Does Islamic Banking Financing Help the Poor?

Achmad Tohirin¹, Fauzan Husaini²

¹Universitas Islam Indonesia Yogyakarta
²Master Program in Economics, Universitas Islam Indonesia Yogyakarta

Corresponding author: achmad.tohirin@uii.ac.id

Abstract

This study aims to examine the effect of Islamic banking financing in helping poor people. Panel data starts from 2014q1-2018q2 collected from six countries were used in this study. The analysis method used is the panel data analysis. Private consumption expenditure is used to measure the level of poverty. Total Shariah-Compliant Financing is used to measure Islamic banking financing value. Several control variables are involved, such as conventional bank credit, consumer price index and economic growth. The result showed that Islamic banking financing has an effect in reducing the level of poverty better than conventional banking in these countries.

Keyword: Islamic Banking, Poverty, Financing

Introduction

Poverty is an issue faced by almost most developing countries (Todaro, 1997). The United Nations Development Program (UNDP) noted that in 2018, as many as 8.6% of world population are living below the extreme poverty line or earns less than US $ 1.9 per day. Therefore, UNDP makes poverty as one of the top priorities in the Sustainable Development Goals (SDGs) program.

This phenomenon is further compounded by the high level of income inequality. The World Inequality Report (WIR) in 2018 revealed that since 1980 until 2016, the level of inequality in the world has been increasing very rapidly. In almost all countries in the world, the percentage of income of the richest 10% of total income has been growing very fast. In Europe, the richest 10% group controls 37% of the total income. While in America and Canada, the percentage even reached 47%. The most severe conditions exist in Middle Eastern countries with 61% of total income enjoyed by the richest 10%. This phenomenon is certainly very worrying, considering both from governments in each country and the multilateral institutions have carried out various efforts, but the problem still exist.

The financial sector is part of the economic system that functions to transfer economic resources (Merton & Bodie, 1995). Financial institution aims to collect funds from the surplus unit and channel it to the deficit unit. In general, the financial sector has contributed significantly to a country’s economic growth. For developing countries that have the characteristics of poverty and a high concentration of wealth, the transfer of wealth through financial institutions can be done without reducing the wealth of the rich.

The development of the financial sector is assumed to increase the total of production, encourage economic competitiveness and stimulate the working market dynamically (Levine et al, 2000). Various studies that have been conducted show that countries with good financial sector development can encourage increased economic growth, decrease income inequality, and reduce poverty levels (Zhang & Chen, 2015).

According to Kuznet (1955), income inequality will initially increase in line with the increasing per capita income of a country. This happened because at first, the increase in income per capita caused by increasing of total productivity, and most happened in town initially. Thus, middle and upper income people get more benefit from it. However, after reaching a certain level, then the level of income inequality will begin to decrease, due to it starts to distribute to all around country. Therefore, the Kuznet hypothesis has an Inverted U-curve pattern.
The debate over the role of the financial sector in reducing poverty and inequality remains an interesting topic to discuss. On the one hand, the more financing facilities provided, the greater loans can be provided, which will eventually decrease the level of inequality (Galor & Moav, 2004). However, the fact is financial institutions often prioritize middle to upper-income groups compared to low-income groups (Clarke et al, 2011). This condition makes the rich get greater benefits than the poor (Rajan & Zingales, 2003).

Chapra (1996) said that banking with the system used today, namely the conventional system has caused the gap between the rich and the poor to widen. Through this criticism, Chapra offers the Islamic financial system as a solution to that problem. As the growing of Islamic banks development, currently, some Muslim countries have begun to adopt a dual banking system, namely sharia and conventional.

However, the majority of the Muslim population cannot guarantee the market share of Islamic banks in these countries to be greater than conventional banks. In Indonesia, as most Muslim population country, data of OJK in 2018 shows that the market share of Islamic banks has only reached 5.7%. This figure has even stagnated from 2010 to 2018. While Malaysia, as a country that firstly introduced Islamic banks, is roughly 27%. This condition is due to the dual banking system that is still used in both countries. Unlike Iran, which has completely changed its banking system to a system that is 100% already based on sharia compliance. In 2017, Iran's Islamic banking assets have reached USD486 billion and have 42 Islamic banks, and are the most among other countries.

Historically, compared to the conventional banking, which has existed for decades and even hundreds of years ago, the presence of Islamic banks is relatively newer. However, it does not mean its performance is far below conventional banks. Its asset growth is even bigger conventional banks.

Several empirical studies that have been conducted show that Islamic banks contribute positively to a country's economic growth (Tabash1, 2011). Other studies have found that interest-free banking has a much better opportunity to achieve monetary targets (Darrat, 1988).

The mudharabah investment scheme or profit and loss sharing will certainly encourage banks to channel financing to the real sector. Conceptually, the basis of a mudharabah contract is capital participation from the capital owner (shohibul maal) to the mudarib. Therefore, the motive that occurs between the two parties is investment. In the classic mudharabah concept, a mudarib is not required to include collateral, so that everyone who has skill can be eligible to manage mudharabah fund. In Addition, it opens up more opportunities for new businesses to get capital facilities.

However, we still have a little bit research that aim to examine Islamic financial development and poverty nexus. An empirical study conducted by Setiawan (2017) shows that Islamic banks have a smaller effect in reducing poverty in Indonesia. This condition occurs due to the small portion of Islamic financing based on the real sector compared to loans carried out by conventional banks.

The small portion of sharia financing based on the real sector is one of the issues faced today. In Indonesia, the percentage of profit sharing financing from Islamic banks in 2018 was even only 45.44% of the total value of the financing provided. This figure consists of mudharabah with 4.955% and musyarakah at 40.48%. While the rest 51.24% consists of murabaha with 48.35%, qardh with 2.4% and istishna with 0.5%. This condition is certainly very alarming considering that profit sharing financing such as mudharabah has a greater multiplier effect on the economy.

The limited data and the small market share of Islamic Bank make research on this topic still rarely done. The debate over whether the small market share of the Islamic bank can explain the true empirical phenomenon also cast doubt on the research on this topic. Therefore, it is necessary to conduct a far more comprehensive study, so that the results obtained can better represent the actual empirical conditions.

Based on the description above, it is necessary to conduct a more comprehensive study on the role of Islamic banks in overcoming the problem of poverty and inequality. This aims to prove how extent of Islamic banks role in alleviating poverty problem. Therefore, this study is conducted with the aim of seeing the possibility of that relationship.
Literature Review

The study of the intermediary role of banking institutions is considered still quite important to do. The debate over the role of the financial sector in reducing poverty and inequality remains an interesting debate to this day. On the one hand, the more financing facilities provided, the greater the credit that can be borrowed by the poor, which will eventually drive down the level of inequality (Galor & Moav, 2004). However, the reality is that financial institutions often prioritize upper and middle-income groups than low-income groups (Clarke et al, 2011). This condition makes the rich get greater benefits than the poor do (Rajan & Zingales, 2003).

Islamic banking, like conventional banking, also has the same role, namely as an intermediary institution. As an intermediary institution, there are five basic functions they have, namely mobilizing savings, managing risks, obtaining information about investment opportunities, exerting control for the company, facilitating transaction activities and providing facilities for the exchange of goods and services (Levine 2004).

The mudharabah investment scheme or profit and loss sharing will certainly encourage banks to channel financing to the real sector. Conceptually, the basis of a mudharabah contract is capital participation from the capital owner (shohibul maal) to the worker/businessperson (mudharib). Thus, the motive that occurs between the both parties is investment cooperation. In the classic mudharabah concept, a mudharib is not required to include collateral, so that his mudharib segmentation becomes wider, and opens up opportunities for new businesses (start-ups) to get capital facilities.

Research conducted by Darrat (1988) shows that banks with an interest-free banking system are far superior compared to banks with interest system. This conclusion is based on at least three criteria. First, compared to the interest system, the interest-free monetary system shows a much better turnover of money. Second, the interest-free system shows much better stability in terms of the demand for assets. Third, the interest-free system provides much more optimal flexibility for policymakers or monetary authorities in realizing the monetary targets that have been made.

Research conducted by Furqani & Mulyany (2009) found that in the long run, Islamic banking financing has a positive effect on economic growth. Islamic banking also plays an intermediary function that is far better in channeling savings from surplus units to deficit units. In addition, the development of Islamic banking also provides far greater benefits for economic development and economic prosperity in the long term.

In the recent years, research on this topic is still dominated by the conventional financial sector, while Islamic finance is still very limited. As research conducted by Beck et al (2007) shows that in countries with high banking intermediary levels, the level of inequality will decrease very quickly. Furthermore, this study also explains that the role of financial sector development in reducing income inequality occurs when financial institutions succeed in increasing the income of the poor. This finding is also in line with research conducted by Bittencourt (2010) who found that financial sector development and expansion carried out by financial institutions that occurred in Brazil had a significant effect on reducing income inequality. However, this can only be done with an assumption if more resources can be directed to the poor. Increasing wealth in the poor will reduce the inequality gap with the rich.

Kim & Lin’s (2011) finding shows that the poor can only feel the benefits of the financial sector when the depth of a country’s financial sector is at a certain level. When the depth of the financial sector has reached the required level, the poor can feel the process of income distribution. As long as the financial sector has not reached the minimum level, the benefits cannot be felt at all, and even tend to have a bad impact on the poor and can widen the income inequality gap. This finding is based on empirical studies conducted in 72 countries starting in 1960-2005.

Research conducted by Ho & Odhiambo (2016) found that the effect of the relationship between the financial sector and the reduction in poverty levels depends on the proxy used. When using the ratio of domestic credit to GDP as a proxy for the financial sector, the results show a bidirectional relationship between the financial sector and poverty reduction. Meanwhile, when using the money supply (M2) as a proxy, the results are relatively the same in the short term, namely the existence of bidirectional relationships. In the long-run, there is an unidirectional relationship that is
caused by a decrease in the poverty rate to the pace of development of the financial sector. That means, the higher the decline that occurs at the level of poverty, it will affect the increase in the financial sector. The results of this study are based on observations made in China in the period 1978 to 2008.

While Jeanneney & Kpodar (2011) conducted a study based on 92 countries in the period 1950-1999 using the dynamic panel analysis method. This study revealed that the financial sector has two effects in influencing poverty levels, namely direct and indirect effects. The researchers' findings showed that the direct effect of the financial sector has a far greater influence in reducing poverty than the indirect effect model through economic growth. High economic growth does not require a financial institution to prioritize products based on the real sector. This phenomenon occurs in several countries that have high economic growth and financial sector contributions, but high poverty rates. However, the financial sector also plays a role in increasing financial sector instability. This study found that instability in the financial sector caused poverty to become worsened.

Generally, it is shown in more literature that financial development has contribution in reducing income poverty directly by providing credit and financial services to the poor that helps to increase their income through investing productive activities as well as through interest earned from savings. In addition, financial development also effect indirectly by its economic growth stimulating effect (McKinnon, 1973; Schumpeter, 1934).

In contrast to the preceding researches, Seven & Coskun (2016) found that the banking sector (bank development) actually has a positive relationship with the level of inequality. That means, every increase in the financial sector is in line with the poverty level increase. Meanwhile, the negative effect is actually seen in the growth of poor people's income. This finding is based on research conducted since 1987-2011 in 45 emerging countries.

Findings from research conducted by Law and Tan (2009) even show that there is no significant relationship between financial sector development and the level of inequality. This result is based on observations made in Malaysia in the period 1980 to 2000. This condition occurred due to the low attention of the financial sector both banking and capital markets in providing credit facilities to households. Therefore, the financial sector must be far more concerned in facilitating capital assistance for households.

Setiawan (2017) conducted research that examine the role of Islamic bank in reducing poverty. It appeared that conventional banks have a far greater effect than Islamic banks in reducing poverty. This condition occurs due to the capacity of sharia-based real sector financing that was smaller than in conventional banks. This research was based on empirical studies conducted in Indonesia since 1992-2012 using the panel regression analysis method using the Two Stage Least Square (TSLS) estimation method. An interesting finding from this research is the role of Islamic monetary policy instruments proxied by profit and loss sharing ratios, showing a positive and more elastic effect compared to conventional monetary instruments on poverty levels. The policy implications that need to be considered are that the central bank must be far more careful in determining the amount of profit and loss sharing ratio. In addition, this study found that any increase in economic growth will be followed by an increase in poverty levels.

Compared to the research conducted by Setiawan (2017), this study involved more countries. Therefore, the data used is larger than preceding research, thus it provides broader perspective. However, this research does not do comparative testing between countries.

**Estimation Techniques and Empirical Analysis**

This research is an empirical study conducted in six selected OIC countries namely Iran, Malaysia, Indonesia, Saudi Arabia, Turkey, and Sudan. The data used are quarterly data from 2014q1-2018q2 taken from several credible sources such as Bankscope, World Bank, Bloomberg, Statistics Agency for each country, Islamic Financial Service Board (IFSB), CEIC data, central banks in each country and other credible sources. Thus, the data used is panel data, which is a combination of time series and cross-section.
The reason for the selection of the six countries as objects of research is based on the unique characteristics of Islamic banking in each of these countries. According to the Islamic Financial Services Industry Stability Report 2018, Iran and Sudan are countries with a share of Islamic banking reaching 100% (Full market share). Malaysia and Saudi Arabia both have a market share of more than 20% (medium market share). While Turkey and Indonesia both have a market share of less than 10% (less market share). Of course, the use of the six countries will represent a better value.

In this study, the natural log of household consumption expenditure measures poverty (LnPOV). This proxy is selected because the consumption expenditure tend to be reliably documented and stable enough when compared to their income (Majid et al, 2019; Sehrawat & Giri, 2016; Odhiambo, 2010; Quartey, 2005; Datt and Ravallion, 1992). According to World Bank definition, poverty is the inability to attain a minimal standard of living measured by people basic consumption.

While Islamic banking financing is measured by the natural logarithm of Total Shariah-Compliant Financing (LnIBF). In addition, several control variables are also used, such as conventional bank credit (LnLoan) measured by the natural logarithm of Net loans & advances to customers of conventional banking. Then the consumer price index (LnCPI) measured by the natural logarithm of consumer price index. Another control variable is economic growth (LnG) measured by the natural logarithm of gross domestic product. Thus, this study proposes the following general multiple regression:

\[ \text{LnPOV}_{it} = \alpha_0 + B_1 \text{LnIBF}_{it} + B_2 \text{LnLoan}_{it} + B_3 \text{LnCPI}_{it} + B_4 \text{LnG}_{it} + \varepsilon_{it} \] (1)

Where LnPOV is the poverty level, LnIBF is the proxy used to measure Islamic banking financing, LnLoan is conventional banking loan, LnCPI is consumer price index and LnGrowth is the economic growth.

It is necessary to select a suitable model based on the characteristics of the panel data. The specific method is as follows. First, the Chou test is used to decide whether common effect model (CEF) should be used, or fixed effect model (FEM). If p-value is less than 5% (significance level), the fixed effect model should be used. Second, the Hausman test is used to determine whether a random-effects model (REM) should be used or fixed effect model. If the corresponding p-value is far less than the significance level, the fixed-effects model is chosen. Otherwise, a random-effects model should be used.

Results and Discussion

In the following Table, we show the development of Islamic banking assets in five countries that were the object of research.

<table>
<thead>
<tr>
<th>Table 1. Islamic Banking Asset Among Five Countries (USD million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
</tr>
<tr>
<td><img src="graph.png" alt="Graph of Islamic Banking Asset Among Five Countries" /></td>
</tr>
</tbody>
</table>

Source: IFSB (2018)

The value of Islamic banking assets in Iran is still the highest. This condition was even encouraged by the policy of converting the banking system, which was originally conventional to fully Shariah compliance.
Does Islamic Banking Financing Help the Poor?

As explained above, here we are testing what models we will use here. After testing, the fixed effect model (FEM) is eventually selected compared to other models.

| Table 2. Model selection; Chou and Hausman test |
|-----------------|----------------------|
| **Test Type**   | **p-value**          |
| Chou test       | 0.0000***            |
| Hausman test    | 0.0000***            |
| Model Chosen    | Fixed Effect Model   |

***indicates a fixed effect model

The results are based on two tests that have been carried out. First, a Chou test is conducted to determine whether CEM or FEM will be selected, this decision based on the p-value. The P-value of the Chou test is 0.000 (<0.01), meaning that the fixed effect model can be chosen. Second, by carrying out the Hausman test. By looking at the Hausman test p-value, we can determine whether FEM or REM we will use in this study. The Hausman test p-value is 0.0000 (<0.01), which means we are still using FEM.

Since the estimation suggest us to use FEM, that we suppose to include the cross-effect of each country. The cross-effect are as follow:

| Table 3. Cross-Section Fixed Effect |
|-------------------------------|----------|
| CROSSID | Effect |
| Indonesia | 0.961400 |
| Malaysia | -0.839169 |
| Iran | -1.227492 |
| Saudi Arabia | -0.611885 |
| Turkey | 0.592122 |
| Sudan | 1.125024 |

Fixed effect model assumes the existence of intercept differences in each country in this study. These differences indicate the uniqueness of each country. According to Table 3, Sudan has the most powerful effect of Islamic banking financing in reducing poverty, than followed by Indonesia, Turkey, Saudi Arabia and the lowest is Iran. Surprisingly, both Sudan and Iran that have 100% Islamic banking market share have different cross effect value. This result shows that a country with higher market share does give higher effect in reducing poverty.

This study aims to look at the relationship between the Islamic banking financing in reducing poverty. Therefore, the main hypothesis raised in this study is the positive influence of the development of Islamic finance since proxy used to measure poverty is the private consumption expenditure in each country. Thus, expected effect is positive. The increase in consumption is assumed to be in line with the improvement of people's welfare. The existence of the Islamic banking financing is expected to influence in improving economic welfare by increasing people's purchasing power. According to World Bank definition, that poverty is the inability to attain a minimal standard of living measured by people basic consumption.

Below are the results of panel data regression testing:
Table 4. Result of Panel regression Analysis (Fixed Effect Model)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>-7.889</td>
<td>1.244</td>
<td>-6.339</td>
<td>0.000</td>
</tr>
<tr>
<td>LnLoan</td>
<td>0.012</td>
<td>0.015</td>
<td>0.810</td>
<td>0.419</td>
</tr>
<tr>
<td>LnIBF</td>
<td>0.483</td>
<td>0.067</td>
<td>7.174</td>
<td>0.000</td>
</tr>
<tr>
<td>LnG</td>
<td>0.305</td>
<td>0.056</td>
<td>5.379</td>
<td>0.000</td>
</tr>
<tr>
<td>LnCPI</td>
<td>-0.173</td>
<td>0.039</td>
<td>-4.377</td>
<td>0.000</td>
</tr>
</tbody>
</table>

R-squared 0.986  
Adjusted R-squared 0.984  
F-statistic 751.758  
Prob(F-statistic) 0.0000  

In this study, Islamic banking financing is proxied by the Value (or percentage) of Shari’ah-compliant financing by economic activity. While poverty is proxy by private consumption expenditure. Therefore, a positive coefficient does not mean that poverty increases, but decreases. An increase in consumption is assumed that purchasing power is increasing.

The positive effect on the LnPOV variable in the estimation results above explains the contribution in reducing poverty through increasing people’s purchasing power. From table 3, we can see that the p-value of Islamic banking financing (LnIBF) is 0.000 or smaller than alpha 0.05 (5%), with a coefficient of 0.48321. This means that the financing provided by Islamic banking has a statistically positive effect on the level of public consumption. This also means that financing from Islamic banks can statistically increase the level of wealth of the community, or it can be said to have an effect in reducing the level of community poverty.

In order to see the real value of Islamic banking financing in reducing poverty, other control variables are involved, including conventional bank credit (LnLoan) measured by the natural logarithm of Net loans & advances to customers of conventional banking. Therefore, we can see, whether the nominal differences of financing provided both Islamic and conventional banks, will give the same results as the nominal.

Meanwhile, loan given by conventional banks proxied by Net loans & advances to customers, show the opposite. In contrast to the results of sharia banking financing, the estimation result shows no relationship, since the p-value is 0.419 or greater than alpha 0.05 (5%).

Other control variables are economic growth and the consumer price index, each showing a different result. Economic growth (LnG) with a p-value of 0.0009 and a coefficient of 0.235803 means it has a significant influence in reducing poverty. While the consumer price index (LnCPI), has no effect on changes in poverty levels in countries that are the object of research.

Islamic and conventional banking role in reducing poverty

When compared to the research conducted by Setiawan (2017), which found that the effect of Islamic banking was smaller than conventional banks in reducing poverty, the results of this study actually found that credit provided by conventional banking did not have any significant effect on poverty. It means that Islamic banking has better effect in reducing poverty proxied by private consumption expenditure. Indeed, it would be better if poverty was measured by the level of income generated by the community. However, these results at least provide an overview of how conventional bank credit affects the ability to consume of the society.

Islamic banking financing is enable the poor to increase their consumption level by two way. Firstly, by giving them capital to start or expand their business. Secondly, since mudharabah should be channeled to the real sector, than SMEs will get more capital to expand their business and increase their production level, it means more worker will be involved. Thus, the welfare level of poor will increase.

As the study conducted by Mallick (2018), a key component of monetary policy in overcoming the problem of poverty is through the availability of credit allocated to the business
Does Islamic Banking Financing Help the Poor?

sector. Therefore, low credit interest rates will encourage people to invest. This additional capital will then encourage the industry to expand its business, and is expected to absorb more workers.

Conceptually, Islamic banks are designed to encourage capital/wealth transfers from surplus units to deficit units. That way, the financing provided by Islamic banks should be more in the form of working capital/ business investment. It is intended that Islamic banking not only provides financial product facilities that benefit the rich but also encourages the productivity of the poor by providing capital for business.

To encourage the effectiveness of Islamic banking in reducing poverty, the products offered must be adapted to the conditions and economic characteristics of the community. According to Sanadjihitu (2015), poverty alleviation programs should be adjusted to the economic demographic characteristics of the community. The main factor to consider is the sector that absorbs the most labor, the sector that contributes the most to GDP and the greatest economic potential in each country. By knowing the conditions and character, Islamic banking products will be far more effective in reducing poverty levels of the community.

For example, in Indonesia, the sector that absorbs the most labor is the MSME sector. Thus, the government and banks need to focus on providing capital for this sector. However, the given capital should not only be focused on the development of existing MSMEs, but also can stimulate the emergence of new MSMEs. By doing so, greater employment will be created so that the unemployment rate can be further suppressed.

Regarding to this research, the results will certainly be better if the market share of Islamic banking can be greater. IFSB data, in 2017, only two countries have a 100% market share of Islamic banking, namely Iran and Sudan. The two countries have changed their banking system to 100% based on sharia compliance. Saudi Arabia’s Islamic banking market share is 51.5%, Malaysia is 24.9%, while Turkey and Indonesia are only around 5-6%.

However, the large portion of working capital financing must be followed by good liquidity management. If not, banks will face liquidity problems. Therefore, funding must be followed by professional assistance. From the selection of prospective recipients of financing, monitoring of business development, to the completion of the program followed by the desired target, that is established businesses.

Conclusion

This study aims to look at the effect of Islamic banking financing in reducing poverty. The results show that Islamic banking financing affects in reducing poverty levels. Furthermore, this study found that Islamic banks have a greater effect than conventional banks.

Islamic banking has products such as mudarabah that are able to encourage the productivity of the real sector. In addition, Islamic banking is also prohibited from investing in financial markets that are full of speculative elements. Thus, Islamic banking will provide more financing products aimed to the real sector.

References


Does Islamic Banking Financing Help the Poor?

405X(03)00125-9.


