around 50% debt receipts worth Rs. 63,207 crores would be mobilized as domestic banks credit. However the figures of revised budget estimates for 2008-09 states that market loans (amounting Rs. 261,972 Crores) are over 80% of total debt receipt by the GoI. The increased flow of subsidized bank loans to GoI for financing fiscal deficit is in fact creating problems for economic growth of the economy because it is creating hurdles for banks to increase the supply of cheaper credit to the private sector at a time when they needs it to minimize their output cost and combat recession. It is observed that beside fall in international demands, the availability of equity finance or cheaper credit sources have affected the business confidence. The equity financial sources are drying up after reversal of capital flows from stock markets due to global meltdown. External Commercial Borrowings (ECBs) and Export Credits have also declined. This all had affected the growth rate for industries.

Industry wise GDP growth trend during recent years

Industry	2006-07	2007-08 (QE)	2008-09 (RE)	Percentage change over previous year	
				2007-08	2008-09
1. Agriculture, forestry & fishing	531,315	557,122	566,045	4.9	1.6
2. Mining & quarrying	60,038	61,999	64,244	3.3	3.6
3. Manufacturing	440,193	476,303	487,739	8.2	2.4
4. Electricity, gas & water supply	60,544	63,730	65,899	5.3	3.4
5. Construction	205,543	226,325	242,577	10.1	7.2
6. Trade, hotels, transport and communication	778,896	875,398	954,589	12.4	9.0
7. Financing, insurance, real estate & business services	409,472	457,584	493,356	11.7	7.8
8. Community, social & personal services	385,118	411,256	464,926	6.8	13.1
9. GDP at factor cost	**2,871,120**	**3,129,717**	**3,339,375**	**9.0**	**6.7**

Source: - CSO press release dated 29th May 2009.

Besides evaluating fall in annual growth rate of Gross Domestic Product (GDP) from 9.0% in 2007-08 to 6.7% in 2008-09, it would also be important to analyze the growth trend for different industries during last year. The Manufacturing industry employing majority of non agricultural workers observed deepest fall where annual growth rate fell to 2.4% in 2008-09 compared to 8.2% in 2007-08. Similarly the annual growth rate of agriculture, forestry and fishing fell to 1.6% in 2008-09 against 4.9% an year ago.

However the increase in annual growth rate for Community, Social and personal services has remarkably increased to 13.1% in 2008-09 as compared to 6.8% in 2007-08 reflecting the impact of increased expenditures by the Government by financing schemes like NREGS. But it would be important to notice that such expenses have not only increased the fiscal deficit beyond estimated budget for 2009-10, only 9% Indian workforce engaged in Community, Social, and Personal services expected to be benefited through it.

Thus the excess flow of subsidized bank credits to GoI for financing deficit budget is ultimately restraining the economic growth.

Fearing for even higher fiscal deficit?

To reduce the fiscal deficit, it is simple to either cut the expenses or increase the revenues. But under present conditions, it is not possible either to increase the revenue receipts or to cut the expenditures because any increase in taxation will be disastrous at a time when recession has hit the business community and are already demanding for more stimuli to recover. When there is mounting pressure to increase the stimuli, the expenditure is suppose to increase further. Moreover the political promises (to provide subsidized foods and increase flagship programme expenses) by the new Parliamentarians before the election would also increase the plan expenditures. It all increases the possibility of any further increase in the current fiscal deficit.

What the Government should do now?

Considering the constraints to increase the revenue receipts and cut the plan expenditures to control fiscal deficit, the GoI needs to innovate new products for public finance. As almost 60% of total expenditures are made for debt servicing, GoI needs to substitute the debt receipts with equity funds. Since SEBI failed to protect the stock markets and NBFCs dealing in MFs and VCs are not in a position to mobilize huge long term investment funds, GoI needs to innovate Sovereign equities to mobilize adequate amount of non debt receipts for consolidation of public finance.

Considering the available options of capital sources in international market, there are chances to get Islamic funds instead of mere equity funds from the Muslim countries. The equity funds are somehow different from Islamic Funds in the manner that when equity funds are mixed with debt funds, it doesn't remain Islamic Funds.

Islamic Bond (Sukuk) for public finance in India:

Islamic economist Dr. Shariq Nisar in his paper '*Islamic Bonds (Sukuk): Its Introduction and Application*' writes that the recent innovations in Islamic finance have changed the dynamics of the Islamic finance industry. Specially in the area of bonds and securities the use of Sukuk or Islamic securities have become increasingly popular in the last few years, both as a means of raising government finance through sovereign issues, and as a way of companies obtaining funding through the offer of corporate Sukuk. Beginning modestly in 2000 with total 3 Sukuk worth $336 millions the total number of Sukuk by the end of 2007 has reached to 244 with over US$ 75 billion funds under management. Dr. Shariq summarizes the growth of Sukuk in following table.

Year	Sukuk Size (USD million)	Number of Sukuk
1990	30.00	1
2000	336.30	3
2001	780.00	4
2002	985.83	9
2003	5717.06	36
2004	7209.53	67
2005	12033.76	89
2006	48114.82	225
2007	75538.70	244
2008	32242.16	156
Total	**182988.16**	**834**

Recent studies about Sukuk at http://online.wsj.com/ indicates that although by recently the Sukuk market has managed to come back modestly, but only for higher corporate issuers. IFIS data show that so far this year, more than $7.6 billion of Sukuk have been issued. Almost all this year's fund-raisers have been governments or government-related, the overwhelming majority from Southeast Asian countries such as Indonesia. The Middle Eastern market that drove the pre-2007 boom has also sprung into life this month with a $500 million issue for the government of Bahrain, which was boosted to $750 million because of strong demand. Thus there is no harm if GoI study the feasibility of innovating Islamic products to consolidate public finance in India.

Scope of Islamic Bond in India:

Since India houses second largest Muslim population of the world, it is expected that at least 20% Indian Muslims who are economically better off and desperately looking for real Islamic investments would grab it with enthusiasm. Unfortunately so far India has yet to launch any real Islamic bond or Mutual fund because somehow all the so called ethical mutual fund have been mixing equity funds with debts.

Moreover unofficial sources indicates that considering the higher growth rate of India, some larger Islamic banks and financial institutions like Islamic Development Bank, Dubai Islamic Bank and others desire to invest in Indian infrastructure but do not find suitable opportunities. So, we find the scope to study the prospects of Islamic Bond (Sukuk) from GoI to finance infrastructures.

Sector-wise Projected Investment for the Eleventh Plan

(Rs crore at 2006–07 prices)

Sectors	Projected investment for 11th five year Plan	
	Rs. crore	Shares (%)
1. Electricity (incl. NCE)	666,525	32.42
2. Roads and Bridges	314,152	15.28
3. Telecommunication	258,439	12.57
4. Railways (incl. MRTS)	261,808	12.73
5. Irrigation (incl. Watershed)	253,301	12.32
6. Water Supply and Sanitation	143,730	6.99
7. Ports	87,995	4.28
8. Airports	30,968	1.51
9. Storage	22,378	1.09
10. Gas	16,855	0.82
Total (Rs crore)	**2,056,150**	**100**

Data Source: http://planningcommission.nic.in/

Fiscal deficits can be reduced by the Sukuk funds:

Since returns to Sukuk holders comes from the actual returns from the project there is no chance of any interest burden on the economy. In case there is any loss in the specified project that will also be duly shared by the Sukuk holders. Thus Sukuk finance negates any possibility of interest burden on the economy and removes the chances of fiscal deficit due to interest payments on borrowed debts to finance infrastructural needs of the economy.

We have higher revenue expenditures due to higher debt servicing ratio total expenditure. The problem is also that capital expenditure is much behind the target and growth rate can't be foster if we lack infrastructure. Thus while we need to stimulate the economy, it is better to introduce Sukuk by Indian Government as it would not only help building infrastructure, increase capital expenses and stimulate the economy, but also reduce the revenue deficits, debt servicing ratio and also revenue deficits.

Financing the deficit through more of subsidized bank loans is creating problems for the banks to reduce lending rates for private sector; as a result the private sector are getting lower amount of credits at higher costs. Besides the recent global recession, this hardening credit supply is adversely affecting the growth rate of agriculture and manufacturing industry by witnessing negative growth rates in during last 6 months. Thus deficit finance is not helping majority of Indian workforce as agriculture and manufacturing collectively provide livelihood to around 63% workers. So, to ensure foster and inclusive growth by way of providing sufficient and affordable credits to private sector, the increased flow of subsidized bank loans to GoI should be reduced otherwise private sector will continue to suffer and we may not be able to attain desirable growth rate even by increasing the fiscal deficits to stimulate the economy.

Since Sukuk is bounded with religious faith, the economic rationality is secondary aspect in decision making by the investors. The top priorities for Sukuk holders are to ensure that –

1. The returns are Halal (legal according to Islamic ethics) and investments will be used for building potential infrastructures for national development, thus the investments and returns may draw tax incentives as well which may stand as compensation against lower rate of returns.
2. The investments are meant for legal share (proportionate ownership) in the infrastructure.
3. There would not be any fraud or cheating by the fund managers and the investments would not be spent for promoting unethical and unlawful activities (as prohibited by Islamic ethics).
4. The investments will be in safe hands to carefully develop the assets and not manipulate it.
5. Even if the rate of returns are low as compared to market returns on other investments, the advantage of earning Halal income, tax incentives on investments upon national infrastructure would be some compensatory advantages to the Sukuk holders.

Since all sorts of returns on Sukuk are free from interest and does not exceed to the actual asset value, whatever is paid as returns to Sukuk holders is to pay from the actual earnings from the asset created by that particular investment. There is no need to borrow any debt to pay Sukuk returns or repay the whole Shukuk funds because all the Shukuk holders collectively own the asset. They will thus proportionately gain or loose according to appreciation or decline in the value of that particular asset.

Indian Institute of Islamic Infrastructure Funds (IIIIF):

It is desirable that the GOI set up an autonomous financial corporation as 'Indian Institute of Islamic Infrastructure Funds' (IIIIF) to grab the national and international market of Shariah Funds and mobilize adequate funds for the infrastructural investments in India. If IIIIF succeeds soliciting cooperation with leading Islamic investment and development banks around the world, hopefully we may not need debt based receipts for deficit finance especially to meet the infrastructural requirements in India. The services of such banks may be solicited through GOI securities with assured lease rent after completion of particular infrastructure projects. Once India manages to mobilize project based Islamic Infrastructure funds, with such funds specific borrowed debts may be repaid to reduce the debt burdens.

Based on the projection by the Planning Commission of India, the estimated requirements of infrastructure investment is Rs. 20,56,150 crores. Considering the commercial aspects of different sectors, it is expected that IIIIF may help us arrange 93% of the total requirements amounting Rs. 19,12,420 crores for 11th five year plan's infrastructural needs. Only the investment need of water supply and sanitation amounting Rs. 1,43,730 may not be sellable otherwise infrastructure projects of all other sectors seems sellable through equity based Government securities by IIIIF upon which any specific amount as % of investment could be assured as returns in terms of lease rents after completion of the projects. IIIIF along with RBI and Ministry of Finance may design such equity based Government Securities (Sukuk). Further such securities may be traded in open market as RBI has recently framed policy for stripping and reconstitution of Government securities to enhance the trading scope of securities. However for Sukuk, there could be assured lease rent or dividend as rate of returns instead of interest.

Conclusion:

Islamic Finance in terms of Sukuk may help India raise required infrastructure investment funds for the Government and the corporate sector. It may solve the most threatening challenge of our economy by providing equity funds for infrastructure against Government Securities enabling GOI reduce its fiscal deficit after repaying borrowed debts for capital expenditures through equity funds; and also by arranging equities for the corporate sector. Wish the proposed IIIIF may reduce the fiscal deficit allowing India attain foster and inclusive growth as it carries following promising features –

1. Reduce the fiscal deficit of India even if our revenue receipts declines and we need to increase the plan capital expenditures to stimulate the economy.
2. Help India save amount up to 6% of our GDP we pay as interest over debt receipts.
3. Enable GoI to repay debt receipts borrowed for financing the infrastructure investments.
4. Provide desirable equity fund for the corporate sector at a time when external financial resources are dried up and the cost of domestic bank credits are not affordable.
5. Once GoI succeeds arranging sufficient infrastructure funds through Sukuk and repays debts borrowed for capital expenditures, it would reduce the load of public finance on domestic banks thus enable them to reduce the cost on credits specified under PSA or for private sector enterprises.

There could be many more significances of IIIIF if we resolve it without any prejudice for the sake of national interest.