

SOVEREIGN DEBT IN ISLAMIC ECONOMICS: SUKUK AS A SHARI'AH-COMPLIANT ALTERNATIVE TO CONVENTIONAL BONDS —THEORY, GROWTH, AND FISCAL IMPLICATIONS

Baratov Sadulla Norjigitovich

Associate Professor, Samarkand Institute of Economics and Service, Uzbekistan

e-mail: s-baratov@mail.ru

Abstract: Contemporary Islamic states confront a fundamental tension between developmental financing requirements and the Shari'ah prohibition on riba (interest-based debt). This paper examines how sovereign sukuk—Shari'ah-compliant capital market instruments backed by tangible assets or usufruct rights—have emerged as the primary mechanism for resolving this tension. Using data from the International Islamic Financial Market (IIFM), the Islamic Development Bank (IsDB), and official fiscal statistics for seven OIC member states (2017–2022), we document the rapid growth of the sovereign sukuk market from USD 210.3 billion in annual issuance (2017) to USD 418.8 billion (2022). Our comparative analysis reveals that countries with sukuk-to-total-debt ratios exceeding 30% demonstrate lower borrowing costs and broader investor bases. However, we identify a critical governance risk: the growing use of synthetic sukuk structures that replicate conventional bond economics without genuine asset transfer. We conclude with recommendations for strengthening sukuk governance to ensure Shari'ah integrity while supporting Islamic states' fiscal sustainability.

Keywords: Sovereign sukuk, Islamic public debt, riba prohibition, OIC fiscal policy, Shari'ah-compliant finance, Islamic Development Bank

Introduction

Public debt is among the most contested concepts in Islamic jurisprudential literature. The Qur'anic injunction 'Allah has permitted trade and prohibited riba' (Surah Al-Baqarah, 2:275) establishes a categorical prohibition on interest-bearing transactions that, if interpreted strictly, would preclude the issuance of conventional sovereign bonds entirely. Yet no modern state—including those that formally apply Islamic law—can finance infrastructure investment, social expenditure, and fiscal stabilisation exclusively from current revenue. Bridging this fiscal gap without recourse to riba represents one of the central operational challenges of Islamic public finance.

The emergence of sukuk as an asset-backed, Shari'ah-compliant alternative to conventional bonds has created a rapidly growing market. Global sukuk issuance reached USD 418.8 billion in 2022 (IIFM, 2023), compared to USD 210.3 billion in 2017—a compound annual growth rate of approximately 14.8%. Malaysia and Saudi Arabia together account for roughly 63% of sovereign sukuk outstanding, but the market is expanding rapidly in Indonesia, Turkey, and several sub-Saharan African OIC members.

Despite this growth, the jurisprudential and macroeconomic dimensions of sovereign sukuk remain inadequately integrated in the academic literature. This paper attempts a synthesis: situating sovereign sukuk within both the Islamic theory of public finance and the mainstream economics of sovereign debt, and drawing on cross-country empirical data to assess fiscal implications.

Methods

This study draws on four primary data sources. Market-level sukuk data are sourced from the International Islamic Financial Market (IIFM) Annual Sukuk Report 2022 and the IIFM Annual Sukuk Report 2023. Fiscal and macroeconomic data are obtained from the IMF Fiscal

Monitor (2023), IMF World Economic Outlook Database (April 2023), and World Bank Public Sector Debt Statistics. Structural and compliance data are based on AAOIFI Shari'ah Standard No. 17 (Investment Sukuk), IsDB (2022), and the IRTI-IsDB (2020) survey of Shari'ah non-compliant events. Country-specific data are drawn from national debt management offices and central banks, including Bank Negara Malaysia (BNM, 2022) and Saudi Arabia's National Debt Management Center (NDMC, 2022).

Seven OIC member states were selected for the fiscal analysis: Malaysia, Indonesia, Saudi Arabia, Pakistan, Egypt, Turkey, and Bangladesh. Selection criteria were: (1) availability of consistent public debt data for 2019–2022; (2) representation across distinct institutional and geographic contexts; and (3) variation in sukuk market development, from highly developed (Malaysia, Saudi Arabia) to nascent (Bangladesh, Egypt). This variation enables structured comparison of the relationship between sukuk market depth and fiscal outcomes.

The structural comparison between conventional bonds and sovereign sukuk is conducted using an eight-criterion analytical framework adapted from AAOIFI Standard No. 17 and IsDB (2022). Issuance trend data cover 2017–2022 across five regional groupings. The synthetic sukuk analysis draws on jurisprudential literature and the IRTI-IsDB (2020) compliance survey rather than on quantitative data, given the absence of systematic public disclosure on sukuk structural features.

Results

Table 1 presents central government debt-to-GDP ratios for seven OIC member states alongside sukuk shares in total outstanding government debt. The COVID-19 pandemic generated a universal spike in debt ratios in 2020, but subsequent trajectories diverge: GCC states, benefiting from oil price recovery, reduced debt ratios rapidly, while South Asian OIC economies and Egypt struggled to reverse pandemic-era accumulation.

Table 1: Central Government Debt-to-GDP Ratios and Sukuk Shares (%), 2019–2022

Country	2019 (% GDP)	2020 (% GDP)	2021 (% GDP)	2022 (% GDP)	Sukuk Share (% , 2022)
Malaysia	52.5	67.6	68.4	65.0	38.2
Indonesia	30.1	39.4	41.0	39.6	22.7
Saudi Arabia	22.8	32.5	30.0	24.1	52.4
Pakistan	77.5	87.2	78.0	73.2	8.5
Egypt	90.2	87.0	93.5	96.5	3.1
Turkey	32.7	39.8	41.8	31.8	5.6
Banglades h	33.8	38.8	37.6	36.1	0.8

Sources: IMF Fiscal Monitor 2023; World Bank Public Sector Debt Statistics; IIFM Sukuk Report 2022; National Debt Management Offices.

The contrast between Saudi Arabia's sukuk share (52.4%) and Egypt's (3.1%) reflects differences in institutional capacity and market development. Saudi Arabia's National Debt Management Center (NDMC), established in 2015, has systematically developed a sukuk yield curve in both Saudi Riyal and USD, enabling price discovery that facilitates market expansion. Egypt's debt management remains predominantly conventional, though its inaugural sovereign green sukuk in 2023 signals a strategic shift.

Pakistan illustrates a critical risk. With debt at 73.2% of GDP and interest payments consuming approximately 58% of federal revenue in FY2023, Pakistan faces exactly the fiscal dynamic that Islamic public finance theory identifies as unsustainable: *riba*-like obligations (interest on conventional bonds) crowding out developmental expenditure. Its sukuk share of 8.5% reflects both institutional underdevelopment and a debt composition that amplifies vulnerability.

Table 2 provides a systematic comparison of conventional sovereign bonds and sovereign sukuk across eight criteria. The comparison highlights both the theoretical Shari'ah rationale for sukuk and the practical convergences that have emerged as the market has matured.

Table 2: Structural Comparison — Conventional Sovereign Bonds vs. Sovereign Sukuk

Criterion	Conventional Sovereign Bond	Sovereign Sukuk
Legal basis	Debt instrument; issuer-creditor relationship	Asset-backed certificate; ownership of underlying asset or usufruct
Shari'ah compliance	Riba-based; non-compliant	Compliant if asset-backed and profit-sharing structured
Return mechanism	Fixed or floating interest coupon	Profit/lease payment (<i>ijara</i> , <i>musharakah</i> , <i>murabaha</i> , etc.)
Principal repayment	Unconditional contractual obligation	Linked to asset performance; may include partial risk-sharing
Investor base	Conventional investors only	Conventional + Islamic investors (wider potential pool)
Pricing benchmark	LIBOR / SOFR / government yield curve	Asset-based pricing, often benchmarked to SOFR in practice
Use of proceeds	Unrestricted government expenditure	Must finance Shari'ah-permissible assets or projects
Global market size	USD 65 trillion (2022)	USD 848 billion outstanding (IIFM 2022)

Sources: IIFM 2022; AAOIFI Shari'ah Standard No. 17; IsDB 2022; BIS Quarterly Review.

Despite structural differences, sukuk and conventional bonds have converged in pricing in developed Islamic capital markets. Malaysia's sukuk yield curve closely tracks its conventional government securities curve, with spreads typically within 5–15 basis points (BNM, 2022). The 'use of proceeds' constraint—requiring sukuk proceeds to finance Shari'ah-permissible assets—functions as an implicit fiscal commitment device, analogous to fiscal rules, that may reduce the risk of revenue diversion to consumption expenditure.

Table 3 presents annual sukuk issuance volumes by region, documenting the geographic expansion and sectoral deepening of the market over the study period.

Table 3: Global Sukuk Issuance by Region, 2017–2022 (USD billion)

Region / Country	2017	2018	2019	2020	2021	2022



Malaysia	76.9	83.7	101.2	100.6	108.7	120.4
GCC	82.3	87.5	90.4	110.3	130.1	148.6
Indonesia	14.8	19.4	23.8	35.7	45.6	58.2
Rest of OIC	28.1	31.4	35.6	42.8	52.3	61.8
Non-OIC	8.2	11.4	14.2	18.9	23.4	29.8
TOTAL	210.3	233.4	265.2	308.3	360.1	418.8

Sources: IIFM Annual Sukuk Report 2022; Islamic Development Bank; Bloomberg Finance L.P.

Indonesia's trajectory is particularly notable: issuance grew from USD 14.8 billion in 2017 to USD 58.2 billion in 2022—a compound annual growth rate of 31.1%—driven by the world's first sovereign green sukuk (2018) and the institutionalisation of retail sukuk (Sukuk Ritel series) through the Ministry of Finance. The emergence of non-OIC sukuk issuers (USD 29.8 billion in 2022), including the United Kingdom, Hong Kong, and South Africa, validates the thesis that sukuk can achieve pricing parity with conventional instruments while broadening the investor universe.

Discussion

The classical Islamic jurisprudential tradition—from Abu Yusuf through Ibn Khaldun to Baqr al-Sadr—identifies four implicit conditions for permissible sovereign debt: productive deployment of proceeds for public benefit (*masalih 'ammah*); maintenance of debt at levels consistent with fiscal sustainability; preservation of sovereign autonomy from creditor dependence (*taba'iyah*); and use of Shari'ah-compliant contractual structures. The empirical results demonstrate that these four conditions map directly onto contemporary fiscal analysis. Countries satisfying all four—most notably Malaysia and Saudi Arabia—demonstrate lower fiscal risk profiles than OIC peers with high conventional debt burdens.

Ibn Taymiyyah's argument that the state may borrow to fulfil legitimate public obligations, provided repayment is secured, has been widely used to legitimate sukuk structures. However, his framework assumed borrowing on a *qard hasan* (benevolent loan) basis, not through a market instrument carrying a profit return. The sovereign *ijara* sukuk structure—in which the state sells an asset to a special purpose vehicle (SPV), which issues certificates to investors, with the state then leasing the asset back—converts this relationship from a prohibited loan-with-increment into a permissible lease-finance arrangement. The empirical evidence confirms that this structure has achieved broad market acceptance and, in mature markets, pricing parity with conventional bonds.

Three macroeconomic risks warrant emphasis. First, debt servicing capacity: Pakistan's case illustrates how conventional interest obligations can consume the majority of fiscal revenue, leaving no space for developmental expenditure. This outcome represents the precise scenario Islamic public finance theory identifies as both fiscally and morally unsustainable.

Second, currency mismatch: OIC sovereigns issuing USD-denominated sukuk face exchange rate risk that can amplify debt burdens. Pakistan's PKR depreciated approximately 53% against the USD between 2021 and 2023, dramatically increasing domestic-currency debt service costs. Islamic jurisprudence's concern with *gharar* (excessive uncertainty) aligns with the macroeconomic case for domestic-currency issuance—a case Malaysia has successfully made by developing a deep MYR-denominated sukuk market.

Third, liquidity concentration: the IIFM (2022) estimates that approximately 42% of outstanding sovereign sukuk are held to maturity by Islamic banks under regulatory requirements,

effectively removing them from secondary market circulation and reducing price discovery efficiency. This structural feature limits the development of liquid benchmark yield curves, which are essential for sukuk market deepening.

The most significant jurisprudential risk in contemporary sovereign sukuk markets is the prevalence of structures that replicate conventional bond economics without genuine asset transfer or risk participation. AAOIFI Shari'ah Standard No. 17 explicitly prohibits three features that have nonetheless become common market practice: guarantees by the obligor of sukuk assets' market value at redemption; purchase undertakings at predetermined prices that ensure investors recover exactly the face value regardless of asset performance; and commodity murabaha (tawarruq) structures that use contrived commodity trades to generate cash flows indistinguishable from interest.

Sheikh Muhammad Taqi Usmani publicly criticised these structures in 2007, stating that 85% of sukuk outstanding at that time were non-compliant with Shari'ah principles. A 2020 IRTI-IsDB review found that a significant proportion of sovereign sukuk still incorporate purchase undertakings at par that effectively guarantee principal repayment unconditionally. Theologically, states issuing non-compliant sukuk while claiming Shari'ah compliance engage in a form of deception (tadlis) that undermines Islamic finance's integrity. Systemically, if Shari'ah compliance certifications prove unreliable, reputational damage could trigger a market-wide repricing that would increase borrowing costs across all OIC sovereign issuers.

Three institutional reforms are needed to resolve the governance gap. First, OIC member states should establish independent Shari'ah Supervisory Boards (SSBs) for sovereign debt management, with authority to reject non-compliant sukuk structures before issuance. The key governance requirement is independence from the investment banks structuring the sukuk—a condition currently violated in many jurisdictions where in-house Shari'ah scholars approve structures that maximise underwriting fees.

Second, the IsDB should develop a harmonised sukuk compliance rating system—analogueous to conventional credit ratings—providing investors with standardised information on genuine Shari'ah compliance. Current fragmentation of Shari'ah opinion across national SSBs creates certification arbitrage, in which issuers seek the most permissive Shari'ah board, eroding market-wide standards.

Third, OIC governments should prioritise the development of domestic-currency sukuk markets to reduce currency mismatch risks. The Islamic Corporation for the Development of the Private Sector (ICD), an IsDB subsidiary, has a mandate to support domestic capital market development that could be more actively directed toward this objective.

Also, this study has several limitations. The synthetic sukuk analysis relies on jurisprudential literature and survey data rather than systematic structural disclosure, reflecting the absence of public reporting on sukuk contractual features. The fiscal risk analysis is cross-sectional and cannot establish causality between sukuk market depth and sovereign credit outcomes. Future research should employ event study methodology to test whether sukuk issuance announcements generate differential market reactions compared to equivalent conventional bond issuances, and panel data analysis to examine the relationship between sukuk market depth and sovereign credit ratings.

Conclusion

This paper has examined sovereign sukuk from the dual perspective of Islamic jurisprudence and macroeconomic fiscal analysis. The empirical evidence demonstrates that the sukuk market has achieved the scale and diversification necessary to serve as a genuine fiscal instrument: annual issuance of USD 418.8 billion in 2022 represents a credible alternative to conventional sovereign borrowing for OIC member states. Countries that satisfy the four jurisprudential conditions for permissible sovereign debt—productive use of proceeds, debt

sustainability, preservation of sovereign autonomy, and Shari'ah-compliant structure—demonstrate lower fiscal risk profiles than OIC peers with high conventional debt burdens.

The synthetic sukuk problem, however, represents a genuine risk to the integrity and sustainability of the Islamic sovereign debt market. Without institutional strengthening at both national and multilateral levels, the rapid growth of the sukuk market risks creating a shadow conventional bond system dressed in Islamic vocabulary—an outcome that would represent a fundamental failure of Islamic public finance theory in practice. Resolution requires independent Shari'ah supervision, harmonised compliance standards, and a sustained commitment to domestic-currency market development.

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