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WAYS OF FINANCING GOVERNMENT PROJECTS THROUGH ISLAMIC INSTRUMENTS

U. A. Yuldasheva
Doctor of Economics, Professor of the Department
of International Finance at TSUE

Mukhtorova Nafisa Ilxomovna
TSUE Master's Student

Abstract
Islamic finance has emerged as a prominent method for financing government projects, primarily due to its ethical foundations and the increasing global acceptance of its principles. This paper examines the various ways in which governments can utilize Islamic financial instruments to fund development and infrastructure initiatives. It specifically addresses the use of Sukuk (Islamic bonds), Mudarabah, Musharakah, Istisna, and Ijarah. Through the presentation of statistical data and relevant visual aids, this study analyzes how these instruments are applied in the financing of government projects, tracks the global expansion of Islamic finance, and explores their alignment with ethical and sustainable development objectives. The paper concludes by discussing the potential opportunities and challenges associated with the use of Islamic finance as a critical tool for government funding.

Keywords: Islamic finance, Islamic bonds, Musharakah, Istisna, Ijarah, IDB, World Bank.

Introduction

The President of the Republic of Uzbekistan has approved the "Uzbekistan — 2030" strategy. Among its objectives are creating opportunities for all citizens to realize their potential, fostering a healthy and educated generation, shaping a strong economy, and ensuring justice, the rule of law, and security.

The "Uzbekistan — 2030" strategy outlined in the decree includes the following key ideas: [1]

- Joining the group of upper-middle-income countries through sustainable economic growth;
- Creating an education, healthcare, and social protection system that fully meets the needs of the people and international standards;
- Establishing favorable ecological conditions for the population;
- Building a just and modern state that serves the people;
- Guaranteeing the country's sovereignty and security.

The strategy covers five priority areas:

- Creating favorable conditions for each individual to realize their potential;
- Ensuring the well-being of the population through sustainable economic growth;
- Saving water resources and protecting the environment;
- Ensuring the rule of law and establishing a state administration that serves the people;
- Consistently pursuing a policy based on the principle of a "safe and peace-loving state."

The implementation of the strategy and the achievement of its targeted indicators have been declared a priority task for all state bodies and organizations in the country. In the direction of ensuring the well-being of the population through sustainable economic growth, the tasks include accelerating reforms in the banking system, increasing the volume of the banking services market, and developing competition in the sector. Furthermore, the task of introducing Islamic finance standards and regulations in at least three commercial banks, as well as establishing the legal foundations of Islamic finance, has also been set. In conclusion, it can be stated that the fulfillment of these tasks will further develop Islamic finance and, in turn, increase opportunities for financing projects through Islamic financial instruments.

Governments around the world encounter significant challenges when it comes to funding infrastructure, social, and environmental projects. Conventional financing methods, such as bonds and loans, often carry high costs and risks. In contrast, Islamic finance, grounded in principles of equity, risk-sharing, and ethical investment, presents an alternative approach to raising capital for public initiatives. Islamic financial tools, including Sukuk (Islamic bonds), Mudarabah, Musharakah, Ijarah, and Istisna, offer governments the opportunity to finance development projects while adhering to Shariah law, which prohibits interest-based financial transactions.

This paper examines the application of these instruments in financing government projects and explores the global expansion of Islamic finance, supported by relevant statistical data and graphs. It provides a comprehensive overview of the primary Islamic financial instruments, analyzes their role in public sector financing, and highlights the potential opportunities and challenges associated with their use.

Literature Review

Ayomi Rarasati and Mambang Trigunarsyah (2019) Research on Islamic project financing in infrastructure conducted predominantly in Islamic countries and developed countries showed its many benefits. As a developing country with a majority of Muslim population, it is reasonable to expect that Islamic project financing may also be a suitable option for financing alternatives in Indonesian infrastructure development. According to their opinion Islamic financing has only been implemented in infrastructure projects in Indonesia in the last decade with the use of instruments such as murabaha, musharaka and istisna integrated into financing such infrastructure projects. However, murabaha is the most common form of transaction used to develop infrastructure assets. In the context of Indonesian infrastructure projects, Islamic banks play the most important role in financing infrastructure projects through the use of the sharia scheme. There are some possible issues that might hamper the implementation of Islamic project financing in infrastructure projects, namely a lack of understanding of concept and a resistance to its use. [2]

Sepideh Khavarinezhad1, Paolo Biancone (2021) According to their study Islamic financing has emerged in the world financial literature intending to provide a new model for replacing traditional and conventional financial systems and providing financial, commercial and investment facilities and opportunities following the principles of Sharia . This system has been able to identify its various dimensions. Due to the particular benefits and advantages of Islamic financing, the issue of Islamic financing has now become critical in the international arena. In this regard, various financial institutions and tools have been invented and used. Nowadays, the benefits of Islamic financing have led to its expansion and growing importance; a wide range of Islamic financial institutions are operating not only in Islamic countries but also in some western

countries. In addition, the number and scope of activities of financial institutions and banks providing Islamic financial services are increasing. [3]
Islamic finance encompasses financial activities and instruments that adhere to Shariah law, which forbids interest (riba), uncertainty (gharar), and unethical investments. Increasingly, governments worldwide are turning to Islamic finance as an alternative method for funding infrastructure and development initiatives (Mirakhor & Iqbal, 2011). Among the various Islamic financial tools, Sukuk has become especially significant in supporting government projects (Hassan & Ashgar, 2019).[4]
The adoption of Sukuk as a financing method has seen substantial growth in recent decades. According to the Islamic Financial Services Board (IFSB), the Sukuk market expanded from USD 20 billion in 2000 to nearly USD 250 billion in 2023 (IFSB, 2023). Countries like Malaysia and the UAE have successfully issued Sukuk to fund infrastructure projects, highlighting the instrument's effectiveness and viability (Ahmed, 2018). [5] Additionally, Mudarabah and Musharakah are frequently employed in joint venture financing, while Istisna and Ijarah are particularly suited for funding construction and leasing activities (Khan, 2016). [6] Despite these benefits, challenges remain related to regulatory frameworks, investor participation, and market liquidity (Ariff & Finn, 2017).[7]
Several studies have explored the integration of Islamic finance in government projects, with most emphasizing that Islamic financial instruments align closely with sustainable development objectives by focusing on risk-sharing and ethical investment (Bitar & Valenzuela, 2020). [8] However, they also point out the need for deeper market development, clearer regulatory frameworks, and enhanced investor education to fully unlock their potential.

Research Methodology

This study uses a qualitative approach to examine the use of Islamic financial instruments for government projects. It uses primary and secondary data from international financial institutions and scholarly articles. The study evaluates the effectiveness of Islamic financial instruments in public sector financing, focusing on successful case studies of governments using Sukuk and Mudarabah for infrastructure projects. Statistical tools are used to analyze global Sukuk market, government issuances, and financial trends, highlighting growth patterns in Islamic finance for government financing over the past decade.

Analysis and Discussion of Results

Islamic finance is based on principles that align with Islamic law, or **Shariah**, which prohibits activities such as interest (riba), excessive uncertainty (gharar), and investment in unethical or haram (forbidden) industries. The primary goal of Islamic finance is to promote justice, equity, and fairness in financial transactions, while ensuring that both risk and reward are shared in a manner consistent with Islamic ethical standards. As a result, Islamic financial instruments are designed to facilitate investment and financing without violating these principles.
These instruments are used for various purposes, including project financing, infrastructure development, and social investments, offering Shariah-compliant alternatives to conventional financial products. The following section outlines the key Islamic financial instruments and their types: Sukuk (Islamic Bonds), Mudarabah (Profit-Sharing Contract), Musharakah (Joint Venture

Partnership), Ijarah (Leasing Agreement), Istisna (Contract for Manufacturing and Construction), Wakala (Agency Agreement).[9]

Sukuk are among the most prominent Islamic financial instruments, commonly referred to as "Islamic bonds." Unlike conventional bonds, which are debt-based and involve the payment of interest, Sukuk represent ownership in an underlying asset or a project. The profits earned by Sukuk holders stem from the revenue generated by the asset or project, not from interest payments.Sukuk are asset-backed securities that allow investors to share in the risks and rewards associated with a particular asset or project. Unlike conventional bonds, Sukuk represent partial ownership in an asset or business and provide returns based on the asset's performance, rather than fixed interest payments.[10]

Governments around the world have increasingly used Sukuk to fund major infrastructure and development projects. In 2023, the global Sukuk market reached USD 250 billion, a notable increase from USD 160 billion in 2018. Key examples of government Sukuk issuance include Malaysia's USD 5 billion Sukuk to finance the East Coast Rail Link project and Saudi Arabia's USD 6 billion Sukuk for its Vision 2030 program. These figures highlight the growing importance of Sukuk as a viable financing tool for governments.[11]

According to the case in previous years, the sovereign Sukuk issuances are the main contributor of the global Sukuk market progression and in 2023 issuances grew by 21.9% or USD 136.3 billion as compare to 2022 issuances of USD 111.80 billion. The sovereign, quasi sovereign issuers led by Saudi Arabia, Indonesia, Malaysia, UAE, Türkiye, Bahrain, Qatar, Nigeria etc., continue to provide a strong foundation to the Sukuk market. During 2023 two new jurisdictions namely Egypt and Philippines entered the Sukuk market by issuing sovereign Sukuk issuances of USD 1.50 billion and USD 1.00 billion respectively. As of end 2023, total sovereign Sukuk issuance since inception stands at USD 1,128 billion, which is around 56.40% of all global Sukuk issuances. Image 1 below shows the trend of sovereign Sukuk issuances since inception.[12]

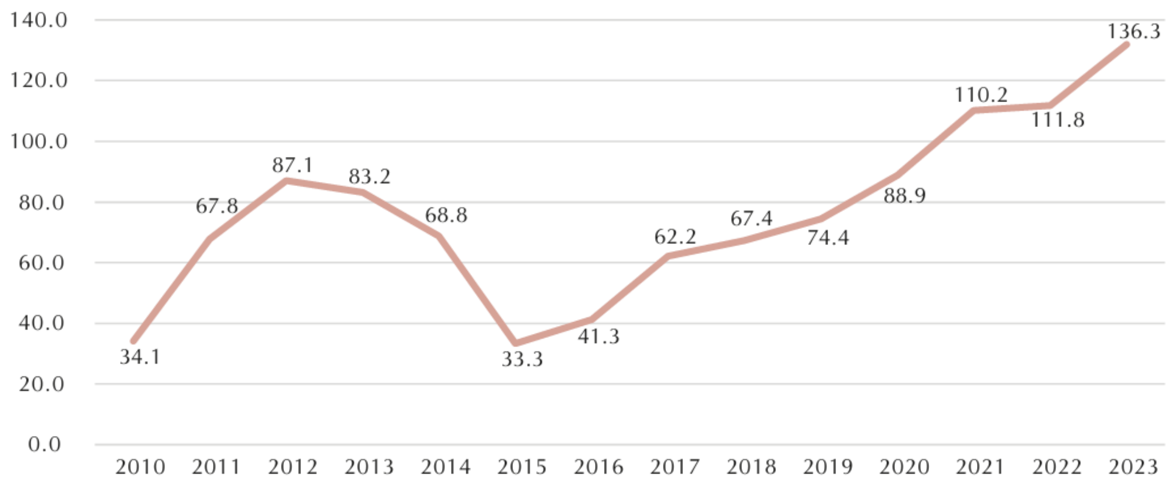

Image 1 Global Sovereign Sukuk Issuances (JAN 2001 - DEC 2023) All Tenor, All Currencies, in USD Billion

Total Sovereign Sukuk Issuance USD 1,128 Billion (JAN 2001 - DEC 2023)

Source: IIFM Sukuk database

Mudarabah and Musharakah are profit-sharing contracts that enable governments to partner with private investors in financing projects. These structures are suitable for joint ventures, where both the government and private parties contribute capital and share the profits and losses.

Mudarabah: In Mudarabah, one party provides capital while the other manages the project. The profits are shared based on a predetermined ratio, and losses are borne by the capital provider.

Musharakah: In Musharakah, both parties contribute capital and share the profits and losses equally or according to a pre-agreed ratio.

These instruments are particularly useful in large-scale infrastructure projects where the government seeks to partner with private investors for risk-sharing. For example, Saudi Arabia has used Mudarabah and Musharakah structures for financing major infrastructure and real estate projects under its Vision 2030 plan.

If we focus on the Islamic instruments referred to as Ijarah and Istisna. Ijarah is a leasing agreement where the government rents out an asset to a private entity or investor, generating rental income. The government retains ownership of the asset, but the lessee has the right to use it for a specified period.

This structure is often used in financing public infrastructure such as roads, airports, and schools. Governments can lease these assets to private companies or institutional investors, generating income while maintaining ownership.

The use of Ijarah in financing public sector projects has been widespread in the UAE, where several major infrastructure projects have been financed through leasing arrangements. For example, the UAE has financed parts of its airport expansion and public transportation systems through Ijarah.

Istisna is a contract used to finance the construction of tangible assets, including infrastructure projects like roads, bridges, or buildings. In this arrangement, the government contracts the construction of a project and agrees to make payments to the contractor in stages as the construction progresses, with the final payment being made upon completion of the project.

This financial tool is especially beneficial for long-term construction endeavors, such as the development of new urban areas or large public infrastructure projects. For instance, nations like Malaysia and Saudi Arabia have employed Istisna to fund the construction of smart cities and extensive infrastructure developments.

The global Islamic finance industry has seen rapid growth, particularly in the areas of Islamic banking and Islamic capital markets, including Sukuk issuance. According to the Islamic Financial Services Board (IFSB), the global Islamic finance market is expected to reach USD 5 trillion by 2025, up from USD 2.9 trillion in 2020.

According to Islamic Financial Services Board (IFSB) 2023 report, Global Islamic Finance Market Growth is driven by the increasing demand for ethical and sustainable investment options, as well as the growing acceptance of Islamic finance principles in both Muslim and non-Muslim countries. The rise of Sukuk as a tool for financing government projects is one of the most significant developments in the Islamic finance sector. According to the World Bank, Sukuk issuance has become a mainstream financing tool for infrastructure projects, accounting for 60% of global Sukuk issuances in recent years.

Governments in countries like Saudi Arabia, Malaysia, and the UAE have been leading the way in using Sukuk to finance public sector projects. In 2022, the Dubai government raised USD 1.5 billion through a Sukuk issuance for the expansion of the Dubai Metro. Similarly, Malaysia issued USD 4.5 billion in Sukuk for the construction of its Mass Rapid Transit (MRT) system.[13]

In addition to Sukuk, Islamic finance has also seen growth in Mudarabah, Musharakah, and Ijarah-based financing for government projects. The Islamic Development Bank (IDB) has played a key role in facilitating such financing, particularly in Africa and Asia. In 2023, the IDB approved over USD 2 billion in financing for public projects across member countries.[14]

While Islamic finance offers considerable potential for government funding, it also faces several challenges:

Legal and Regulatory Framework: In many countries, there is an absence of a comprehensive legal and regulatory system to support Islamic finance, especially regarding Sukuk issuance and other Islamic financial products. Governments need to establish clear regulations for Sukuk issuance, Shariah compliance, and investor protection to enable the growth of this sector.

Awareness and Education: There is a continued need to raise awareness and improve understanding of Islamic finance among policymakers, financial institutions, and investors. Governments must invest in education and training to enhance participation in Islamic finance markets.

Liquidity and Market Depth: Liquidity in Islamic financial instruments remains a concern in some markets. Both governments and financial institutions must collaborate to establish secondary markets and create more tradable instruments.

Despite these obstacles, Islamic finance presents significant opportunities to support government projects. The ethical principles of Islamic finance align with global sustainable development goals, making it an appealing option for governments aiming to finance socially responsible initiatives.

Conclusion

Islamic financial instruments, including Sukuk, Mudarabah, Musharakah, Ijarah, and Istisna, provide governments with a viable, ethical, and Shariah-compliant alternative to conventional financing methods for public projects. The expanding global Islamic finance sector, particularly in Sukuk issuance, reflects the growing acceptance and use of these instruments. Countries such as Malaysia, Saudi Arabia, and the UAE have effectively utilized Islamic finance to support infrastructure and development projects, and this trend is anticipated to continue in the future.

Although challenges such as legal frameworks, liquidity, and awareness still exist, the potential for Islamic finance to enhance sustainable government funding is substantial. As the global Islamic finance market continues to expand, governments must explore innovative approaches to utilizing these instruments, fostering a more diversified and sustainable method of financing public sector initiatives.

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