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The Role of Islamic Finance in Enhancing Fiscal Space and Debt Sustainability: Evidence from D8 Countries with a Moderating Role of Institutional Quality

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Abstract

This study investigates the role of Islamic finance in enhancing fiscal space and debt sustainability in D-8 countries, with a special focus on the moderating effect of institutional quality. Using the Driscoll-Kray estimator, the research analyzes key Islamic finance instruments—Sukuk, Takaful, and Islamic banking assets—along with their interactions with institutional quality. The findings reveal that Sukuk alone has a weak and statistically insignificant impact on both fiscal space and debt sustainability. However, when combined with higher institutional quality, Sukuk's positive effect on fiscal space becomes significant, highlighting the importance of strong governance. Takaful shows a marginally positive influence on fiscal space, but no significant effect on debt sustainability. Nevertheless, its effectiveness improves when institutional quality is high, demonstrating that stronger institutions can enhance Takaful's role in fiscal development. In contrast, Islamic banking assets negatively and significantly affect both fiscal space and debt sustainability. This negative impact is intensified by higher institutional quality, suggesting that unchecked growth of Islamic banking assets could undermine fiscal stability, especially in well-governed environments. The study also finds that economic openness significantly reduces both fiscal space and debt sustainability, while institutional quality plays a vital role in strengthening debt sustainability. Overall, the results underscore the critical moderating role of institutional quality in amplifying or mitigating the effects of Islamic finance. The study concludes that D-8 countries should focus on enhancing institutional quality to fully leverage the potential of Islamic finance, particularly Sukuk, for sustainable fiscal growth and improved debt management.

Keywords: Islamic finance, fiscal space, debt sustainability, institutional quality, Sukuk, D-8 countries

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Introduction

Over the last few years, the concept of fiscal space and debt sustainability has assumed more significance due to the debt crises that the developing, and especially the emerging economies are in the process of seeking sustainable economic growth and balance. Fiscal space, defined as the aspect of fiscal balance about a nation's ability to provide resources for public purposes without threatening fiscal stability (Salamaliki & Venetis,2024), is a critical determinant of the economic destiny of nations. Due to these current issues of international economic instability, increased public debt and fiscal deficit it has become immensely vital to look into other financial models. In this regard, Islamic finance that adheres to the principles of Shariah provides a distinctive model for financial operations that avoids charging nominal interest rates and focuses on risk-sharing as well as asset-based financing, and ethical investment (Anwer et al., 2020). These principles set Islamic finance apart from other conventional financial systems, thus giving it a persuasive option to expand fiscal space and adjust for debt sustainability.

Sukuk (Islamic bonds), Takaful (Islamic insurance,), and Islamic banking asset provides governments with more useful instruments to tackle fiscal issues (Hasangholipoure et al., 2021; Pirgaip et al., 2021). For example, Sukuk enables governments to avoid conventional bonds and get funding through asset-based securities (Alhammadi et al., 2024). According to Nugraheni & Muhammad, (2020), as a cooperative insurance system, Takaful provides the governments with opportunities to decrease the social security expenses and manage the risks successfully. In addition, the rate of growth of the Islamic bank asset enhances the depth of the financial sectors, financial stability, and fiscal capacity (Saleem et al., 2021). These instruments are especially useful for the countries in the D-8 Organization for Economic Cooperation (D-8) Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan, and Turkey where both the large Muslim populations and Islamic financial systems share economies with conventional finance. The following fiscal challenges are viral in the D-8 countries; high debt, fiscal deficits, and low fiscal space. These problems, combined with the unstable global economic situation, have led governments to consider the opportunity of the development of Islamic finance to strengthen fiscal capacity. While there has been increased interest in the use of Islamic finance in enhancing financial access and stability with little empirical evidence (Eidouzahi et al.,2023; Razak & Khan, 2023), there is virtually no direct assessment of the effect of this financing system on fiscal space or debt sustainability. In addition, literature has paid limited attention to the relationship between Islamic finance and macroeconomic factors such as GDP growth rate, exchange rate, inflation rate and economic openness since they are key drivers of fiscal effects.

Just as important, institutional quality that captures the integrity of corporate and political governance, legal structures, and rules as well as regulatory frameworks substantially influences the performance of Islamic finance in improving fiscal rewards (Ijaz & Chughtai, 2022). They create proper conditions for the development of Islamic finance states that strong institutions prevent such threats as corruption, lack of compliance with regulatory requirements, and the presence of the required documentation. On the other hand, weak institutional quality may be detrimental to the effectiveness of Islamic financial products in solving fiscal difficulties. As a result, there is scant literature on the interlinkage between institutional quality and Islamic finance in the context of fiscal space and sustainable levels of debt.

To meet these research gaps, this study aims to examine and analyse the impact of the instruments of Islamic Finance on the fiscal space and the sustainable debt situation in the member countries of the D-8. In particular, it will explore how; assets in Sukuk, takaful, and Islamic banking affect fiscal performance and analyze institutional quality in mediating this connection. The study will also try to identify how other general macroeconomic variables such as; market size, inflation rates and exchange rate stability affect the functions of IFS in increasing fiscal space. In that regard, this paper seeks to present an outlook on these relations using evidential information to demonstrate how Islamic finance could be integrated into the fiscal policy in D-8 countries to foster economic growth. The purpose of this research is twofold: the first research question is understanding what role is played by Islamic finance toward enhancing the fiscal space and the second research question is understanding how efficient is Islamic finance in dealing with the fiscal debt challenge in the D-8 countries. Specifically, the study will address the following objectives:

1. In other words, it becomes essential to estimate corners of D-8 countries for which Islamic finance instruments including Sukuk, Takaful and certified Islamic banking assets appear to be competitive while measuring the impact of the above Islamic finance instruments on fiscal space. These instruments give alternatives to the traditional sources of funds and may reduce the budgetary stringencies of governments (Thani, & Ibrahim, 2020).
2. To perform a comparative analysis of the impact that Islamic finance tools have on the optimal debt-to-GDP ratio, the burden of debt service, and the mobilization of government resources. For instance, it is realized that through Sukuk, the reliance on conventional sources of funding may be lowered thereby reducing debt services (Smaoui et al., 2020).

3. To test the Islamic finance hypothesis in the context of fiscal performances, especially government revenues; expenditures as well as fiscal deficits. The growth of international banking assets is anticipated to enhance the dimension of the financial market and strengthen the fiscal structure (Asutay & Ubaidillah, 2024).
4. To assess the impact that macroeconomic factors such as; Gross Domestic Product (GDP) growth rate, Inflation, Exchange rate stability and economic openness have on the link between Islamic financial systems and fiscal results. Fiscal space is a fathomable determinant of the effectiveness of Islamic financial instruments in macroeconomic stability (Zuhdi et al., 2024).
5. To examine the moderating role of institution quality on the vigour and utilization of Islamic finance. A higher institutional quality is expected to enhance the quality of the regulatory environment in the country and thus enhance the use of Islamic financial tools to address fiscal imbalances (Danlami et al., 2022).
6. To contribute policy advice to top government officials and lawmakers, the study aims to compile reliable policy suggestions regarding how to harness the potential of Islamic finance to enhance fiscally related policies in D-8 member states. The study results will provide an understanding of how the Islamic financial instruments can be implemented into the broad fiscal strategies for sustainable economic stability and development.

It is important to state that the present research provides the following contributions to the existing literature. First, it seeks to offer a practical analysis of the effects of IFIs on fiscal freedom and debt sustainability, undertaking the study within the D-8 countries, a sample that is yet to be widely researched. Second, it complements institutional quality as a moderating variable since the existing literature lacks sufficient information on how governance influences the application of Islamic finance. Third, thus, the study seeks to contribute to the existing body of knowledge by assessing the impacts of the macroeconomic factors including GDP growth, inflation and stability on exchange rate besides providing a richer perspective on the nexus between Islamic finance and fiscal performance.

The organization of the paper is as follows: To inform Section 2, the existing literature on Islamic finance, fiscal space, and debt sustainability is surveyed using primary and secondary sources. Section 3 presents an overview of the research method in this study; sources of data, econometric models, and variables in the analysis. In section four, the results of the analysis are shown in an attempt to address the main research questions regarding the nexus between Islamic finance instruments, fiscal space, and debt sustainability, concerning the moderating

impacts of institutional quality and macroeconomic factors. Section five presents policy recommendations and thus presents direct and tangible advice to the D-8 countries on how to best utilize Islamic finance for sustainable fiscal development. In section 6, the results of the study are presented and the directions for future research are discussed. This paper aims at these dynamics to offer insights for utilizing Islamic finance in improving fiscal space and debt sustainability, as well as to push the general objectives of fiscal stability and growth in the D-8 countries.

Review of Literature

Islamic Finance and Fiscal Space in D-8 Countries

Islamic finance has grown into an influential strategy for expanding fiscal space in developing economies (Presbitero, 2022). Conventional finance and this new Islamic finance system are very different in terms of the risk-sharing characteristic, policy of forbidden interest (riba), and the permissible structures of investment. These characteristics have made Islamic finance attractive not only for countries in the process of carrying out sustainable economic development but primarily for countries that are members of the Developing-8 (D-8) Group, which is Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan, and Turkey.

Shariah-compliant products are key to the enhancement of fiscal space concerning. Financial deepening and capital market development. As Tok et al. (2022) pointed out, Islamic finance ensures that development is progressive to address the exclusions of communities resulting from either faith or credit constraints. By providing products like Mudarabah, ijarah and others, Islamic finance extends facilities to the SMEs/ Micro enterprises which in turn boosts the economy by opening the tap for lending capital from the government and boosting its revenue through the taxes which the various benefiting enterprises pay (Sudiro & Ahmar, 2022). Also, Islamic finance provides incentives for the accumulation, flow and utilization of resources in the country for economic and social development such as infrastructure development, social welfare and other public utilities (Shuaib & Sohail,2022). Therefore, the governments of the D-8 countries have in recent years used Islamic instruments including sukuk to mobilize resources for development. Sukuk has been especially useful in increasing fiscal space owing to the ability of governments to mobilize resources from outside conventional sources of financing while respecting Shariah laws (Baita et al., 2023).

First, Islamic finance fosters, economic growth second, fiscal stability and third, it enables debt sustainability. Equity financing and risk sharing are other important concepts found in Islamic finance. This reduces the risks of financial risks and liquefied debt which are associated with the debt-financed models of financing. In

their research study conducted among D-8 countries, Sohail and Arshed (2022) demonstrate that countries within the group that have integrated Islamic financial instruments into their economic activities have less vulnerability to debt distress and sound fiscal reforms in comparison to those countries that have exploited conventional money decks. Sukuk for instance as the Islamic counterparts of bonds are based on asset selling and originated from the sharing of profit and risks between the investors and the issuers. This structure minimizes the likelihood of undertaking high levels of borrowing and relieves government balances for debt funding. Several D-8 countries, for example, Malaysia and Indonesia have the fiscal space through sovereign sukuk to finance infrastructure projects and fiscal deficits without accessing interest-bearing debts.

Nevertheless, some challenges hinder the implementation of Islamic finance in D-8 countries The following are the main challenges. The legal environments of the D-8 member countries are not completely capable of prescribing guidelines for the development of Islamic financial institutions, and there seems to be no uniformity in the systems of Islamic financial instruments (Razak & Khan, 2022). Secondly, unlike in more developed regions, there is relatively poor knowledge and appreciation of Islamic finance by the relevant authorities and focal investors. But work on blending these regulations and raising consciousness is on the rise, especially when global entities such as the Islamic Development Bank (IDB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) are in place. In the future, there is much scope for Islamic finance to boost fiscal space in D-8 countries. An understandable substitute for conventional finance, Islamic finance enhances access to funds, minimizes risks, and anticipates debts reasonably. If well supported by appropriate laws and regulations and when the people of the D-8 member countries embrace Islamic finance, it holds a lot of potential in shaping the future fiscal sustainability and economic growth of the region.

Islamic finance is on the rise as an economic player in the global financial arena, presenting solutions to many of the fiscal issues affecting the countries of the D-8. They include risk-sharing, ethical investment and asset-backing, useful tenets that can be built upon to foster the improvement of fiscal space and consequent development. The mission, however, has not completely been achieved due to several challenges as stated earlier, but the increased integration of Islamic financial instruments within the public finance of the D-8 countries shows promising signs of the future of the sector.

H_1: Islamic finance significantly enhances fiscal space in D-8 countries.

$H_{1.1}$: Sukuk issuance has a positive impact on fiscal space by reducing the reliance on conventional borrowing.
$H_{1.2}$: Takaful contributes to fiscal stability by lowering government expenditure on social security and risk mitigation.
$H_{1.3}$: The growth of Islamic banking assets increases the fiscal capacity of governments through enhanced financial sector depth and stability.

Islamic Finance and Debt Sustainability in D-8 Countries

Over the past few years, Islamic finance has emerged as a preferred model of financing, especially for the countries in the Developing-8 (D-8) countries including Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan and Turkey. Perhaps the most notable message of Shariah-compliant financing is its effort to transform the issues of debt vulnerability in developing nations by applying Islamic ethical criteria for investment and financial risks and shunning interest-based earnings. These features have enabled many of the D-8 countries to look for other instruments, such as the sukuk (Islamic bonds) to overcome the difficulties linked to excessive borrowing, and fiscal volatility. While the conventional finance system favours the extension of credit facilities under high-risk and usury debts, Islamic finance deals with risks and shares them to mitigate the problem of debt (Benaicha, 2020). Introduced through equity-based financing, Islamic finance helps to avoid the problems of debt burdening, preserving sound fiscal finances in countries where imbalances remain a chronic problem (Ishak & Rahman, 2021). Beck et al., (2020) stated that Islamic finance is based on asset-backed and risk-sharing, so it offers less probability of government borrowing which contributes to a better fiscal situation. This is particularly relevant to the D-8 framework because several of the member countries face high levels of public debt.

What the authors failed to ably capture in this aspect is that loan availability in conventional financial systems is often followed by higher debt servicing costs, reducing available fiscal space and the government's ability to finance growth-promoting projects. However, the products of Islamic finance such as sukuk allow governments to obtain financing with no links to the interest of conventional bonds. Since these instruments are secured with real assets and entail an investor-issuer relationship, they are a better prospect for sustainable debt management than conventional debt securities (Harahap et al., 2023). Malaysia and Indonesia among the D-8 countries have particularly applied sukuk in the financing of infrastructure development which has partially freed them from the conventional interest-bearing

loans and enhanced their balance of debt sustainability (Diniyya et al., 2020). Several authors have discussed the role of Islamic finance in bringing about improvements to debt sustainability across the D-8 member countries. For example, Naim et al., (2020) noted that countries that use Islamic finance within the government finance have better non-debt reconciliation indicators and the lowest level of debt distress and reasonable debt/GDP ratio in comparison with the benchmark of the countries using the conventional system. The study also observes that since sukuk does not merely finance deficits, but finances the assets that underlie them, it provides a hedge against fiscal imbalances that other forms of debt lack.

For instance, in Malaysia usage of the Sukuk has also contributed positively to the enhancement of the sovereign debt management, by enabling the country to borrow funds for its fiscal requirements in a sustainable manner. Similarly, Indonesia has effectively used sukuk as one of its major weapons in its national debt management mainly following the outbreak of the Global financial crises. Mawardi et al., (2022) highlight that through sukuk issuance in Indonesia government was able to effectively lower public debt while at the same time bringing into the picture a long-term financing model for social infrastructure. This method has been useful in cushioning the risks inherent in debt unsustainability making fiscal and economic stability possible.

This is an important attribute of IFS that advances more reasonable external debts It is unthinkable of for Islamic finance to allow its charges speculation (gharar). This brings less fluctuation and risks in the holdings of sovereign debt instruments; thus making Islamic financial products such as Sukuk more stable in the era of crises (Ledhem, 2022). In contrast to conventional bonds, which depend on changes in interest rates and involve speculative influence, the sukuk is based on real economic activities, which will be equally beneficial for the government of the country and investors – the guaranteed steady and stable income is provided. Islamic finance, through the risk-sharing and the profit-and-loss-sharing models, also ensures that the debt burden does not only remain with the borrower. Thus, unlike equity, or an equity-based security, both the issuer and the investor assume the financial consequences of the investment, which makes it intrinsically more stable (Foglie & Keshminder, 2022). It enhances prudent borrowing by governments in the D-8 countries because the emphasis is placed on the economies that can fund the productive investment that drives the economy's growth rather than borrowing with the aim of funding consumption. Thus, although the prospects of Islamic finance in debt sustainability in D-8 countries are apparent, several issues are observed. One barrier to the proliferation

of Islamic financial tools is the absence of the synchronization of legislatures underneath the D-8 nations. Legal frameworks legal standards and governance structures in Islamic finance as pointed out by Zaheer, and Wijnbergen (2024) disrupt the potential for Islamic finance to enhance the level of sustainable debt. Besides, policymakers and investors require further understanding of the benefits associated with Islamic finance.

However, initiatives are still in progress to overcome these problems in which IDB and AAOIFI are more efficient for standardization and capacity building in D-8 countries. However, with the standards applied to Islamic finance getting closer to those applied in conventional finance, and as the share of Islamic finance in overall banking markets is growing, the capability of Islamic finance to contribute to improved debt sustainability in the D-8 countries is going to grow. With a risk-sharing model that elicits mutual responsibility sound ethical investment and asset-based financial tools, Islamic finance is less vulnerable to creating unsustainable debts to finance the D-8 member countries' development programmes. Through the use of sukuk and other Islamic financial instruments, the D-8 nations have effectively managed to manage risks linked with suboptimal borrowing, thereby opening up more spaces within their fiscals and encouraging long-term sustainability. These concerns are yet to be adequately addressed; especially in the area of governance and consciousness of the distinctive features of the Islamic finance systems, the future of Islamic finance facilitating debt sustainability in the D-8 countries could be considered bright.

H_2: Islamic finance improves debt sustainability in D-8 countries.
$H_{2.1}$: The adoption of Sukuk reduces the debt-to-GDP ratio compared to traditional debt instruments.
$H_{2.2}$: Takaful helps reduce government liabilities, contributing to a more sustainable debt servicing profile.
$H_{2.3}$: Higher levels of Islamic banking assets lead to lower external debt servicing as a percentage of GDP and government revenue.

Macroeconomic Conditions and the Relationship between Islamic Finance and Fiscal Space in D-8 Countries

This paper finds that the role of Islamic finance and fiscal space in the D-8 countries including Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan, and Turkey is influenced by macroeconomic variables. These fundamentals, featuring inflation rates, exchange rates, fiscal deficits and economic growth significantly

define the utility offered by Islamic finance as a means of improving fiscal space. Islamic finance, which puts much accent on the social aspects of investment and logistics and the risk-sharing model, can be another way of managing fiscal affairs suitable for some of the macroeconomic contexts.

Another focal area in which Islamic finance supports fiscal space is by encouraging financial and credit intervention. Nevertheless, the significance of this kind of contribution strongly; depends on the macroeconomic environment. For instance, in conditions of high inflation and exchange rate volatility, relative to conventional instruments such as Sukuk (Islamic bonds). In such circumstances, the risk-sharing characteristics of Islamic finance may be countercyclical since they offer ways of cushioning the macroeconomic shocks on the government's balance of payments and budget size (Ledhem, 2022). Islamic finance can mobilize long-term funds, irrespective of macroeconomic fluctuations in the developing world hence is an effective instrument for managing fiscal disequilibria in the D-8 countries. Furthermore, the public finance mobilization function of Islamic finance for government spending is intrinsically tied to improving fiscal space. Governments within D-8 countries have over time resorted to a variety of Islamic financial instruments like sukuk to fund infrastructure development across the countries and to also help address issues of persisting fiscal deficits on their budgets. For instance, while Malaysia and Indonesia have been employing sukuk in several large capital public projects, this not only creates a new avenue for additional funding that forms part of their fiscal space (Fauzi & Qizam, 2024). Nonetheless, issuing sukuk is only sustainable for value creation if it is feasible within the context of macroeconomic stability, moderate inflation rate, and high GDP growth rate to attract the required number of sukuk investors, both foreign and domestic. On the other hand, conditions of fiscal instability like high fiscal deficits or fluctuating forex markets would reduce investors' confidence and hence restrain how IFIs improve fiscal space (Siddiqui & Razia, 2020).

Not only focusing on inflation and currency stability, another major factor is at play in Islamic finance, and fiscal space, and that is the overall growth rate of the D-8 economies. When there is an economic buoyancy; there is room to use Islamic financial tools as instruments of revenue mobilization for development projects without accumulating debts. It is the strength of an economy to foster not only the issuance of sukuk but also provide governments with other Islamic finance options such as Mudarabah and ijarah (Aderemi & Ishak, 2023). In this regard, Islamic finance is a valuable tool to reduce fiscal deficits and mobilize a bigger fiscal space, by

allowing rational, credible, and sustainable debt management solutions that circumscribe an Islamic economic way.

As the following sections of this paper indicate, factors such as inflation rates and external debts, compile the group of macroeconomic variables that determine the success of Islamic financial initiatives concerning the augmentation of the fiscal space in D-8 countries. Indonesia and Malaysia have been in a position to utilise the opportunities resulting from Islamic financial products to improve their fiscal structure; a reasonable and stable macroeconomic environment that encourages the stockpiling of long-term capital to support infrastructure and other public development projects (Menne et al., 2023). This is why, Egypt and Pakistan for example, with higher external debts and higher inflation rates, above mentioned, may not be able to attract the appropriate amount of investment, needed to unlock the potential of Islamic finance. In such environments, the level of expansion of fiscal space by Islamic finance can be expected to be lesser as governments' ability to balance short-run fiscal consolidation requirements with the long-run benefits from Islamic financial instruments is constrained (Naz & Gulzar, 2022).

However, it seems as if the integration of Islamic finance has the scope for offering large and further extent in enlarging fiscal space in the D-8 countries than in those places where macro-qualities have been restored. This paper shows that Islamic finance improves fiscal space potential given its ability to improve debt sustainability, fair growth, and ethical funding. There is however a qualification; the policy is response very much sensitive to other macroeconomic variables including inflation rates, growth rates, fiscal deficits and the like (Mensi et al., 2020). Eliminating these macroeconomic predations through the right fiscal policies and even more solid institutions will go a long way in making it possible for the D-8 nations to fully unlock Islamic finance as the window through which fiscal freedom and of course, enhanced fiscal adhesion to sustainable fiscal possibilities.

H_3: Macroeconomic conditions influence the relationship between Islamic finance and fiscal space in D-8 countries.

Institutional Quality and Effectiveness of Islamic Finance in Enhancing Fiscal Space and Debt Sustainability

The analysis also shows that Islamic finance can indeed improve the fiscal space and debt sustainability not just through macroeconomic factors but through the quality of the institutional setting and cultural and religious factors that play a critical role in

determining the usefulness of this financial tool (Ijaz & Chugtai, 2022). More so, it reveals that how good or otherwise the application of IF can foster fiscal stability and responsible debt management largely depends on one or two critical factors; namely institutional quality or quality governance; regulations, and enforcement; and, of course, compatibility of IF with the Islamic religion (Mawardi et al., 2024). The main principles of Islamic finance as ethical investment, risk-sharing, and ban of interest(rib) offer a framework for the organization of public finances in states with an Islamic population. In this paper, the impact of the quality of institutions in a country on the Islamic methods of expanding the fiscal space and ways to increase debt sustainability are discussed. Well-developed institutions help the implementation of Islamic financial ideas because they demand correct legal regulation, clarity, and execution enforcement (Franzoni & Allali, 2018). For instance, nations with sound rules on corporate governance and competent financial structures facilitate the Islamic financial tool like sukuk, which enhances fiscal stability. As pointed out by Widiastuti et al., (2022), the density of institutional structures facilitates the translation of efficient fiscal demands to correct Islamic finance forms for their management and makes it possible for these countries to issue Islamic financial products by Sharia norms and international standards.

Nonetheless, the ability of Islamic finance to improve fiscal space and reduce risks of debt is slightly contingent on the extent of understanding and compatibility of Islamic finance laws among the government structures and the public. Where governments of countries are culturally and religiously inclined to Islamic finance, especially in Malaysia and Indonesia, sovereigns have issued sukuk and other Islamic debt instruments to help fund large infrastructure projects, meaning fiscal accommodation and sustainable debt levels (Ijaz, 2025; Zulkhibri, 2019). There is an additional validation of society, and people's religion in the countries where Islamic finance is incorporated into the PFM reinforcing its legitimacy and effectiveness.

However, where their awareness and application of Islamic finance are still in their infancy, the use of Islamic financial tools may be less effective. For instance, in some of the D-8 countries, there could be little or no information on the benefits of Islamic finance either among the policymakers or the populace. This can lead to the reduced uptake of Islamic financial instruments and opposition to the adoption of Islamic finance in public debt funding. According to Ahmed and Khan (2020), there is a failure to understand the cultural and religious aspects of Islamic finance in some integration contexts, therefore there remains a tendency to resort to conventional

monetary assets and liabilities much as there are Islamic solutions for more sustainable fiscal space and public debt management.

On the one hand, the relationship between institutional quality and the Islamic religion underlines qualitatively the impact of Islamic finance on fiscal space and debt sustainability. By enhancing legal structures that are consistent with Islamic finance, it will be easy for the Islamic financial markets to develop. Where institutions are not only sound but are also more closely linked with the cultural and religious compatibility of Islamic finance, there is the added possibility of Islamic finance contributing fiscally to stability (Obaidullah, 2015). This is most conspicuous in Malaysia especially because the government has aligned itself to the task of establishing a legal structure that fosters Islamic financial structures while at the same time observing the Shariah law. The end goal is to have a growing Islamic financial industry that helps create fiscal space and contain debt.

However, as seen in Figure 3, in countries characterized by low institutional quality and low degree of compliance with Shariah, the potential of Islamic finance can be limited. For instance, in Nigeria and Egypt, there is no appropriate legal structure for the development of Islamic finance instruments due to the absence or inadequate legislation and regulation on financial instruments for Islamic finance; In addition, institutional macro environment challenges such as corruption may hamper the expansion of Islamic finance markets (Hassan & Rabbani, 2023). This has eased lending and borrowing control in these countries hence restricting them to issue Islamic finance to increase fiscal space and enhance sustainability of debts.

H_4: Institutional quality and the Islamic religion affect the effectiveness of Islamic finance in enhancing fiscal space and debt sustainability.
$H_{4.1}$: Higher institutional quality increases the effectiveness of Islamic finance products in managing fiscal space.
$H_{4.2}$: The predominance of the Islamic religion positively moderates the adoption and impact of Islamic finance on fiscal space and debt sustainability.

Methods and Data Sources

Therefore, the research objectives of this study include the following ones: to analyze Islamic finance indicators' influence on fiscal space and debt sustainability in D-8 countries. Dependent variables (DVs) are fiscal space and debt sustainability while the independent variables (IVs) are Islamic finance indicators. However, some control variables are incorporated due to the macroeconomic environment and institutions

quality. The following sub-sections provide a more comprehensive description of the variables, data sources as well as the model specification and empirical strategy to be used in this study.

Data period and sources

Based on the principles of sound research methods of data collection and analysis, this study set out to offer dependable findings on the double-edged relationship between banking sector concentration risk, energy sustainability and the moderating influence of institutional quality in the BRI countries. The analyzed period includes the years from 2010 to 2023, which precisely allows for defining long-term trends and developments in the sector of Islamic Finance Instruments. Table 1 shows the variable name, definition, data source and data period.

Table 1: *Variable name, Definition, Data source and Data period*

Variable Name	Definition	Data Source	Data Period
Fiscal Space	Government's capacity to increase spending without risking debt sustainability.	World Bank Indicators	2010-2023
Debt Servicing/GDP	Debt payments as a percentage of GDP, showing debt burden.	World Bank Indicators	2010-2023
Debt Servicing/ Government Revenue	Share of government revenue used for debt payments.	World Bank Indicators	2010-2023
Primary Fiscal Balance	Government revenues minus expenditures, excluding interest.	World Bank Indicators	2010-2023

Sukuk	Shariah-compliant bonds represent ownership of assets or projects.	Country Specific Data	2010-2023
Takaful	Islamic mutual insurance based on shared risk.	World Bank Indicators	2010-2023
Islamic Banking Assets	Assets in banks operating under Islamic principles.	World Bank Indicators	2010-2023
Institutional Quality	Strength of institutions supporting economic stability.	World Bank Indicators	2010-2023
GDP	The total value of a country's goods and services.	World Bank Indicators	2010-2023
Economic Openness	A country's engagement in international trade and investment.	World Bank Indicators	2010-2023

Source: Author

Sample selection

The D8 countries encompass a group of developing countries drawn from three geographical regions. Thus, while going to a tactical level, we have illustrated possibilities of growth and development through the insight of Islamic finance asset balances and fiscal space. The sample also allows the authors to compare the efficiency of different policy activities and financial instruments in countries where a large share of the population is Muslim. Examining these economies may be useful for other economies that seek to build Islamic finance & sustainable government expenditure.

Econometric Model

This paper uses the Dynamic Common Correlated Effects (DCCE)–Mean Group (MG) model for D-8 countries to analyze the dynamic interactions between Fiscal Space, Debt Sustainability and some of the other Islamic finance-related variables namely Sukuk, Takaful, and related Islamic Banking Assets. The analysis also tests the role of Institutional Quality as a moderator while controlling for macro-level variables of Gross Domestic Product growth rate and degree of Economic openness. This methodology is appropriate for D-8 countries because it provides the dynamic interconnection of these variables and enables endogeneity problems in the interaction of Islamic finance, fiscal policies and economic context to be taken into account. To overcome this issue, this study applies panel data methodologies that combine both cross-sectional and time series data which enable a proper analysis of the effect of Islamic finance on fiscal space and debt sustainability. The study starts with checking the stationarity of the data to justify the application of the DCCE-MG model. This model helps in analyzing the correlation between Sukuk Takaful and Islamic Banking Assets together with Fiscal Space and Debt Sustainability controlling for the mediating influence of Institutional Quality.

The econometric equation can be represented as follows:

In this paper, we will consider Fiscal Space (FS) as dependent on the key Islamic finance variables (Sukuk, Takaful, Islamic Banking Assets) with regression coefficients moderated by Institutional Quality (IQ), while covarying GDP Growth (GDP) and Economic Openness (EO).

Equation 1: Fiscal Space without Moderation

$$FS_{i,t} = \beta_0 + \beta_1 Sukuk_{i,t} + \beta_2 Takaful_{i,t} + \beta_3 IBA_{i,t} + \beta_4 GDP_{i,t} + \beta_5 EO_{i,t} + \epsilon_{i,t}$$

Where:

$FS_{i,t}$ = Fiscal Space for country i at time t
$Sukuk_{i,t}$ = Sukuk issuance for country i at time t
$Takaful_{i,t}$ = Takaful indicator for country i at time t
$IBA_{i,t}$ = Islamic Banking Assets for country i at time t
$GDP_{i,t}$ = GDP Growth rate for country i at time t
$EO_{i,t}$ = Economic Openness for country i at time t
$\epsilon_{i,t}$ = Error term

Equation 2: Fiscal Space with Moderation

$$FS_{i,t} = \beta_0 + \beta_1 Sukuk_{i,t} + \beta_2 Takaful_{i,t} + \beta_3 IBA_{i,t} + \beta_4 GDP_{i,t} + \beta_5 EO_{i,t} + \beta_6 IQ_{i,t} + \beta_7 (Sukuk_{i,t} \times IQ_{i,t}) + \beta_8 (Takaful_{i,t} \times IQ_{i,t}) + \beta_7 (IBA_{i,t} \times IQ_{i,t}) + \epsilon_{i,t}$$

Equation 3: Debt Sustainability without Moderation

$$DS_{i,t} = \beta_0 + \beta_1 Sukuk_{i,t} + \beta_2 Takaful_{i,t} + \beta_3 IBA_{i,t} + \beta_4 GDP_{i,t} + \beta_5 EO_{i,t} + \epsilon_{i,t}$$

DS $_{i,\,t}$ = Debt Sustainability for country i at time t

Equation 4: Debt Sustainability with Moderation

$$DS_{i,t} = \beta_0 + \beta_1 Sukuk_{i,t} + \beta_2 Takaful_{i,t} + \beta_3 IBA_{i,t} + \beta_4 GDP_{i,t} + \beta_5 EO_{i,t} + \beta_6 IQ_{i,t} + \beta_7 (Sukuk_{i,t} \times IQ_{i,t}) + \beta_8 (Takaful_{i,t} \times IQ_{i,t}) + \beta_7 (IBA_{i,t} \times IQ_{i,t}) + \epsilon_{i,t}$$

Understanding the relationship: Data analysis and discussion

Descriptive statistics and correlation matrix

The descriptive statistics of the variables are presented in Table 2, and it shows that data is normally distributed. The analysis shows that all these variables have moderate skewness and kurtosis coefficients and none of them contain outliers that are considerably far from the variable mean. This means that data has a fairly good chance of being normally distributed and we can go ahead with most of the conventional assumptions of statistical tests.

Table 2: *Descriptive Statistics*

Variable	Mean	Std dev	Min	Max
FS	56.03784	20.40286	24.86514	85.78853
DS	4.03e-09	.9987875	-1.436456	2.371836
SUK	204.8616	417.6351	.83	1297
TAK	4.167747	4.172917	.1660219	28.09719
IBA	45.29867	30.9135	8.12036	133.817

GDP	4.28e+11	2.78e+11	6.51e+10	1.37e+12
EO	68.42707	45.52327	24.70158	210.3743
IQ	-.4898253	.6444836	-1.709233	.7992313

Source: Author

Note: FS denotes Fiscal Space, DS denotes Debt Sustainability, SUK denotes Sukuk, TAK denotes Takaful, IBA denotes Islamic Banking Assets, GDP denotes Gross Domestic Product, and EO denotes Economic Openness.

The correlation matrix in Table 03 presents the results of the statistical analysis of the connections between the selected measures relevant to fiscal space, debt sustainability, Islamic finance, and economic indicators. Some literature has found a weak positive relationship between FS and DS and SUK, but a negative relationship between FS and IBA and GDP with these findings suggesting that higher fiscal space does not necessarily equal a bigger Islamic banking industry or GDP. There is a positive correlation between sukuk and DS while correlation coefficients with other variables such as Takaful (TAK) and Economic Openness (EO) are relatively weak or negative. It proves that GDP and EO have significant correlations with other variables, where some economic variable such as IQ has a positive correlation with Islamic banking and GDP but opposite with fiscal space and economic openness. These, in turn, point out the contrasting extent of connectivity of these financial and economic signals.

Table 3: *Correlation Matrix*

Variable	**FS**	**DS**	**SUK**	**TAK**	**IBA**	**GDP**	**EO**	**IQ**
FS	1							
DS	0.0737	1						
SUK	0.5563	0.1405	1					
TAK	-0.0458	-0.0980	0.0249	1				
IBA	-0.2575	-0.3324	-0.1392	-0.2283	1			

GDP	-0.5664	0.3803	-0.2891	0.0234	0.0060	1		
EO	-0.1243	-0.5308	-0.2718	0.1059	0.4667	-0.1614	1	
IQ	-0.1517	0.1823	-0.2697	-0.3528	0.6165	0.3220	0.3820	1

Source: Author

Note: FS denotes Fiscal Space, DS denotes Debt Sustainability, SUK denotes Sukuk, TAK denotes Takaful, IBA denotes Islamic Banking Assets, GDP denotes Gross Domestic Product, and EO denotes Economic Openness.

Evaluation of Variable Stationarity

Table 04 represents the Significance tests and Fisher-type test for stationarity, which provided a mixed picture for the key variables and their total values are provided below. Fiscal space (FS) is non-stationary in both tests, with the LLC test statistic at 3.2780 (p-value: 0. Large and positive and close to 9995 for the Hu type statistic, and 0.2099 (p = 0.4169) for the Fisher type statistic. Debt sustainability (DS), however, is stationary across both tests, with LLC at –11.1820 (p-value: 0.) decreasing at 0000) as in Fisher type at 3.6207 (p = 0.0001. For Sukuk (SUK), the LLC test shows stationarity (–2.2436, p-value: 0. It rejected the null hypothesis of stationary by using Kw statistic (-0178, p-value:0.0124) while the Fisher-type test used showed that it was non-stationary (-2.8284, p-value: 0.9977). Similarly, Takaful (TAK) shows non-stationarity in the LLC test (–0.1497, p-value: 0. The pooled estimator without considering the ARCH changes being equal to 4405 does not have the Fisher-type test, though the result is nonstationarity with value 3.7445, and p-value 0.0001. Islamic banking assets (IBA) display stationarity in the LLC test (–3.3728, p-value: 0. WL; data (0004) to the contrary, in the Fisher-type test as is discussed above, the outcome is non-stationary (0.5924, p- 0.2768). Gross domestic product (GDP) presents borderline stationarity in the LLC test (–1.5030, p-value: 0. Fisher-type test = -0.7495; p-value = 0.7732 Coefficients derived from the equation Mp: 0664: While co-integration vector shows non-stationarity Economic openness (EO) shows stationarity in the LLC test (-1.896, p-value: 0.999). Finally, institutional quality (IQ) shows non-stationarity in the LLC test (–0.5488, p-value: 0. The nonstationarity in the mean is evident in the Augmented Dickey-Fuller test of (-12.2916) but stationarity at the 1% level in the Fisher-type test with values of 3.9138 and p-value 0.0000. Several

of these values imply that additional analyses are needed to reconcile the value differences that were observed with some of the variables.

Table 4: Stationarity Test

Variable	LLC Panel Unit root test (p-value)	Fisher Type Panel Unit root test (p-value
FS	3.2780 (0.9995)	0.2099 (0.4169)
DS	-11.1820 (0.0000)	3.6207 (0.0001)
SUK	-2.2436 (0.0124)	-2.8284 (0.9977)
TAK	-0.1497 (0.4405)	3.7445 (0.0001)
IBA	-3.3728 (0.0004)	0.5924 (0.2768)
GDP	-1.5030 (0.0664)	-0.7495 (0.7732)
EO	-1.8960 (0.0290)	-0.0512 (0.5204)
IQ	-0.5488 (0.2916)	3.9138 (0.0000)

Source: Aurhor

Note: FS denotes Fiscal Space, DS denotes Debt Sustainability, SUK denotes Sukuk, TAK denotes Takaful, IBA denotes Islamic Banking Assets, GDP denotes Gross Domestic Product, and EO denotes Economic Openness.

Principal Component Analysis Results for Debt Sustainability

The findings of the PCA for the variables involved in the commonalities of debt sustainability demonstrate the viability of the hypothesis of high correlation between the factors and the ensuing principal components depicted in Table 05. Similarly, the variable DSGDP has a residual variation percentage of 4.25%, while its extraction value is 0.9541, which shows that the variable inheritance is about 95.41% of the principal components, and therefore significantly related to the components. DSGR also has an extraction value of 0.6690 which is equivalent to 66.90 per cent hence indicating that a moderately strong percentage of its variance is being explained by the components. Lastly, A Fiscal Balance (FB) = 0.6891; hence, 68.91% of its extraction values are explained and show a fairly good correlation with the principal components. The trace value of 3 suggests that the three was the number of

components extracted in the analysis, while the Rho value of 0.000 shows a statistically acceptable model fit suggesting that these three components have the capacity of capturing the variance in the indicator of debt sustainability.

Table 5: *Principal Component Analysis*

Communalities in Debt Sustainability through principal component analysis (PCA)	
Variables	**Extraction**
DSGDP	0.9541
DSGR	0.6690
FB	0.6891
Trace	3
Rho	0.000

Source: Author

Note: *DSGDP denotes Debt Servicing to GDP Ratio, DSGR denotes Debt Servicing to Government Revenue, FB denotes Fiscal Balance.*

Driscoll-Kray Estimator Results: Analyzing Fiscal Space and Debt Sustainability

In the case of the present research, results derived from the Driscoll-Kray estimator give information regarding the role of different Islamic finance indicators in fiscal space. Table 06 represents the estimation results for Fiscal space, The coefficient for Sukuk for this model is 0.0049433, p=0.726 Thus, it can be inferred that the impact of Sukuk (SUK) is very weak and insignificant as far as the fiscal space is concerned. Non-life Insurance (TC) has only a negligible influence with a positive coefficient of growth in fiscal space with a coefficient of 0.018757, Takaful (TAK) with a coefficient of 1.324891 has a nearly significant positive effect on the dependent variable (p = 0.051). Fiscal space was regressed against Islamic banking assets (IBA), and the results of regression analysis show that the coefficient of IBA measures such as -0.2468409 while the p-value is 0.000 suggesting that a higher level of IBA constrains fiscal space. In the case of GDP, the coefficient is -4.21e-11 p<0.000 which means that it has a statistically significant negative effect on fiscal space though it is statistically insignificant. The result reveals that fiscal openness significantly declines with EO; coefficient =- 0.0609545, p < 0.004). The variable Institutional quality (IQ) has a coefficient of 1.999559 and a p-value of 0.778 therefore, does not affect fiscal space (=0.778).

The analysis of the coefficients of the interaction between Islamic finance indicators and institutional quality shows the following dynamics. Finally, the result found that there is a positive and significant correlation between SUK x IQ, where the coefficient of 0.0259163, and p-value = 0.0000, indicates that when there is higher institutional quality, Sukuk has a positive impact on fiscal space. The regression coefficient for the interaction between Takaful and institutional quality (TAK x IQ) is 1.318644 and though non-significant, with a p-value of 0.065, has a positive sign which suggests that fiscal space may be enhanced by higher standards of institutional quality. The coefficient for Islamic banking assets multiplied by institutional quality (IBA x IQ) is negative and statistically significant at –0.1370027 with a p-value of 0.000, taking a holistic view of the results, this means IBA constrains fiscal space with the added effect of the quality of institutions in the country. The fit indexes reveal that the cut-off estimate of the posited model is 86.32929, and the p-value is also less than 0.000 suggesting that is statistically significant. This gives an R-squared value of 0.6458 meaning that the fitted model accounts for 64.58% of the variation in fiscal space a reasonably good fit for the analysis.

Table 6: *Driscoll-Kray Estimator (Fiscal Space)*

Impact of Islamic Finance Indicator on DV: Fiscal Space (Driscoll-Kray Estimator)			
Model	**Hypothesis**	**Coefficient**	**P-Value**
SUK	*H1.1*	.0049433	0.726
TAK	*H1.2*	1.324891	0.051
IBA	*H1.3*	-.2468409	0.000
GDP	*H3*	-4.21e-11	0.000
EO	*H3*	-.0609545	0.004
IQ	*H4*	1.999559	0.778
Interaction Terms			
SUK x IQ	*H4.1*	.0259163	0.000
TAK x IQ	*H4.1*	1.318644	0.065

IBA x IQ	*H4.1*	-.1370027	0.000
Fit Indexes			
Constant		86.32929	0.000
R-Square		0.6458	

Source: Author

Note: FS denotes Fiscal Space, DS denotes Debt Sustainability, SUK denotes Sukuk, TAK denotes Takaful, IBA denotes Islamic Banking Assets, GDP denotes Gross Domestic Product, EO denotes Economic Openness, SUK x IQ, TAK x IQ, IBA x IQ denotes interaction term between Sukuk, Takaful and Islamic Banking Asset with Institutional Quality.

Table 07 depicts the Driscoll-Kray estimator results, and the effect of the Islamic finance indicators on the sustainability of debt was revealed. The coefficient for Sukuk (SUK) is positive and equal to 0.0008114 with a p-value of 0.659 meaning. Sukuk has a very poor and insignificant positive impact on the dependent variable. Likewise, Takaful (TAK) has values of 0.0116971 and 0.879, meaning it does not affect debt sustainability. However, Islamic banking assets IBA have negative a highly significant relation where the variable has a coefficient of - 0.0175295 and p-value of 0.000 which means that as the level of IBA increases debt sustainability reduces in a country. In this model, GDP is not significant to debt sustainability since the coefficient is 1.51e-13, and the p-value is 0.670. Yet economic openness (EO), on the other hand, is negative and statistically significant with a coefficient of -0.0100585 and p-value $0 < 0.000$, suggesting that an increase in EO decreases debt sustainability. From the findings, institutional quality (IQ) is significantly predictive of debt sustainability with the coefficient estimate a = 1.723864, and p = 0.001, indicating that high institutional quality increases debt sustainability.

The results of the interaction terms show other relationships that are as follows. Therefore, the hypotheses marked as SUK x IQ have a test value of 0.0003172 which is positive and significant at a 5% level of significance with a p-value of 0.019 implying enhanced institutional quality of the positive effect of Sukuk on debt sustainability. The negatively signed coefficient estimates of TAK x IQ = -0.0278423 and a p-value of 0.054 only provide evidence that whilst Takaful may have a negative impact on the sustainability of debt, this impact is cushioned where there is an institutional quality. As expected, the level of Islamic banking assets (IBA x IQ) is statistically significant and has negative coefficients of -0.0059846 and a p-value of 0.034, suggesting that debt sustainability in countries with better institutional quality

is worse off with the expansion of Islamic banking assets. Based on the analysis the model exhibits a constant equal to – 1.990 049 while the p= 0.000 is an indication of the fact that the model is statistically significant. However, they show a positive relationship with the quantity of debt sustainability although the value of R-squared is 0.6421. Current, lagged, and interactive effects of different Islamic finance indicators for the sustainability of debt, as defined by the model exclusively, include Islamic banking assets and institutional quality both individually and collectively.

Table 7: *Driscoll-Kray Estimator (Debt Sustainability)*

Impact of Islamic Finance Indicator on Debt Sustainability (Driscoll-Kray Estimator)			
Model	**Hypothesis**	**Coefficient**	**P-Value**
SUK	*H2.1*	.0008114	0.659
TAK	*H2.2*	.0116971	0.879
IBA	*H2.3*	-.0175295	0.000
GDP	*H3*	1.51e-13	0.670
EO	*H3*	-.0100585	0.000
IQ	*H4*	1.723864	0.001
Interaction Terms			
SUK x IQ	*H4.2*	.0003172	0.019
TAK x IQ	*H4.2*	-.0278423	0.054
IBA x IQ	*H4.2*	-.0059846	0.034
Fit Indexes			
Constant		1.990049	0.000
R-Square		0.6421	

Source: Author

Note: FS denotes Fiscal Space, DS denotes Debt Sustainability, SUK denotes Sukuk, TAK denotes Takaful, IBA denotes Islamic Banking Assets, GDP denotes Gross Domestic Product, EO denotes Economic Openness, SUK x IQ, TAK x IQ, IBA x IQ denotes interaction term between Sukuk, Takaful and Islamic Banking Asset with Institutional Quality.

Policy Recommendations

The research evidence of this study supports and builds on the current literature concerning the function of Islamic finance in improving fiscal sustainability. Prior research has also emphasized the part played by Sukuk in improving fiscal sustainability by providing ample fund-sourcing ideas to lower dependency on generally recognized debt securities. Therefore, the improvement in the institutional quality of the countries in this analysis that is associated with a higher level of Sukuk corresponds with the findings of Najeeb & Vejzagic (2020) who suggested that the sound institutional environment augments the resilience effect of IFI on fiscal sustainability. This has an implication that for D-8 countries to make optimum use of Sukuk it requires institutional changes. Takaful, which presented a marginal effect on fiscal space and a mixed effect on the sustainability of debt, has not been a prominent focus of prior analysis. For instance, El-Gamal (2019), it was discovered that although Takaful can offer different risk-sharing tools that assist in balancing the public sector, the impact is relatively higher in those nations that have better frameworks regulating the markets. This calls for a paradigm shift in the area of governance to unlock the Takaful in the context of fiscal policy. The negative and statistically significant relationship between Islamic banking assets and fiscal space, and between assets and debt sustainability supports studies like Al-Sadig (2017) where he cautioned that if Islamic banking is growing rapidly, but not accompanied by the growth in regulation, it can create inefficiencies which put pressure on the public finances. When the above negative effect is compounded with higher institutional quality, this means that Islamic banking requires more refined legalization for it to provide positive outcomes to fiscal health.

Finally, the adverse effect of economic openness on fiscal space and debt sustainability supports the contention made by Kammer et al. (2015) that open economies can become easily vulnerable to shocks in economies by relying too much on external funding. As a result, this study provides added impetus to the suggestion that the D-8 member countries should pursue openness but carry out it in conjunction with policies that would support fiscal solvency. Altogether, these studies contribute to the existing literature enriching it with more detailed information and highlighting

how the usage of Islamic finance instruments, if applied as instruments of a long-term vision, can positively impact the fiscal sustainability of developing countries when backed by proper institutions.

In conclusion, section five presents policy implications and solutions for the D-8 countries giving the policy maker and anyone interested in sound policies for the implementation of Islamic finance for sustainable fiscal growth. Consequent to the findings on the effect of Islamic finance indicators, this work realizes that wisdom must be given to Sukuk, Takaful, Islamic banking assets and institutional quality. These elements do not only perform semi-independent functions in formulating fiscal space and debt sustainability but also moderate institution quality in equal proportion.

The lesson for the D-8 countries is that to optimise the benefits that accrue from Sukuk, it is necessary to shore up the institutions that underpin Islamic finance to amplify the benefits that accrue from the Islamic banking asset and to offset the costs associated with such assets. The results indicate that enhancing institutions offers the best shot at enhancing the efficacy of Sukuk in financing fiscal space and debt sustainability concerning the issues raised on Islamic banking assets. As well, while maintaining openness in economic policies, fiscal discipline is another factor that enables an environment whereby Islamic finance can support long-run fiscal sustainability. These recommendations can be seen as a directional map that any policymaker wishes to work towards realizing a more sustainable and resilient fiscal framework where the strategic deployment of IF is warranted.

Conclusion

Therefore, this study emphasizes that Islamic finance can begin a process of changing the fiscal and debt situation in D-8 countries and states at the same time that institutional quality has a moderating impact. The findings indicate that a moderate relationship exists between Sukuk and fiscal space/fiscal debt sustainability when the Sukuk is issued and enhanced independently but substantially if supported by the standard institutional framework. Takaful shows little effect on fiscal space but when institutional quality is relaxed it brings a lot of luck to Takaful and that makes the argument that good governance is the key to successful management of the concept. However, the Islamic banking asset ratio is negatively associated with both the fiscal indicators and it is relatively worse with higher IIP implying that some risks must be well harnessed.

In addition, it was evident that economic openness has a negative moderating effect on fiscal space and debt sustainability; a fact that refuted the hypothesis that the external economic environment may dethrone the domestic fiscal balance. Thus, this paper finds out that Institutional quality is one of the key challenges affecting the business environment in the D8 countries in the efficient utilization of Islamic finance. It comprises the establishment of proper measures for regulation, bettering the issue of transparency and establishment of proper framework for proper financial governance. Thus, the governments of these countries might better coordinate the use of Islamic financial products, particularly, Sukuk and Takaful, to improve the permanent fiscal development and the quality of the debt. The present paper presents important findings that can be useful to future policies in the amendment of the process of incorporating IF into the general economic plans to attain sustainable economic development and stability in the future.

Papers examining the relationship between Islamic finance and fiscal space and debt sustainability can develop several interesting directions for further studies. According to the literature review, more representative research in the longitudinal form, objecting changes in any D-8 country as a result of Islamic finance over a certain period may help to outline the development of these financial instruments as well as their impact on fiscal stability more objectively. Comparative studies of the nature of the relevance of Islamic finance in non-members of the D-8 but similar economies may provide the best solutions to such development. Furthermore, looking at the influence of Islamic finance in certain industry segments like infrastructure, healthcare and education, may provide more concrete insights into the role it plays. Perhaps, the qualification of broad indicators to measure institution quality can improve the knowledge of its role as the moderator of the Islamic Finance and Fiscal Results Association. Finally, an assessment of the current Islamic finance-related policies and institutional quality will be useful in determining areas that need policy adjustments, while assessing the impact of global economic forces on Islamic finance effectiveness in improving the fiscal space and debt sustainability will be useful in adopting the best way forward.

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